



CORPORATE AND SECURITIES LITIGATION

BY SARAH S. GOLD AND RICHARD L. SPINOGATTI

Guidance Sought on Pleading Corporate Scienter

In a recent decision, U.S. District Judge Harold Baer of the Southern District of New York certified an interlocutory appeal of his prior decision denying a motion to dismiss a §10(b) claim, finding a substantial ground for difference of opinion about the standard for pleading scienter of a corporate entity. *In re Dynex Capital, Inc. Sec. Litig.*, 2006 WL 1517580 (June 2, 2006) (*Dynex II*).

Judge Baer had held that scienter could be adequately alleged with respect to the corporation even where scienter was not adequately pleaded as to any particular employee, but then found existing case law sufficiently murky to warrant certification to the U.S. Court of Appeals for the Second Circuit to clarify the standard.

The 'Dynex' Case

Dynex is a putative class action against Dynex Capital Inc., its subsidiary, Merit Securities Corp., and two corporate officers for violations of §§10(b) of the Securities Exchange Act in connection with the sale of asset-backed bonds. The bonds were collateralized by pools of mobile home installment sales contracts, and the fraud allegations focused on nondisclosures and misrepresentations concerning the source and creditworthiness of the collateral. *In re Dynex Capital, Inc. Sec. Litig.*, 2006 WL 314524, *1 (SDNY Feb. 10, 2006) (*Dynex I*). On defendants' motions to dismiss, Judge Baer found that the allegations of scienter of the individual defendants were insufficient to plead a §10(b) claim, but the allegations of scienter as to the corporate defendants were sufficient. Thus, he allowed the §10(b) claim to proceed against the corporate defendants but dismissed the claim (with leave to



Sarah S. Gold Richard

L. Spinogatti

replead) against the individuals. *Id.* at *8-10, 12.

Discussing the familiar test for pleading §10(b) scienter, Judge Baer observed that facts must be alleged that give rise to a strong inference of fraud, either by alleging facts (a) demonstrating motive and opportunity to commit fraud, i.e., allegations of concrete benefits the defendant could realize by means of the alleged nondisclosures or false statements and the likelihood of achieving those benefits by the means alleged, or (b) constituting strong circumstantial evidence of conscious misbehavior or recklessness, i.e., specific allegations of the defendant's knowledge of facts or access to information contradicting the defendant's public statements. *Id.* at *8. The court found no facts alleged to demonstrate that the individual defendants benefited in some concrete or personal way from the alleged fraud (defeating a "motive and opportunity" pleading); and the general allegations of reckless corporate conduct were conclusory and not linked to the particular individuals, who were not alleged to have seen specific reports or statements indicating malfeasance or contradicting their public statements (defeating a "conscious misbehavior or recklessness" pleading). *Id.* at *8-9.

In contrast, Judge Baer found the pleading adequate with respect to the corporate

defendants. The allegations of a reckless course of conduct by Dynex were that it "systematically" disregarded various indicia of uncreditworthiness and ignored signs that the collateral was defective, it "typically" and "systematically" waived internal underwriting guidelines at regional and corporate levels, and otherwise repeatedly engaged in conduct to obtain high loan volumes without regard to loan quality. *Id.* at *9-10. The corporation allegedly had motive and an opportunity to commit fraud, as it entered the market with the intention of quickly consummating large volumes of loans and bundling them into asset-backed bonds, seeking to make short-term profits at the expense of unsuspecting investors. And the allegation that Dynex "systematically originated defective loans, despite clear signs that the borrowers were not creditworthy" constituted strong circumstantial evidence of recklessness. *Id.* at *10. Thus, although there were insufficient allegations of personal benefits or conduct to ground individual §10(b) liability, there were sufficient allegations of corporate benefits and conduct to warrant proceeding on the §10(b) claim against the corporation.

The corporate defendants moved for reconsideration or to certify an interlocutory appeal. Judge Baer denied reconsideration but granted certification. He explained that in *Dynex I* he held that a plaintiff "may...allege[] scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation." *Dynex II*, 2006 WL 1517580 at *2. The decision, he noted, was supported by *In re WorldCom, Inc. Sec. Litig.*, 352 FSupp2d 472, 497 (SDNY 2005), and three other New York district court cases, but was contrary to *Kinsey v. Cendant Corp.*, 2004 WL 2591946, *13 (SDNY Nov. 16, 2004), and *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F3d 353, 366 (5th Cir. 2004). *Id.*

Judge Baer found that the two pertinent Second Circuit authorities cited by the parties created uncertainty. In *State Teachers Retirement Board v. Fluor Corp.*, 654 F2d 843, 853 (2d Cir.

Sarah S. Gold is a partner and **Richard L. Spinogatti** a senior counsel at Proskauer Rose. **Karen E. Clarke**, an associate at the firm, assisted in the preparation of this article.

1981), the Second Circuit affirmed a grant of summary judgment to the company on a Rule 10b-5 claim because there was no evidence that any of the company's officers acted with scienter—which implies that the Second Circuit would disapprove of a “collective” or “corporate” scienter theory in the context of a §10(b) claim. 2006 WL 1517580 at *3. However, more recently, in *Press v. Chemical Investment Servs. Corp.*, 166 F3d 529, 538 (2d Cir. 1999), the Second Circuit found that the plaintiff had adequately alleged motive and opportunity to defraud by the corporate defendants without reference to the state of mind of any individual employee or agent, holding that to require more “would make virtually impossible a plaintiff's ability to plead scienter in a financial transaction involving a corporation, institution, bank or the like that did not involve specifically greedy comments from an authorized corporate individual.” *Id.* at 538. To resolve the uncertainty, Judge Baer thought it appropriate to certify an interlocutory appeal on “the permissibility of pleading corporate or collective scienter.” 2006 WL 1517580 at *3.

