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REPORT

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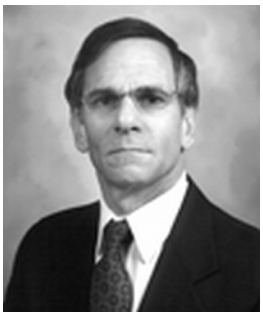
Whose Mind Is It Anyway? Pleading and Proving Corporate Scienter



SCOTT B. SCHREIBER, ANDREW T. KARRON, AND KAVITA KUMAR PURI

Mr. Schreiber co-chairs Arnold & Porter's Securities Enforcement and Litigation Practice; Mr. Karron and Ms. Puri are, respectively, a partner and associate whose practices focus on securities enforcement and litigation.

Since the dawn of litigation under Section 10(b) of the Securities Exchange Act of 1934 more than 60 years ago, corporations consistently have been named as defendants.[1] Yet, despite this long history, a fundamental question regarding the liability of corporate defendants remains incompletely resolved: who

[1] *See, e.g., Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (finding that there is a private right of action under Section 10(b) against the individual defendants and corporate defendants).

 ISSN 0037-0665

must be found to possess the requisite scienter – the required state of mind – as a necessary requirement to hold the corporation liable for a material misstatement or omission? Must plaintiff establish scienter on the part of a named defendant such as the chief executive officer or chief financial officer? On the part of other officers or directors? On the part of any corporate employee – even if they are not named in the complaint or involved in making the statement?

Three recent cases in the U.S. District Court for the Southern District of New York highlight the continuing importance of this issue and the absence of a definitive standard. In reviewing a settlement between the U.S. Securities and Exchange Commission (SEC) and the Bank of America of securities fraud claims relating to the alleged failure to disclose in a proxy statement certain bonuses to Merrill Lynch employees, Judge Rakoff questioned why claims were asserted only against the corporate defendant and not against any individual defendants who actually signed the relevant disclosure documents or participated in their preparation.[2] The issue similarly is presented in *In re Vivendi Universal, S.A. Securities Litigation*, where on January 29, 2010, a jury found Vivendi liable under Section 10(b) for numerous public statements even though it exonerated Vivendi's Chief Executive Officer and Chief Financial Officer, whom the jury found not to have acted with scienter, and plaintiffs presented no evidence that any other individual made any of the challenged statements with scienter.[3] Vivendi filed a post-trial motion for judgment as a matter of law or a new trial on the grounds that the verdict is legally unsustainable.[4] And, most recently, the SEC's lawsuit against Goldman, Sachs & Co. named not only the firm but also one executive alleged to have been directly and substantially involved in the challenged synthetic CDO transaction and disclosures relating to it.[5]

I. Scienter As a Critical Element Of Section 10(b) Securities Fraud Liability.

Both Congress and the courts have long recognized that scienter is an indispensible element of a Section 10(b) claim by either the SEC or a private plaintiff. To establish Section 10(b) liability, ''the action's basic elements include: (1) a material misrepresentation or omission; (2) scienter, i.e., a wrongful state of mind; (3) a connection with the purchase or sale of a security;'' and, in private litigation, ''(4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as transaction causation; (5) economic loss; and (6) loss causation, i.e., a causal connection between the material misrepresentation and the loss.''[6] Scienter has been defined as ''a mental state embracing intent to deceive, manipulate, or defraud.''[7] Congress underscored the importance of scienter in the Private Securities Litigation Reform Act of 1995, which required that, to survive a motion to dismiss, private securities plaintiffs must allege facts sufficient to give rise to a strong inference of scienter.[8]

II. How The Courts of Appeal Have Addressed Corporate Scienter

In addressing the issue of corporate scienter, federal courts of appeals generally have addressed three fundamental questions. First, is scienter on the part of an individually named defendant, who is an officer of the corporation, required to establish corporate scienter? Second, if corporate scienter may be inferred based on that of an individual affiliated with a corporation who is not a named defendant, what level of authority must that person have had generally and what responsibility must that person have had with respect to the allegedly material misstatement or omission? Finally, can corporate scienter be inferred through a collective scienter theory, in which corporate scienter is based on the communal knowledge of all or any of the corporation's employees or agents, regardless of whether or not they played any role in publishing the challenged statement?

No circuit court of appeals has upheld an allegation or judgment of corporate liability based on a broad collective corporate scienter theory such as that described above.[9] Rather, the courts consistently have focused on the second question and considered whether plaintiff

[2] Memorandum Opinion & Order at 8-11 (Sept. 14, 2009), *SEC v. Bank of America Corp.*, 09 Civ. 6829 (JSR) (S.D.N.Y.) (rejecting SEC's argument that the SEC could not prove that the ''individuals making false proxy statements . . . participated in the making of the false statements knowing the statements were false or recklessly disregarding the high probability the statements were false'' because the Bank relied on the advice of its counsel). This decision involves an alleged violation of Section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a), and not Section 10(b), but the elements for these actions are similar but for the fact that Section 14(a) concerns proxy statements in particular.

