



## SECOND CIRCUIT REVIEW

BY MARTIN FLUMENBAUM AND BRAD S. KARP

### *The Pleading Standard for Corporate Scierter*

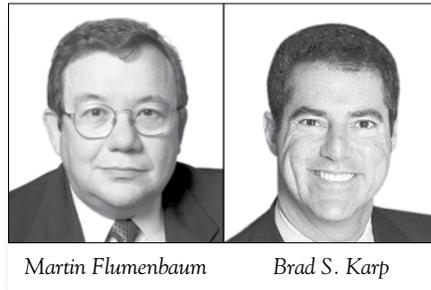
In this month's column, we discuss *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*,<sup>1</sup> in which the U.S. Court of Appeals for the Second Circuit clarified the requirements for pleading "corporate scierter" in connection with claims for securities fraud under the Public Securities Litigation Reform Act (PSLRA).<sup>2</sup>

In its decision, written by Judge John Walker Jr., and joined by Judges Guido Calabresi and Rosemary Pooler, the court held that to plead corporate scierter adequately, the identification of a specific individual defendant is not necessarily required. While a plaintiff must allege that at least one corporate agent had the requisite intent, the court concluded that "it is possible to raise the required inference [of scierter] with regard to a corporate defendant without doing so with regard to a specific individual defendant."<sup>3</sup>

That possibility notwithstanding, in this case, the Court found that plaintiff had failed to allege the "strong inference" of scierter that the PSLRA requires.<sup>4</sup> It vacated the district court's denial of defendants' motion to dismiss for failure to plead scierter. The case was remanded to the district court with instructions to dismiss plaintiff's complaint as to defendants Dynex Capital Inc. and Merit Securities Corp., with leave for plaintiff to amend and replead.<sup>5</sup>

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#### **Background and Procedural History**

Plaintiff Teamsters Local 445 Freight Division Pension Fund filed a securities fraud class action in the U.S. District Court for the Southern District of New York against Dynex Capital Inc. and Merit Securities Corp. as corporate defendants (collectively, corporate defendants) and Stephen Beneditti and Thomas Potts as individual defendants, alleging violations of §§10(b) and 20(a) of the Securities Exchange Act of 1934.<sup>6</sup>

Dynex is a Virginia-based financial services company and Merit is one of its subsidiaries. From 1996 to 1999, Merit made thousands of loans to people seeking to buy manufactured homes. Merit then pooled these loans and issued two sets of asset-backed securities secured by the loans: Series 12 and 13 Bonds.<sup>7</sup>

Plaintiff alleged that its fund purchased approximately \$450,000 of Dynex's Series 13 Bonds. The complaint alleged that because Dynex was a late entrant to the financial market for manufactured homes, Dynex was required to purchase loans from risky borrowers. To accomplish this task, plaintiff alleged that Dynex "overtly told dealers that they were willing to buy bad paper (i.e., very risk loans)" without disclosing such a practice in the offering materials that accompanied the bond issuances.<sup>8</sup> Further, plaintiff alleged

that defendants "misrepresented the cause of the bond collateral's poor performance; misrepresented the reasons for restating its loan loss reserves; and concealed the loans' faulty underwriting."<sup>9</sup>

Defendants moved to dismiss the complaint, claiming that plaintiff failed to plead scierter adequately. District Judge Harold Baer Jr. of the Southern District of New York held that the plaintiff failed to plead scierter adequately with respect to the individual defendants—Beneditti and Potts—because although "plaintiff aptly described a pattern of reckless corporate behavior, plaintiff...failed to link that behavior to any culpable individuals," and granted Beneditti's and Potts' motion to dismiss.<sup>10</sup> The district court also held that plaintiff had adequately pleaded scierter as to the corporate defendants. "A plaintiff may, and in this case has, alleged scierter on the part of a corporate defendant without pleading scierter against any particular employees of the corporation."<sup>11</sup> Since plaintiff's allegations constituted "strong circumstantial evidence of...recklessness," the district court denied corporate defendants' motion to dismiss for failure to plead scierter adequately.<sup>12</sup>

The district court denied defendants' motion for reconsideration, but certified the partial denial of the motion to dismiss for interlocutory appeal. On appeal, defendants argued that the district court erred when it found plaintiff had adequately pleaded scierter against the corporate defendants even though plaintiff had failed to plead scierter as to any specifically named individual defendant.<sup>13</sup>

#### **The Second Circuit Decision**

The Second Circuit held that, under certain circumstances, a plaintiff may successfully plead scierter against a corporate defendant without pleading scierter against an individual

defendant. Significantly, however, the court's opinion also clarified that a plaintiff must allege that at least one corporate agent had the requisite scienter under the PSLRA.

