UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK
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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-against-

CKB168 HOLDINGS, LTD., et al.,

Defendants.
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REPORT AND RECOMMENDATION

13-CV-5584 (RRM)

ROANNE L. MANN, UNITED STATES MAGISTRATE JUDGE:

In a Report and Recommendation entered on November 3, 2015, this Court recommended that plaintiff Securities and Exchange Commission (the "SEC") be granted two adverse inference instructions as sanctions against defendants Hung Wai (Howard) Shern ("Shern"), Rui Ling (Florence) Leung ("Leung"), CKB168 Holdings Ltd., WIN168 Biz Solutions Ltd., CKB168 Ltd., CKB168 Biz Solutions Inc., and Cyber Kids Best Education Ltd. (together, the "Foreign Defendants"), based upon their violations of Rule 37 of the Federal Rules of Civil Procedure (the "FRCP"). See Report and Recommendation (Nov. 3, 2015) ("11/3/15 R&R"), Electronic Case Filing ("ECF") Docket Entry ("DE") #295.[1]

After this Court issued its Report and Recommendation, significant changes to Rule 37 went into effect. In light of the rule change, the Court now modifies its recommendation. It recommends that the SEC's Amended Motion for Sanctions Against Defendants Howard Shern

[1] Shern and Leung each filed objections to this Court's recommendations, see Letter with attachments . . . from Howard Shern (docketed Nov. 30, 2015), DE #299; Letter with attachments . . . from Florence Leung (docketed Nov. 30, 2015), DE #300, which have not yet been ruled upon by the District Court. The SEC filed a response to these objections. See Reply in Opposition . . . (Jan. 18, 2015), DE #331.

and Florence Leung (Sept. 8, 2015), DE #276, be denied without prejudice, with the right to renew that motion, in the event the case proceeds to trial, and to attempt to make the requisite showing of intent based on the evidence adduced at trial.

BACKGROUND[2]

In making its previous recommendations, the Court found that the Shern and Leung had acted with "a sufficiently culpable state of mind to support spoliation sanctions," 11/3/15 R&R at 13 -- either (1) because they were grossly negligent in failing to preserve the requested materials, see id., or (2) because the requested materials never existed in the first place, and Shern and Leung had acted in bad faith by refusing to confirm that fact unequivocally, see id. at 15. Under then-applicable case law in this Circuit, simple negligence was a sufficiently culpable state of mind to support Rule 37 sanctions. See, e.g., Residential Funding Corp. v. DeGeorge Fin. Corp., 306 F.3d 99, 113 (2d Cir. 2002) ("[D]iscovery sanctions, including an adverse inference instruction, may be imposed upon a party that has breached a discovery obligation not only through bad faith or gross negligence, but also through ordinary negligence . . . ."). Accordingly, the Court recommended as a sanction that, at trial, the jury be given a pair of permissive adverse inference instructions:

> (1) From the fact that the Foreign Defendants produced no evidence of any actual plans or preparations to take CKB public, the jurors may infer that no such documents ever existed and that the Foreign Defendants had no plan and made no preparations to take CKB public.
>
> (2) To the extent that the jurors find that any unproduced evidence ever existed, they may infer that the unproduced evidence would support the SEC's allegation

[2] The Court assumes familiarity with the prior rulings in this case, and incorporates by reference its previous findings and analyses, except to the extent stated herein.

that the Foreign Defendants had no plan and made no preparations to go public. 11/3/15 R&R at 16.

On December 1, 2015, amendments to the FRCP went into effect. Rule 37(e) now states that:

> If electronically stored information that should have been preserved in the anticipation or conduct of litigation is lost because a party failed to take reasonable steps to preserve it, and it cannot be restored or replaced through additional discovery, the court:
>
> (1) upon finding prejudice to another party from loss of the information, may order measures no greater than necessary to cure the prejudice; or
>
> (2) *only upon finding that the party acted with the intent to deprive another party of the information's use in the litigation may*:
>
> (A) presume that the lost information was unfavorable to the party;
> (B) instruct the jury that it may or must presume the information was unfavorable to the party; or
> (C) dismiss the action or enter a default judgment.

Fed. R. Civ. P. 37(e) (emphasis added). The amended rules govern in "all proceedings in civil cases" commenced after December 1, 2015, and, "insofar as just and practicable, all proceedings then pending." Order of the Supreme Court of the United States (Apr. 29, 2015), http://www.supremecourt.gov/orders/courtorders/frcv15_5h25.pdf. According to the Advisory Committee's notes, the new Rule 37(e)(2) "rejects cases such as Residential Funding . . . that authorize the giving of adverse-inference instructions on a finding of negligence or gross negligence." Fed. R. Civ. P. 37(e)(2) advisory committee's note to 2015 amendment.

In light of the above, the Court directed the SEC and Shern and Leung to file submissions addressing the impact of the recent revision to Rule 37 on this Court's 11/3/15 R&R. See Order To Show Cause (Jan. 15, 2016), DE #330. In particular, the parties were

ordered to show cause why the Court should not modify its recommendation. See id. at 3.

