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Second Circuit Significantly Increases the Burden of Pleading Corporate Scier

Last week, the Second Circuit issued a ruling that significantly heightens the already heavy burden plaintiffs face in pleading corporate scier. The Second Circuit affirmed dismissal of a putative securities class action against Kimberly-Clark Corporation and Avanos Medical, Inc. based on alleged misrepresentations by those companies' senior executives. The decision upheld the district court's ruling that plaintiff's proposed amended complaint failed to raise a strong inference of corporate scier. The Second Circuit ruled that a plaintiff cannot establish corporate scier merely by relying on the statements of employees who never communicated their knowledge to specific senior executives who (i) made the challenged statements, or (ii) whose knowledge could fairly be imputed to the corporation. The Second Circuit also found that, although the challenged statements allegedly concerned the companies' "key product," this was not an "exceedingly rare instance" in which the information was "so dramatic that collective corporate scier may be inferred." The decision will be particularly useful to companies and executives defending a securities fraud complaint with allegations attributed to low- or mid-level "former employees" or "confidential witnesses."

Background

Kimberly-Clark, a multinational personal care corporation headquartered in Texas, and Avanos, a medical technology company headquartered in Georgia, manufacture the "MicroCool Breathable High Performance Surgical Gown"—personal protective apparel typically worn by medical professionals to prevent exposure to highly infectious diseases.¹ In June 2016, plaintiff filed a putative class action in the Southern District of New York against these companies (the "Corporate Defendants"), and several of their officers. According to the complaint, defendants knew that their surgical gown had failed various quality-control tests, but continued to misrepresent to shareholders that the gown met industry safety standards.

In March 2018, the district court found that plaintiff had failed to plead a strong inference of scier as to any defendant and dismissed the case. Plaintiff then moved to set aside the judgment and to file an amended complaint, quoting testimony from three high-ranking employees of the Corporate Defendants during a trial of claims for consumer fraud concerning the same surgical gown. The employees had testified that they had "prepared documents for senior Kimberly-Clark executives that detailed manufacturing problems and

¹ *Jackson v. Abernathy, et al.*, No. 19-cv-1300, slip op. at 4 (2d Cir. May 27, 2020).

resulting product compliance failures,” and that those documents had been “presented to senior management.”²

Despite these new allegations, the district court ruled that the amended complaint still did not adequately allege scienter against any defendant and therefore denied plaintiff’s motion. Plaintiff appealed this decision only as to the Corporate Defendants; according to plaintiff, the amended complaint adequately alleged that the corporations acted with fraudulent intent.

The Jackson Decision

The Second Circuit unanimously affirmed the district court’s order, finding that the amended complaint did not adequately allege scienter against the Corporate Defendants. The Court explained that, “[w]here a defendant is a corporation, this requires pleading facts that give rise to a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter.”³

First, the Second Circuit found that the testimony from the consumer fraud trial was insufficient to demonstrate that any individual whose knowledge could be imputed to the Corporate Defendants had acted with scienter. Although the testifying employees stated that they had prepared documents detailing compliance failures and presented those documents “to senior executives,” the Court found that this testimony was not “sufficiently particularized to raise a strong inference of scienter against any individual, much less one whose knowledge may be imputed to the Corporate Defendants.”⁴ The Court explained that there was “no connective tissue between” the testifying employees’ knowledge and the Corporate Defendants’ alleged misstatements.⁵

Second, according to plaintiff, the surgical gown “was of such core importance” to the Corporate Defendants that their senior executives must have known of the alleged falsity of the representations at issue.⁶ The Second Circuit rejected that argument. Plaintiff’s “naked assertion” that the gown was a “key product” was “plainly insufficient” to raise a strong inference of corporate scienter.⁷ And the Corporate Defendants’ statements concerning the surgical gown’s compliance with industry safety standards were not sufficiently “dramatic” to make this an “exceedingly rare instance” in which collective corporate scienter could be

² *Id.* at 6.

³ *Id.* at 9.

⁴ *Id.* at 11.

⁵ *Id.* at 12.

⁶ *Id.*

⁷ *Id.*

inferred.⁸ The decision left open the question of what type of statement might meet such an exacting standard.

Implications of the *Jackson* Decision

The Second Circuit's decision heightens the already heavy burden plaintiffs face in pleading corporate scienter in a securities fraud lawsuit. The decision establishes a two-step framework for plaintiffs seeking to impute an individual employee's knowledge to a corporate entity. First, plaintiffs must plead particular facts demonstrating that an employee's knowledge was shared with, or communicated to, a specific senior executive. Second, plaintiffs must plead a strong, non-speculative connection between that shared knowledge and the alleged misstatements that would make it fair to impute the senior executive's knowledge to the corporation.

This standard will provide a strong defense to companies that face securities fraud complaints replete with allegations attributed to "former employees" or "confidential witnesses," who are often low- or mid-level employees far removed from the senior officers who prepare and sign corporate disclosures that contain the allegedly misleading statements. And, although the decision specifically concerns corporate scienter, the requirement that plaintiffs allege particular facts showing that negative information was shared with a specific senior executive should similarly help shield corporate officers who are accused of making misleading statements themselves. Officers and directors may also be able to use the Second Circuit's reasoning to argue that a complaint fails to adequately allege the "culpable participation" prong of a Section 20(a) control person claim where the allegations are similarly premised on knowledge of low- or mid-level employees that was never communicated to the officer or director.

The Second Circuit also expressed deep skepticism that senior corporate officers should be expected (or presumed) to know major developments affecting a company's core business—the so-called "core operations theory." While the Court recognized there may be an "exceedingly rare case" in which a challenged statement is "so dramatic" that scienter can be inferred on such a theory, a simple allegation that the alleged fraud concerned a company's "key product" is insufficient. Securities fraud defendants now have additional ammunition to attack this often-pleaded theory at the motion to dismiss stage.

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⁸ *Id.* at 10.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel

+1-212-373-3553

sbuergel@paulweiss.com

Andrew J. Ehrlich

+1-212-373-3166

aehrlich@paulweiss.com

Brad S. Karp

+1-212-373-3316

bkarp@paulweiss.com

Daniel J. Kramer

+1-212-373-3020

dkramer@paulweiss.com

Jane B. O'Brien

+1-202-223-7327

jobrien@paulweiss.com

Walter Rieman

+1-212-373-3260

wrieman@paulweiss.com

Richard A. Rosen

+1-212-373-3305

rrosen@paulweiss.com

Audra J. Soloway

+1-212-373-3289

asoloway@paulweiss.com

Securities Litigation & Enforcement Practice Management Associate Daniel S. Sinnreich, and Associate Angela J. Galdamez contributed to this Client Memorandum.