[3] *See, e.g.*, Jury Verdict Form, *In re Vivendi Universal, S.A., Securities Litigation*, 1:02-cv-05571-RJH-HPB (S.D.N.Y.), Dkt. # 998 (Howell, J.); *Viva Vivendi! New York Plaintiffs' Firms Score Huge Verdict*, WSJ Law Blogs (January 29, 2010), *available at* http://blogs.wsj.com/law/2010/01/29/viva-vivendi-new-york-plaintiffs-firms-score-huge-verdict/tab/article/; *Vivendi Will Appeal to Overturn Jury Verdict* (January 29, 2010), *available at* http://www.vivendi.com/vivendi/Vivendi-Will-Appeal-to-Overturn.

[4] Consolidated Memorandum of Law in Support of Vivendi S.A's Renewed Motion for Judgment as a Matter of Law Pursuant to Rule 50(b), Or, In the Alternative, for a New Trial Pursuant to Rule 59 at 13-14;54-55; *In re Vivendi Universal, S.A., Securities Litigation*, 1:02-cv-05571-RJH-HPB (S.D.N.Y.), Dkt. # 1025 (Howell, J.); Jury Verdict Form, *In re Vivendi Universal, S.A., Securities Litigation*, 1:02-cv-05571-RJH-HPB (S.D.N.Y.), Dkt. # 998 (Howell, J.).

[5] *See* Complaint, *Securities and Exchange Comm'n v. Goldman Sachs & Co. and Fabricio Tourre*, 10-CV-3229 (S.D.N.Y. 2010).

[6] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005) (internal quotation marks and citations omitted) (some emphasis omitted). *See also Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008). We focus here on Rule 10b-5(b) claims, the most common type of Section 10(b) claim; *scienter* is a required element of any Section 10(b) claim.

[7] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[8] 15 U.S.C. § 78u-4(b)(2) (requiring plaintiffs' complaint ''state with particularity facts giving rise to strong inference that defendant acted with the required state of mind.'').

[9] Some courts of appeal have mistakenly characterized other circuits' decisions as having proposed or approved collective *scienter* theories. *See, e.g., Glazer Capital Management, LP v. Magistri*, 549 F.3d 736, 743 (9th Cir. 2008) (suggesting that the Second and Seventh Circuits have approved collective *scienter*). However, as explained below, that conclusion is based on a misreading of *dicta* in the relevant opinions.

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pleaded or proved scienter on the part of one or more members of senior management who bore sufficient responsibility for issuing the challenged statements, which could then be attributed to the corporation.[10]

For example, the Second Circuit stated in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, Inc.*, that ''[t]o prove liability against a corporation, of course, a plaintiff must prove that 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.''[11] The court rejected defendants' position that corporate scienter could be alleged only by ''successfully pleading scienter as to an expressly named officer.''[12] Instead, the court held that, although ''there are circumstances in which a plaintiff may plead the requisite scienter against a corporate defendant without successfully pleading scienter against a specifically named individual defendant, the plaintiff here has failed to do so.''[13] The court found that plaintiffs' failure to ''specifically identif[y] any reports or statements that would have come to light in a reasonable investigation and that would have demonstrated the falsity of the allegedly misleading statements,'' or to specify the unnamed corporate employees who allegedly had a ''desire to maintain the appearance of profitability'' was insufficient to establish a strong inference of scienter that could be attributed to the corporation.[14]

> Teamsters would have us infer that *someone* whose scienter is imputable to the corporate defendants and who was responsible for the statements made was at least reckless toward the alleged falsity of those statements. We cannot say, based on the allegations in the complaint, that this inference is at least as compelling as the competing inference, i.e., that the statements were not misleading or were the result of merely careless mistakes at the management level based on false information fed it from below.[15]

Thus, the court of appeals held that because the complaint failed to raise a strong inference of scienter at all, it failed to raise it as to the corporation.

