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A legal update from Dechert's Financial Services and Securities Litigation and White Collar Litigation Groups

Federal Court: Bank Had No Duty to Disclose Information Regarding Illegal Conduct

On November 7, 2005, a federal district court in New Jersey dismissed a putative class action for securities fraud filed against Commerce Bancorp, Inc. ("Commerce Bank") and a number of its officers and directors.¹

Although the court concluded that information regarding illegal conduct by a company is "inherently material" for purposes of a securities fraud claim, the court held that Commerce Bank had no duty to disclose this information and its failure to do so did not render any of its public statements false or misleading. Public companies should be aware of the potential issues raised by the court finding such information "inherently material" and the viable defenses to allegations of a failure to disclose.²

Plaintiffs brought the action on behalf of a class of people who purchased stock in Commerce Bank during the period June 1, 2002 through June 28, 2004.³ Plaintiffs alleged that defendants violated §§ 10(b) and 20(a) of the Securities and Exchange Act of 1934 by failing to disclose unlawful conduct on behalf of Commerce Bank during the relevant period. Plaintiffs argued that defendants made false and materially misleading statements by attributing Com-

merce Bank's positive financial results to its "unique business model" and failing to disclose that the company was actively engaging in illegal practices, such as bid-rigging.⁴

Relying heavily on a decision from the United States Court of Appeals for the First Circuit, the court concluded that "[i]nformation about a corporation's illegal conduct is inherently material for purposes of Rule 10b-5."⁵ The court stated that "a reasonable investor would give considerable weight to a corporation's unlawful practices."⁶ The court observed that in addition to the potential consequences a company may suffer if such conduct is discovered, the willingness to engage in such conduct raises questions about management's competence.⁷

Commerce Bank argued that the alleged illegal activity at issue could not be material because it related to only a small percentage of the Bank's total deposits and revenue. The court rejected this argument. Observing that illegal payments, even though relatively small, can "endanger all of a corporation's business if they

¹ *Galati v. Commerce Bancorp, Inc.*, No. 04-3252, 2005 U.S. Dist. LEXIS 26851 (D.N.J. Nov. 7, 2005) (unpublished).

² Although it held that information regarding the corporation's illegal conduct itself is "inherently material," the court concluded that predictions about the possible effects of illegal conduct were "too speculative to be material." *Id.* at *18.

³ On June 28, 2004, the U.S. Attorney for the Eastern District of Pennsylvania indicted three Commerce Bank/Pennsylvania executives and directors for employing illegal practices to obtain lucrative business with the City of Philadelphia.

⁴ *Galati*, 2005 U.S. Dist. LEXIS 26851, at *11.

⁵ *Id.* at *17 (citing *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22 (1st Cir. 1987) (holding that a company's practice of bribery is material information, even if criminal conduct has not yet become the subject of investigation)). Notably, Alpha Industries, Inc. derived nearly all its income from government contracts. Government regulations contain stringent guidelines for disbaring contractors who engage in illegal activity such as bid-rigging. That distinct fact may render that case distinguishable from cases involving other types of businesses not subject to such regulations.

⁶ *Id.*

⁷ *Id.* at *17-18.

are discovered,” the court concluded that “a corporation’s unlawful practices are material, even if the practices relate to only a minor aspect or portion of the business.”⁸

Even though the court considered the information material, it dismissed plaintiffs’ claims. In so doing, the court reaffirmed that Congress did not intend Rule 10b-5 to provide “shareholders with an avenue for relief against executives for alleged illegal practices or corporate mismanagement.”⁹

The court rejected plaintiffs’ argument that failing to reveal criminal conduct is per se misleading. The court noted that corporations do not have a duty to disclose all material information. Instead, they need only disclose information necessary to insure that the corporation’s statements are not rendered false or misleading by the omitted information. The court held that plaintiffs failed to identify any statement made by Commerce Bank which was rendered materially false or misleading by Commerce Bank’s failure to disclose the alleged illegal conduct.¹⁰

⁸ *Id.* at *18.

⁹ *Id.* at *26.

¹⁰ *Id.*

Although the decision is not a binding precedent, corporations should consider the following “take aways” from the opinion:

- Illegal conduct, even if de minimis in financial statement impact, is inherently material. If you discover illegal activity, even if seemingly minor in either scope or financial statement impact, a company must consider carefully whether it should be disclosed.
- The result of illegal conduct, such as the prospect for criminal charges, is too speculative and unreliable to be material and thus need not be disclosed.
- There is no free-standing duty to disclose conduct merely because it is illegal. General statements about a company’s growth, prospects, financial results, and similar disclosures are not necessarily rendered misleading for failure to disclose illegal conduct. Close scrutiny of prior disclosures must be made to determine whether the illegal activity renders a prior statement misleading so as to require correction.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialserviceslit or www.dechert.com/whitecollar.

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