All three parties responded. Shern reiterates his argument that he had taken "reasonable step[s]" to comply with the SEC's requests for electronically stored information ("ESI"). See Letter E-mailed from Howard Shern in Response to 1/15/2016 Order (Jan. 25, 2015), DE #335 at 1. Moreover, he argues that the revised Rule 37(e) does not support a sanction against him:

> [T]he Court may order measures no greater than necessary to cure the prejudice [caused by the loss of ESI]. As there is no finding of me acted with the intent to deprive SEC of the information's use in the litigation, no severe measures listed in [Rule 37(e)(2)](A) to (C) could be afforded!!!
>
> In conclusion, I think the recent change of Rule 37(e) is finally doing me a justice!

Id. at 2.

Leung also argues that the revised Rule 37(e) renders sanctions against her inappropriate. See Exhibit 1 to Letter with Attachments E-mailed from Florence Leung in Response to 1/15/2016 Order (Jan. 25, 2015) ¶ 6, DE #336-1. She insists that, in any event, ESI was Shern's responsibility and was "outside [her] control." Id. ¶ 7.

The SEC argues -- perhaps unsurprisingly -- that an adverse inference instruction against Shern and Leung is still warranted, notwithstanding the change to Rule 37(e). See Notice by Securities and Exchange Commission . . . (Jan. 25, 2016) ("1/25/16 SEC Resp."), DE #337. The SEC correctly notes that Rule 37(e) applies only to "ESI that existed and 'should have been preserved.'" Id. at 2 (quoting Fed. R. Civ. P. 37(e)). If the materials that the SEC requested had never existed in any form, then Rule 37(e) would be inapposite. For this reason, the SEC believes that it would still be appropriate for the District Court to include

in its jury instructions the previously recommended first adverse inference charge: that the jurors "may infer that no such documents ever existed and that the Foreign Defendants had no plan and made no preparations to go public." Id. (quoting 11/3/15 R&R at 16).

Regarding the second recommended inference -- that any unproduced evidence that did exist "would support the SEC's allegation that the Foreign Defendants had no plan and made no preparations to go public[,]" 11/3/15 R&R at 16 -- the SEC argues that "[t]he present record supports the conclusion . . . that [the] Foreign Defendants acted with intent" to deprive the SEC of the materials. 1/25/16 SEC Resp. at 2. "The Court's second recommended adverse inference is therefore appropriate even under the new Rule 37(e)." Id.[3]

DISCUSSION

As this Court's 11/3/15 R&R observed, the adverse inference instruction at issue here arose out of the Foreign Defendants' alleged "spoliation" of relevant evidence, specifically, their corporate "back office data." See 11/3/15 R&R at 11 (citing Motion for Sanctions (Dec. 3, 2014) at 2, DE #201). Spoliation is "the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation." Byrnie v. Town of Cromwell, Bd. of Educ., 243 F.3d 93, 107 (2d Cir. 2001) (quoting West v. Goodyear Tire & Rubber Co., 167 F.3d 776, 779 (2d Cir. 1999)). This presupposes that some evidence or potential evidence existed in the first place: if none

[3] The SEC notes further that, because the materials it requested were never produced, it cannot know -- assuming the materials existed -- whether they existed as ESI, in hard copy, or as a combination of both. See 1/25/16 SEC Resp. at 2 n.1. It is thus unclear the extent to which Rule 37(e) would apply at all.

ever existed, then there can be no sanction for spoliation, though there could be sanctions for other misconduct during the discovery process.[4]

In this case, the Foreign Defendants provided the SEC with a hard drive purportedly containing approximately 32 gigabytes of their back office data. See 11/3/15 R&R at 3.[5] After some initial difficulty, information technology specialists with the Federal Bureau of Investigation were able to successfully recover data on the hard drive. See id. at 5. Nonetheless, the hard drive did not appear to contain certain information that the SEC had requested, including material suggesting whether the Foreign Defendants had taken steps to explore a public offering. Id. at 5-6.

The Court considered two plausible explanations for this lack of information: either some or all of the requested materials had existed at some point, and the Foreign Defendants destroyed or otherwise failed to preserve them ("Scenario 1"); or the requested materials never existed at all ("Scenario 2"). See 11/3/15 R&R at 13. Considering Scenario 1, the Court found that spoliation sanctions would be appropriate because the Foreign Defendants acted, at a minimum, with gross negligence in failing to preserve the requested materials -- a sufficiently

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[4] Shern and Leung have already been sanctioned for their failure to appear at their court-ordered depositions. This Court previously recommended that they be precluded "from offering their testimony, affidavit, or declaration in connection with a dispositive motion or trial[,]" Report and Recommendation (Jan. 7, 2015) at 1, DE #214, a recommendation that Judge Mauskopf adopted in full, see Order Adopting in Part Report and Recommendation (Aug. 12, 2015), DE #262. The only question now before this Court is whether Shern and Leung should additionally be sanctioned for spoliation of the back office data.

