

Recent Discover Lawsuits Provide Compliance Lessons

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In September, a class action lawsuit (*Mannacio v. Discover Financial Services, et al.*, No. 23-cv-06788 (N.D. Ill.)) was filed against Discover Financial Services (“Discover”) alleging Discover and certain current and/or former executives violated the Securities Exchange Act of 1934. Specifically, the class action complaint alleged that the defendants made false and/or misleading statements and/or failed to disclose that: (i) Discover maintained deficient risk management and compliance procedures; (ii) as a result, Discover, among other things, failed to comply with applicable student loan servicing standards, misclassified certain credit card accounts, overcharged customers, and failed to stem its ballooning credit card delinquency rate; and (iii) when these issues became known, they subjected Discover to significant financial exposure, regulatory scrutiny, and reputational harm.

A couple weeks later, a shareholder filed a derivative suit (*Swaziek v. Hochschild, et al.*, No. 23-cv-13890 (N.D. Ill.)) alleging: (i) violations of the Securities Exchange Act of 1934; (ii) breach of fiduciary duty; (iii) unjust enrichment; (iv) abuse of control; (v) gross mismanagement; and (vi) waste of corporate assets. In his complaint on behalf of the company, the shareholder alleged

Discover's Board of Directors (the "Board") misrepresented compliance failings over the course of approximately four and a half years and repurchased more than 58 million shares at a cost of approximately \$6.4 billion from March 2021 through June 2023. According to the shareholder's complaint, Discover overpaid by over \$1 billion for the stock repurchases.

Both complaints alleged that Discover misrepresented its compliance failings on February 20, 2019, when the company filed its Form 10-K with the Securities & Exchange Commission ("SEC") for the fiscal quarter and year ending on December 31, 2018. The complaints cited representations Discover made as to the robust and comprehensive nature of its compliance and risk management program as examples of alleged misrepresentations. The class action complaint alleged Discover provided only boilerplate acknowledgement that a certain amount of risk was inherent in the company's operations. Both complaints also cited subsequent alleged misrepresentations of similar character in 2020, 2021, and 2022.

According to the complaints, on July 20, 2022, Discover issued a press release in which it announced its financial results for the second quarter of 2022. In that press release, Discover also announced that it had launched an investigation into its student loan servicing division related to possible compliance issues and was suspending its share repurchase program. The next day, Discover's share price dropped nearly 9% from the previous day's closing price.

The complaints further allege that, despite disclosing the investigation in July 2022, Discover again touted its robust compliance and risk management program in its February 23, 2023, Form 10-K.

Then, on July 19, 2023, Discover issued another press release announcing its financial results for the second quarter of 2023. In that release, Discover disclosed that it misclassified credit card products over an approximate 15-year period as a result of an acknowledged compliance failure and had received a proposed consent order from the FDIC in connection with an unrelated regulatory matter. The credit card misclassifications allegedly resulted in customers being overcharged. Discover also disclosed it had repurchased approximately 6.8 million shares for \$700 million during the second quarter of 2023.[1] The next day, Discover's share price fell nearly 16%.

On August 14, 2023, Discover issued another press release announcing that CEO, President, and Director Roger Hochschild ("Hochschild") would step down immediately. The company also disclosed that its credit card delinquency rate had increased beyond pre-COVID-19 pandemic levels. Media reports highlighted the increased delinquency rate and speculated that Hochschild's departure was connected to risk management and compliance issues. The next day, Discover's share price fell more than 9%. On an earnings call later that week, Discover's officers admitted the company was "paying the price" for failing to invest adequately in its compliance program. Both lawsuits argue that Discover repurchased shares at inflated levels, based on its failure to disclose the aforementioned issues, and ultimately overpaid by over \$1 billion, at shareholders' expense.

Although both cases remain active and the claims made by the plaintiffs have not yet been proven, they highlight several important considerations for companies, as well as their directors, officers, and executives. First, establishing and maintaining an effective compliance program is paramount. Second, self-serving public statements regarding a company's compliance program are not

sufficient, and in some cases, can expose the company to claims that they are untrue. It is imperative that companies invest in their compliance programs and do not rely on boilerplate assertions that their compliance programs are strong. Third, when companies become aware of potential compliance issues, it is critical that they engage qualified counsel to investigate the issues and advise the company on best practices for disclosure. Fourth, and relatedly, timely and accurate disclosure is essential to protecting the company against claims that share prices were artificially inflated as alleged in the Discover lawsuits.

[1] Although it is not clear from the complaints when Discover resumed its share repurchasing program, it appeared to do so sometime between July 2022 and July 2023.

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