In evaluating the corporate defendants' motion to dismiss, the court initially addressed the pleading standard required for scienter under §21D(b)(2) of the PSLRA. The PSLRA imposes a "more stringent rule for inferences involving scienter," namely, that the plaintiff's complaint must state with particularity facts giving rise to a strong inference of scienter.<sup>14</sup> The court observed that the Supreme Court's recent ruling in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, clarified the meaning of "strong," and provided a definition of scienter.<sup>15</sup> "To qualify as 'strong' within the intendment of §21D(b)(2)...scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."<sup>16</sup> Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud."<sup>17</sup> In addition to the standard of actual intent identified in *Tellabs*, the *Teamsters* court observed that the Second Circuit, in *Novak v. Kasaks*, concluded that recklessness satisfies the scienter requirement in a securities fraud action.<sup>18</sup>

After reviewing the relevant standard, the court addressed the corporate defendants' contention that the district court, as a matter of law, erred by not dismissing the complaint against them. The corporate defendants argued that a plaintiff cannot adequately plead scienter against a corporate defendant unless the plaintiff also has adequately pleaded scienter against particular employees of the corporation. The corporate defendants' argument rested on the belief that allowing a plaintiff to plead scienter against a corporation without doing so against particular employees amounts to acceptance of a "collective scienter" doctrine. A collective scienter doctrine, the corporate defendants argued, is contrary to the principle of corporate liability "that a corporate entity can act with an intent that is not derivative of the intent of one of its employees."<sup>19</sup>

The court did not fully accept the corporate defendants' argument, explaining that it confuses pleading rules and liability rules.<sup>20</sup> To survive a motion to dismiss under the PSLRA, a plaintiff needs only to plead facts against a corporate defendant that "create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter."<sup>21</sup> In some circumstances, the court observed, it is possible to infer a strong

inference of corporate scienter without naming a specific individual because the fraudulent act of the corporation would necessitate sufficient knowledge of the fraud by a corporate official.

The court reasoned that it is possible to satisfy the pleading standard for a corporate defendant without pleading the required strong inference as to a specific individual defendant.<sup>22</sup> But the court's analysis did embrace the argument that the doctrine of collective scienter should be rejected. Although a plaintiff does not always need to allege the strong inference of scienter to a named individual, a plaintiff must plead facts that create a strong inference that "someone's" intent could be imputed to the corporation.

Although the court's holding allows for the possibility that a plaintiff may plead corporate scienter without successfully pleading scienter against a named individual, in this case the court rejected all three of the plaintiff's arguments that its pleading satisfied scienter:

- First, plaintiff argued that the corporate defendants had access to information that was contrary to their public statements.
- Second, plaintiff argued the corporate defendants did not satisfy their duty to monitor the corporations by reviewing and checking information that would have revealed the falsity of the alleged misstatements.
- Finally, plaintiff argued that the corporate defendants had the requisite motive and opportunity to commit fraud because unspecified employees—and thus by imputation the corporation—personally benefited in a concrete way from the alleged fraud.

The court found these allegations to be insufficient, because they did not allege the existence of information showing that the relevant statements made were false or that the corporate defendants had a compelling motive to mislead.<sup>23</sup> The court held that the PSLRA requires the dismissal of a complaint when the allegations in the complaint do not give rise to an inference that "is at least as compelling as the competing inference, i.e., that the statements either were not misleading or were the result of merely careless mistakes at the management level based on false information fed it from below."<sup>24</sup>

## Conclusion

The Second Circuit in *Teamsters* made clear that, under certain circumstances, it is possible to survive a motion to dismiss by pleading facts that raise the required strong inference

of scienter to a corporate defendant without identifying a specifically named individual defendant. Significantly, however, the court also held that the plaintiff must plead facts creating a strong inference that someone whose intent can be imputed to the corporate defendant has the requisite scienter.



1. Docket No. 06-2902-cv, 2008 WL 2521676 (2d Cir. June 26, 2008).

2. 15 U.S.C. §78u-4(b)(2).

3. *Id.* at \*4.

4. *Id.* at \*6; see 15 U.S.C. §78u-4(b)(2).

5. *Teamsters Local 445*, 2008 WL 2521676 at \*6.

6. *Id.* at \*2.

7. *Id.* at \*1.

8. *Id.* at \*2 (citation and internal punctuation omitted).

9. *Id.* (citation omitted).

10. *In re Dynex Capital Inc. Sec. Litig.*, No. 05 Civ. 1897(HB), 2006 WL 314524 at \*9 (S.D.N.Y. Feb. 10, 2006).

11. *Id.*

12. *Id.* at \*10 (quoting *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000)). Under *Novak*, the strong inference requirement is satisfied when the complaint sufficiently alleges "defendants:

(1) benefited in a concrete and personal way from the purported fraud;

(2) engaged in deliberately illegal behavior;

(3) knew facts or had access to information suggesting that their public statements were not accurate; or

(4) failed to check information they had a duty to monitor." *Teamsters Local 445*, 2008 WL 2521676 at \*3 (citing *Novak*, 216 F.3d at 311 (internal citations omitted)).

13. *Teamsters Local 445*, 2008 WL 2521676 at \*1.

14. *Id.* at \*3. Generally, in a civil action the Federal Rules of Civil Procedure only require a short and plain statement showing the plaintiff is entitled to relief. However, under the PSLRA, the sufficiency of a securities fraud complaint is subject to the heightened pleading standards of Rule 9(b). See *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2507 (2007).

15. *Id.* (citing *Tellabs*, 127 S. Ct. at 2504-05, 2507).

16. *Tellabs*, 127 S. Ct. at 2504-05.

17. *Teamsters Local 445*, 2008 WL 2521676 at \*3 (citing *Tellabs*, 127 S. Ct. at 2507).

18. *Id.* (citing *Novak*, 216 F.3d at 308-09).

19. *Id.*

20. The *Teamsters* court explained that the liability rules against a corporation require a plaintiff to prove "an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation." *Id.* at \*4.

21. *Id.*

22. See *id.*

23. *Teamsters Local 445*, 2008 WL 2521676 at \*\*5-6.

24. *Id.* at \*6 (citations and internal quotations omitted).