[5] The Foreign Defendants declined to explain what they meant by "back office data," stating only that what they produced was a "complete image of all information maintained on the corporate server." Memorandum in Opposition (Dec. 12, 2014) at 1, DE #206.

culpable state of mind to support spoliation sanctions under then-applicable law. See id.

Under Scenario 2, even though the Foreign Defendants acted in bad faith during the discovery process, see 11/3/15 R&R at 14-15, they could not be sanctioned for spoliation because there would have been nothing for them to spoliate.

Faced with this uncertainty as to which of the two Scenarios had occurred, the Court recommended a two-part adverse inference instruction:

> (1) From the fact that the Foreign Defendants produced no evidence of any actual plans or preparations to take CKB public, the jurors may infer that no such documents ever existed and that the Foreign Defendants had no plan and made no preparations to take CKB public.
>
> (2) To the extent that the jurors find that any unproduced evidence ever existed, they may infer that the unproduced evidence would support the SEC's allegation that the Foreign Defendants had no plan and made no preparations to go public.

11/13/15 R&R at 16. The Court reasoned that including the first instruction would allow a jury to consider the possibility -- likely, in this Court's view -- that the requested documents had never existed at all.[6] Id. Nonetheless, because this is ultimately a motion for a spoliation sanction, the first instruction should not be given independently of the second one. A party cannot be sanctioned for spoliation without a finding that some spoliation occurred.

The second instruction should be analyzed under the revised Rule 37(e), inasmuch as it is a sanction for missing information that should -- and, logically, would -- have been stored electronically on the hard drive that the Foreign Defendants turned over to the SEC. The amended rule "was adopted to address concerns that parties were incurring burden and expense

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[6] The first instruction corresponds with Scenario 2, while the second instruction corresponds with Scenario 1. In retrospect, it would have been less confusing had the Court, in writing its 11/3/15 R&R, numbered the two Scenarios to align with its two recommended instructions.

as a result of overpreserving data, which they did because they feared severe spoliation sanctions . . . ." CAT3, LLC v. Black Lineage, Inc., No. 14 Civ. 5511 (AT) (JCF), 2016 WL 154116, at *4 (S.D.N.Y. Jan. 12, 2016) (citing Fed. R. Civ. P. 37(e) advisory committee's note to 2015 amendment). As such, a court may not now impose an adverse jury instruction as a sanction for the spoliation of ESI absent a showing of a loss of ESI "because a party failed to take reasonable steps to preserve it," as well as "intent to deprive another party" of the use of that information. Fed. R. Civ. P. 37(e)(2). A court may not impose a sanction at all without a finding of "prejudice to another party[,]" and even then, the sanction may be "no greater than necessary to cure the prejudice . . . ." Fed. R. Civ. P. 37(e)(1).

The SEC argues that "[t]he present record supports the conclusion" that the Foreign Defendants acted with the intent to deprive the SEC of its requested materials. 1/25/16 SEC Resp. at 2. The Court disagrees, as the existing record is not sufficiently clear to support the factual findings that are a prerequisite under the recent revisions to Rule 37. The Court cannot even conclude, as a threshold matter, that the Foreign Defendants destroyed or failed to preserve these materials at all -- simply put, there is a strong likelihood that the materials never existed. See 11/3/15 R&R at 13. Nonetheless, in the event the case proceeds to trial, the SEC should be permitted to renew its motion for Rule 37 sanctions and to make the requisite showing of intent and loss of ESI based on the evidence adduced at trial.[7]

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[7] The SEC has also not, at this point, shown that it was prejudiced by the alleged loss of the materials. Indeed, the non-production of any documents related to a purported initial public offering ("IPO") strongly suggests that no IPO was planned or contemplated. The Court previously recommended that the jury be instructed on permissive inferences, not that certain facts be deemed established. See 11/3/15 R&R at 16. A forceful closing argument by counsel

(continued…)

CONCLUSION

For the foregoing reasons, the Court modifies its recommendation of November 3, 2015 as follows: The SEC's amended motion for sanctions (DE #276) should be denied without prejudice, with the right to renew that motion, in the event the case proceeds to trial, and to attempt to make the requisite showing of intent and lost ESI based on the evidence adduced at trial.

Any objections to this Report and Recommendation must be filed with the Honorable Roslynn R. Mauskopf by February 19, 2016. Failure to file timely objections may waive the right to appeal the District Court's Order. See 28 U.S.C. § 636(b)(1); Fed. R. Civ. P. 72; Small v. Sec'y of Health & Human Servs., 892 F.2d 15, 16 (2d Cir. 1989).

The Clerk is requested to docket this Order To Show Cause into the ECF system and to email copies to defendants Shern and Leung at the following addresses:

For defendant Shern:

Hshern@hotmail.com

For defendant Leung:

Florence_Leung@hotmail.com

SO ORDERED.

Dated: **Brooklyn, New York**
February 2, 2016

/s/ Roanne L. Mann
ROANNE L. MANN
UNITED STATES MAGISTRATE JUDGE

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[7](…continued)
for the SEC could well persuade the jury to draw such a conclusion, without a jury charge from the Court giving it express permission to do so.