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Corporate Scienter Requires Link Between Employees with Knowledge and the Alleged Misstatements

Corporate Defense and Disputes Blog on **May 28, 2020**

The Court of Appeals for the Second Circuit held yesterday that a securities-fraud plaintiff cannot establish corporate scienter without pleading facts showing that employees who allegedly knew of underlying corporate misconduct had some connection to the corporation's purportedly false or misleading public statements. The decision in *Jackson v. Abernathy* should prevent securities plaintiffs from establishing "collective" or corporate scienter in the absence of factual allegations showing a corporate speaker's awareness of the underlying alleged misconduct even if other employees not involved with the corporation's disclosures purportedly had such knowledge.

Factual Background

The *Jackson* case involved two companies that made surgical gowns. The plaintiff alleged that the corporate defendants had misled shareholders about the gowns' quality and infection-prevention capabilities, and he cited statements from three employees who had testified in another case that the gowns' compliance problems were "well known" at the companies.

The District Court dismissed the case and denied the plaintiff's request to replead, holding that the plaintiff had not pled facts showing what the CEO allegedly had been told about the purported problems with the gowns. The Second Circuit unanimously affirmed in a published *per curiam* opinion.

Second Circuit's Decision

The Second Circuit began by reiterating its now-familiar standard for corporate scienter: a plaintiff must plead "facts that give rise to a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter." This person can be the speaker himself or herself. The person also can be some other "officer[] or director[] who [was] involved in the dissemination of the fraud, . . . even if [that person] [was] not the actual speaker." But where the person whose scienter at issue is not the speaker and was not involved with or connected to the dissemination of the alleged misstatements, that person's supposed knowledge cannot be attributed to the corporation for securities-law purposes.

In the *Jackson* case, the only relevant person who allegedly had received the lower-level, nonspeaking employees' warnings about the gowns was the CEO, whose scienter usually can bind a corporation. But the District Court had held that the plaintiff had not pled a strong inference that the CEO had acted with scienter, and the plaintiff had not appealed that ruling. The plaintiff therefore was forced to rely only on the alleged scienter of the lower-level employees, who were not connected with the purported misstatements.

As the Second Circuit explained, the plaintiff's proposed amended complaint "sets forth allegations that three employees knew of problems with the MicroCool gown, but it provides no connective tissue between those employees and the alleged misstatements." In the absence of factual allegations as to "what role those employees played in crafting or reviewing the challenged statements," the plaintiff failed to plead a strong inference of corporate scienter.

Implications

The *Jackson* decision should help defendants oppose securities-fraud complaints that attempt to plead corporate scienter based on the knowledge of lower-level corporate employees who purportedly knew of alleged misconduct but did not make, review, or disseminate the alleged misstatements or omissions that form the basis of the securities-fraud claim. The decision appropriately places the focus on the violation at issue in securities-fraud cases: the alleged misstatements or omissions. Knowledge of underlying misconduct that purportedly makes those statements false or misleading should not bind the corporation for securities-law purposes where the persons with that knowledge had no connection to the alleged misstatements or omissions.

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