Like the Second Circuit, the Ninth Circuit has been reluctant to define precisely the categories of individuals whose scienter may be attributed to the corporation. In *Glazer Capital Management, LP v. Magistri*, it held that, on the facts of that case, ''the PSLRA requires [plaintiff] to plead scienter with respect to those individuals who actually *made* the false statements.''[16] Plaintiffs alleged that two officers actually made the challenged statements, but only alleged scienter with respect to Magistri, the President and CEO.[17] The Ninth Circuit held that because the complaint failed to allege that Magistri ''was personally aware of the illegal payments or that he was actively involved in the details'' of the sales that were the subject of the alleged misstatements, the complaint failed adequate to allege scienter as to him and, therefore, as to the corporation.[18] Although the court hypothesized in *dicta* that, ''in certain circumstances, some form of collective scienter pleading might be appropriate,'' it did not uphold such a pleading standard, nor did it suggest that a collective scienter theory could support a judgment on summary judgment or after trial.[19]

In *Southland Securities Corporation*, the Fifth Circuit rejected the notion of ''collective scienter'' and made clear that any scienter to be attributed to the corporation must reside in a single responsible person who participated in making the challenged statement. The court defined the relevant inquiry as looking ''to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.''[20] The court explained:

> This is consistent with the general common law rule that where, as in fraud, an essentially subjective state of mind is an element of a cause of action also involving some sort of conduct, such as a misrepresentation, the required state of mind must actually exist in the individual making (or being a cause of the making of) the misrepresentation, and may not simply be inferred to that individual on general principles of agency.[21]

While the court's language suggests that something short of a corporate employee or agent's ordering publication of the statement, or having it attributed to them, may suffice for finding corporate scienter, the actual holding of the case is narrower. The court held only that since the complaint adequately alleged scienter with respect to the company's CEO, his scienter could be attributed to the corporation based on principles of *respondeat superior*.[22]

The most comprehensive discussion of corporate scienter – and, ironically, the one that has generated the most confusion – is Judge Richard Posner's opinion for the Seventh Circuit in *Makor Issues & Rights, Ltd. v. Tellabs Incorporated*.[23] The company and certain senior executives were alleged to have engaged in false statements that certain flagship products were ''available'' when they were not yet available for sale due to

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[10] *See infra* pp. 4-10 & nn.11-36.

[11] *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190, 192, 195 (2d Cir. 2008) (emphasis added).

[12] *Id.* at 196.

[13] *Id.*at 192. *See also id.* at 196 (''[W]e do not believe [Congress's pleading requirements] have imposed the rule urged by defendants, that in no case can corporate *scienter* be pleaded in the absence of successfully pleading scienter as to an expressly named officer.'').

[14] *Id.* at 196.

[15] *Id.* at 197 (internal quotation marks and citation omitted).

[16] *Glazer*, 549 F.3d at 745.

[17] *Glazer*, 549 F.3d at 742-43. The alleged misstatements involved certain warranties the corporation — InVision — had made in a merger agreement. Subsequent to the announcement of the agreement, InVision disclosed that it had uncovered certain Foreign Corrupt Practices Act (''FCPA'') violations. It settled these with the SEC and the merger was consummated, but shareholders brought a securities fraud lawsuit against InVision and certain of its officers for misstatements in the representations and warranties made in the merger agreement. *Id.* at 740-43.

[18] *Glazer*, 549 F.3d at 745. *See also In re Apple Computer, Inc., Sec. Litig*, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002), *aff'd*, 127 Fed. Appx. 296, 303 (9th Cir. 2005) (same).

[19] *Glazer*, 549 F.3d at 744.

[20] *Southland Secs. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (emphasis added).

[21] *Id.*

[22] *Id.* at 367.

[23] *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008).

technical difficulties.[24] The court concluded that under the circumstances, it was ''very hard to credit'' that none of the named defendant members of senior management ''involved in authorizing or making [the] public statements . . . knew that they were false,'' and the court concluded that the plaintiffs had, therefore, alleged a strong inference of scienter with respect both to those individuals and the company.[25] That holding, which focuses on the scienter of senior management involved in making the statements at issue, is consistent with those discussed previously. The difficulty, and potential mischief, in the Seventh Circuit's opinion is its analysis and discussion that articulates and does not rule out a somewhat broader potential standard for finding – or at least pleading – corporate scienter than the narrow holding of the case.

The opinion recognizes that ''Intent to deceive is not a corporate attribute.''[26] However, it states that the reason is ''not because 'collective intent' or 'shared purpose' is an oxymoron;'' as the court notes, multimember judicial panels issue opinions that may be said to reflect the collective intent of the panel members who join them.[27] Rather,

> The problem with inferring a collective intent to deceive behind the act of a corporation is that the hierarchical and differentiated corporate structure makes it quite plausible that a fraud, though ordinarily a deliberate act, could be the result of a series of acts none of which was both done with scienter and imputable to the company by the doctrine of respondeat superior.[28]