Pleading Versus Proving

The two cited Second Circuit decisions are not necessarily inconsistent, as they concern different procedural stages. *Press* addressed a Rule 12(b)(6) motion to dismiss the complaint—a stage at which the plaintiff is entitled to some leeway in pleading facts that would give rise to an inference of a reckless or fraudulent intent on the part of the corporate defendant. In *Press*, the Second Circuit recognized that ultimately “[t]he scienter needed in connection with securities fraud is intent ‘to deceive, manipulate, or defraud,’ or knowing misconduct,” 166 F3d at 538 (citing *SEC v. First Jersey Sec., Inc.*, 101 F3d 1450, 1467 (2d Cir. 1996)), but it sought to avoid erecting “a nearly impossible pleading standard when the ‘intent’ of a corporation is at issue.” *Id.*

By contrast, the parties in *State Teachers*, had gone through discovery and reached the summary judgment stage. At that point, a plaintiff is obliged to adduce some evidence of scienter on the part of some corporate agent(s) to proceed to trial on the §10(b) claim against the corporation. In *State Teachers*, the plaintiff had evidently adduced “no evidence on the record before us that Russler or any other Fluor officer acted with scienter,” as would be necessary to establish corporate liability at trial for the nondisclosure at issue. 654 F.2d at 853. Judge Baer's decision can be reconciled with both Second Circuit decisions, as it addressed only the initial pleading standard for scienter.

Nonetheless, there is ambiguity lurking down the road in *Dynex* or any other case in which a plaintiff might seek to establish

corporate scienter on the basis of the collective knowledge and acts of a number of corporate agents rather than the knowledge and acts of specific individuals. This potential conflict was addressed in *In re WorldCom*, which concerned Arthur Andersen's alleged recklessness and rejected Andersen's summary judgment motion on the scienter issue. Relying on a U.S. Court of Appeals for the First Circuit case concerning criminal liability under the Currency Transaction Reporting Act, *U.S. v. Bank of New England*, 821 F.2d 844 (1st Cir. 1987), the *WorldCom* court (Judge Denise Cote) held that, at trial, plaintiffs need not prove that any one individual employee of a corporate defendant

In a case concerning a limited transaction that involves only two relevant corporate agents, it may be clear, even at the pleading stage, that if there is no adequate pleading of scienter for the two individuals to permit a §10(b) claim, then the case also should not proceed against the corporation.

acted with scienter, but rather, proof of a corporation's collective knowledge and intent would be sufficient. “Plaintiff is entitled to show reckless misconduct through a cumulative pattern of decisions and inaction by several Andersen auditors.” 352 FSupp at 497, 499-500.

Section 10(b) cases in other circuits have rejected the collective scienter theory. The U.S. Court of Appeals for the Ninth Circuit did so in *Nordstrom, Inc. v. Chubb & Son, Inc. Sec. Litig.*, 54 F3d 1424, 1435 (9th Cir. 1995) (“there is no case law supporting an independent ‘collective scienter’ theory”). The U.S. Court of Appeals for the Fifth Circuit has rejected it even at the pleading stage. *Southland Sec. Corp. v. Inspire Insurance Solutions Inc.*, 365 F3d 353, 366 (5th Cir. 2004) (“for purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement..., rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment”). And the U.S. Court of Appeals for the Third Circuit has implicitly rejected it in affirming summary judgment dismissing a corporate defendant on the ground that the corporation could not have primary §10(b) liability because there was insufficient evidence of scienter in the

individual defendants. *In re Tyson Foods, Inc. Sec. Litig.*, 2004 WL 1396269, *12 (D. Del. June 17, 2004), *aff'd*, 155 Fed. Appx. 53 (3d Cir. 2004).

The concern motivating courts' rejection of the collective scienter theory is to prevent imputing fraudulent intent to a corporation based upon disconnected knowledge and conduct, i.e., situations such as where “one corporate officer makes a false statement that another knows to be false.” *Kinsey v. Cendant Corp.*, 2004 WL 2591946, *13 (SDNY Nov. 16, 2004) (quoting *In re Apple Computer, Inc. Sec. Litig.*, 243 FSupp2d 1012, 1023 (N.D. Cal. 2002)).

This concern is well-founded in the context of ultimately establishing liability. As a general matter, a corporate entity will not be found to have fraudulent intent unless knowledge and conduct are combined in at least one corporate agent. However, at least at the pleading stage, when a plaintiff is complaining of a widespread course of conduct, he should not be obliged to identify the specific knowledge or mental state of specific corporate agents (of which there might be dozens). The larger the institution, and the more widespread the alleged course of conduct (as in *Dynex*), the more reasonable it is to infer, at the pleading stage, that one or more agents of the corporation must have had the reckless or conscious purpose state of mind.

Conclusion

It is likely there can be no single bright-line rule for pleading and proving corporate scienter in all cases. In a case concerning a limited transaction that involves only two relevant corporate agents, it may be clear, even at the pleading stage, that if there is no adequate pleading of scienter for the two individuals to permit a §10(b) claim, then the case also should not proceed against the corporation.

In contrast, in a case where the allegations concern a widespread course of conduct involving numerous corporate agents linked to a credible corporate motive, as *Dynex* appears to be, it is reasonable to infer at the pleading stage that one or more corporate agents must have possessed the requisite scienter. Discovery will either support that inference or not, and the plaintiff generally will be required to proffer evidence of knowledge and conduct residing together in at least one individual at the summary judgment or trial stage to establish corporate liability.

This article is reprinted with permission from the August 9, 2006 edition of the NEW YORK LAW JOURNAL. © 2006 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact ALM Reprint Department at 800-888-8300 x6111 or visit www.almreprints.com. #070-07-06-0028