

The following article appeared in *New York Law Journal*

February 8, 2008

The Officer and the Janitor: “Collective Scierter” in Securities Fraud Cases

By Jonathan W. Miller and Lyle Roberts

Jonathan W. Miller and Lyle Roberts are partners at Dewey & LeBoeuf LLP, Mr. Miller in its N.Y. office and Mr. Roberts in its Washington DC office. Mr. Roberts co-authored an amicus brief in the Dynex case.

If a corporate officer makes a statement to investors and only the janitor knows the statement is false, can the corporation be liable for securities fraud? The answer has long been “no.” Courts have generally agreed that a corporate defendant can only have acted with scienter (or fraudulent intent) if the corporate agent who made the alleged false statement acted with scienter.¹ In other words, courts have declined to personify a corporation by finding it could have an independent mental state sufficient to support a securities fraud claim. In a handful of recent decisions, however, this basic protection for corporate defendants has been eroded by the application of a “collective scienter” theory of corporate intent that allows corporate liability to attach on the basis of the collective knowledge of the corporation’s employees, regardless of whether those employees had any role in making the alleged false statements.

Those courts that have chosen to distinguish between a corporate defendant’s scienter and that of its speaking employees have applied two equally untenable versions of this theory. Under the “broad version” of collective scienter, applied in *In re Dynex Capital Sec. Litig.*, No. 05 Civ. 1897, 2006 WL 314524 (S.D.N.Y. Feb. 10, 2006) (argued before the Second Circuit on Jan. 30, 2008), the scienter of the corporation can be inferred from general allegations concerning the entity’s “knowledge.” Under the “narrow version,” illustrated by the Seventh Circuit’s recent decision in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, _ F.3d _, 2008 WL 151180 (7th Cir. Jan. 17, 2008) (on remand from the Supreme Court) (“*Tellabs II*”), a corporate defendant’s scienter is sufficiently pled based on allegations that an officer knew or should have known the statement was false – even if that officer is not a defendant and the false statement was made by another individual who lacked knowledge of its falsity.

The facts of these two cases help illustrate the problems of collective scienter. In *Dynex*, the lower court found that the plaintiffs had failed to adequately plead that any of the individual officer defendants acted with a strong inference of scienter in making the

¹ See, e.g., *In re Apple Computer Inc.*, 127 Fed. Appx. 296, 304-305 (9th Cir. 2005); *In re Tyson Foods, Inc. Sec. Litig.*, 155 Fed. Appx. 53, 56 (3d Cir. 2005); *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004).

Americas

Europe

Russia/CIS

Asia Pacific

Africa

Middle East

www.dl.com

alleged false statements. Nevertheless, based on allegations that Dynex “typically” and “systematically” waived its internal underwriting guidelines at the regional and corporate levels, its “underwriters” approved loans despite an imminent likelihood of default, and its “salespeople” purchased loan paper that failed credit standards, the lower court concluded that the case could proceed against the company.² None of the plaintiffs’ allegations, however, identified any particular employee who had both knowledge of the problems and participated in the making of an alleged false statement.

In *Tellabs II*, the Seventh Circuit appeared to reach for and address a collective scienter issue that did not actually exist. The case was on remand from the U.S. Supreme Court’s decision clarifying the overall pleading standard for scienter, in which the Court had directed the Seventh Circuit to dismiss the complaint unless “a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”³ Although the original Seventh Circuit decision had concluded that Tellabs’ scienter was adequately pled based on the existence of a strong inference of scienter as to Tellabs’ CEO, who made the alleged false statements,⁴ on remand the court decided to reverse the normal order of analysis and first consider the corporation’s scienter. The Seventh Circuit held that Tellabs’ scienter could be examined without reference to any individual officer defendant and that it was unnecessary to “name the individuals who concocted and disseminated the fraud.”⁵ The “critical question,” as laid out by the Seventh Circuit, was “how likely it is that the allegedly false statements we quoted earlier in this opinion were the result of merely careless mistakes at the management level based on false information fed it from below, rather than of an intent to deceive or a reckless indifference to whether the statements were misleading.”⁶ In this instance, the court found it “exceedingly unlikely” that the alleged false statements resulted from mere carelessness because they were about “important products” and involved a “huge number of returns.”⁷ In other words, the court found that someone in Tellabs’ management “must have known” about the alleged misstatements, which was sufficient to adequately plead scienter against the corporation.

As a matter of public policy, courts have recognized that securities class action litigation is particularly susceptible to abuse by plaintiffs and their counsel. Indeed, in its recent decision in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, S. Ct. , 2008 WL 123801 at *9 (Jan. 15, 2008), the Supreme Court reaffirmed its continuing concern that “extensive discovery and the potential for uncertainty and disruption in a [securities fraud] lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.” It was in response to such concerns that Congress enacted the Private

² *Dynex*, 2006 WL 314524 at *9.

³ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007).

⁴ *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 603 (7th Cir. 2007).

⁵ *Tellabs II*, 2008 WL 151180 at *6.

⁶ *Tellabs II*, 2008 WL 151180 at *5.

⁷ *Tellabs II*, 2008 WL 151180 at *5-6.

Securities Litigation Reform Act of 1995 (“Reform Act”) for the express purpose of creating heightened pleading standards for securities fraud cases that would limit the ability of plaintiffs to bring meritless claims. The key provision of the Reform Act requires plaintiffs to adequately plead a “strong inference” of scienter as to *each* defendant before a case will be allowed to proceed.⁸

The collective scienter theory, however, undermines the very protections afforded corporations by both the U.S. Supreme Court, in its recent series of securities litigation decisions, and Congress, with the passage of the Reform Act. Under either version of collective scienter, a plaintiff can plead a strong inference of scienter as to a corporate defendant without identifying a single individual defendant (*e.g.*, the corporation’s CEO or CFO) who acted with the requisite knowledge or recklessness in making the alleged misstatement. The broad version of the theory, by completely disconnecting the act from the requisite state of mind, would allow a plaintiff to proceed against a corporation even if the officer who actually made the alleged misstatement did so *innocently*.

The narrow version of the theory has the virtue of actually examining the state of mind of a corporate officer (even if unnamed), but in practice that is hardly an improvement. As to individual defendants, courts have consistently held that the “strong inference” pleading standard created by the Reform Act cannot be satisfied based on allegations that the defendant “must have known” of the misstatements based on (a) title or position; (b) another officer’s state of mind; or (c) the knowledge of low-level employees who did not communicate their knowledge to the defendant.⁹ As illustrated by the *Tellabs II* decision, however, collective scienter allows plaintiffs to effectively use any or all of these pleading strategies against a corporate defendant. Nothing in the Reform Act suggests that Congress ever intended to create a lower pleading standard for corporate defendants (as opposed to individual defendants) and the use of collective scienter seems contrary to Congress’ desire to curtail the filing of meritless suits.

Moreover, the collective scienter theory has serious public policy ramifications. If a corporation can be charged with securities fraud based on the knowledge of any of its employees or agents, the natural corollary is that an officer about to make a public statement should survey all other employees and agents regarding the subject matter of his or her remarks before speaking. Corporate communications to investors would slow to a crawl. Even if the focus were only on “management,” there is nonetheless a significant line-drawing problem. In most publicly-traded companies there are a large number of corporate officers – is it reasonable to charge the corporation with the knowledge of every division head, vice-president, or associate general counsel in the absence of any averments as to whether, *when* and how the relevant knowledge was

⁸ 15 U.S.C. § 78u-4(b)(2).

⁹ See, *e.g.*, *In re NTL, Inc. Sec. Litig.*, 347 F. Supp. 2d 15, 33 (S.D.N.Y. 2004) (title or position); *In re Cross Media Mktg. Corp. Sec. Litig.*, 314 F. Supp. 2d 256, 263 (S.D.N.Y. 2004) (another officer); *Cal. Pub. Employees’ Ret. Sys. v. The Chubb Corp.*, 394 F.3d 126, 150-55 (3d Cir. 2004) (low-level employees).

conveyed to the corporate officers who actually made the alleged false statements? The prospect of endless litigation over whether a non-speaking officer who is alleged to have known the falsity of the statement is sufficiently senior to justify the theory's application seems likely.

It is important to note that the rejection of the collective scienter theory is unlikely to have a significant effect on the ability of plaintiffs to bring securities class actions. Under the prevailing majority rule, plaintiffs have successfully brought many securities class actions against corporate defendants by alleging a strong inference of scienter as to a corporate officer who made an alleged false statement. Indeed, the Seventh Circuit's decision in *Tellabs II* would have been completely unaffected if it had decided (as it had done previously) to examine the scienter of Tellabs' CEO, who made the alleged misstatements, and impute his mental state to the corporation. In cases where a plaintiff is unable to adequately plead scienter as to any individual officer defendant who made an alleged false statement, however, courts should not be in the business of bailing out the plaintiff, and frustrating Congressional intent, by imposing a lower pleading standard as to the corporation.

As note above, the Second Circuit heard oral argument in *Dynex* on January 30, 2008 – a well-reasoned decision from the court rejecting the collective scienter theory would go a long way to stemming the tide of this unwelcome judicial innovation.