The opinion then addresses several hypothetical scenarios. ''For example, someone low in the corporate hierarchy might make a mistake that formed the premise of a statement made at the executive level by someone who was at worst careless in having failed to catch the mistake.''[29] In such a situation, the opinion states, finding corporate scienter would ''attribute to a corporation a state of mind that none of its employees had'' and the opinion implicitly rejects that result.[30] The court also considers the possibility that the low-level employee might deliberately have furnished false information, where his superiors did not know or act recklessly in not knowing it was false when they made the challenged statements. The court states that, under common law agency principles, an employee's communication of false information for his benefit only – such as false financial statements that omit his embezzlement – would not ordinarily be imputed to the corporation.[31] However, the opinion notes, the broad ''furnish information or language for inclusion'' language of *Southland* discussed above implies that corporate scienter might be found in such a circumstance.[32] The court concludes that it ''need not explore'' that possibility – which it appears to view with disfavor – because that ''theory of liability is not argued in this case.''[33]

In light of this discussion, which reflects the court's sensitivity to the difficulties presented by attempting to divine corporate intent, it is surprising that the court goes on to suggest, in *dicta*, that it may conceivably be possible adequately to plead scienter with respect to a corporation even without naming any corporate officer or employee who acted with scienter. The court properly rejects, as impermissible ''group pleading,'' allegations naming ''management'' generally or each corporate officer who signed a challenged statement in group-published documents such as annual reports.[34] But the court then goes on to state

> [I]t is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.[35]

Viewed in context, it is hard to see this language as supporting private securities fraud complaints with scant allegations supporting corporate scienter. First, the hypothetical is *dicta*. Second, it makes clear that if it were applicable at all, it would be only in extraordinary cases. Third, the language focusing on the knowledge and intent of ''corporate officials sufficiently knowledgeable about the company to *know* that the announcement was false'' (emphasis added) makes clear that the opinion is not articulating a ''collective scienter'' approach, but, rather, suggesting that some individual would have sufficient involvement and scienter that could supply the scienter of the company. As a practical matter one would expect plaintiffs to identify such officials and assert claims against them as well; if they could not do so, it would raise questions whether any such corporate officials existed.

III. Why The Courts Have Preserved The Possibility Of Finding Corporate Scienter Even In The Absence Of Scienter Of Named Corporate Insider Defendants

Notwithstanding the relative narrowness of the actual holdings of the cases, these courts of appeals have insisted on articulating legal standards for corporate liability that leave open the possibility of corporate liability even where the liability of a named defendant or other senior officer is not alleged or established. Undoubtedly this reflects, in part, the courts' adherence to the well-recognized principle that courts should seek to avoid deciding issues, and foreclosing claims, not squarely presented by the case at hand.[36]

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[24] *Id.* at 709.

[25] *Id.* at 709, 710. See also id. at 710 (finding it ''exceedingly unlikely'' that the allegedly false statements were the result of merely careless mistakes at the management level based on false information fed it from below'').

[26] *Id.* at 707.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.* at 708.

[33] *Id.*

[34] *Id.* at 710.

[35] *Id.*

[36] *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 345-48 (1936) (courts are not to ''pass upon a constitutional question . . . if there is also present some other ground upon which the case may be disposed of'' (Brandeis, J., concurring)); *Morse v. Frederick*, 551 U.S. 393, 425, 431 (2007) (Breyer, J., concurring in part and dissenting in part) (the ''car-

   ISSN 0037-0665

The ambiguity in the corporate scienter decisions also reflects yet another area of uncertainty in the law of securities fraud: what constitutes ''making'' a material misstatement or omission in violation of Section 10(b) and Rule 10b-5(b), the most common basis for private class action securities fraud suits?[37] The courts of appeals are divided on the issue of what it means to ''make'' a statement, and the broad language of some of the corporate scienter decisions such as *Southland* suggesting that corporate scienter may be found where corporate officials ''make or issue the statement (or order or approve it or its making or issuance, or [] furnish information or language for inclusion therein, or the like)'' with scienter reflects this uncertainty.[38] Some courts adhere to the so-called ''bright line'' test, under which a challenged statement is ''made'' by a defendant only if it is publicly attributed to him. For example, the Second Circuit has held that secondary actors not directly employed by the corporation, such as accountants and lawyers, ''can be held liable in a private damages action brought pursuant to Rule 10b-5(b) only for false statements attributed to the secondary-actor defendant at the time of dissemination.''[39] On the other hand, the Ninth Circuit has held that ''substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statement.''[40] And even in the Second Circuit, attribution has not been required for an insider corporate defendant.[41]

In his concurring opinion in the Second Circuit's recent *PIMCO v. Mayer Brown* decision, Judge Parker noted the continuing confusion in this area of the law and suggested the desirability of clarification by the Supreme Court.[42] Two weeks ago, on the last day of the term, the Supreme Court granted certiorari in *Janus Capital Group Inc. v. First Derivative Traders*, a case that may provide the opportunity for such clarification.[43] *Janus Capital* presents the issue whether a service provider — in this case, an investment adviser to a mutual fund — can be held primarily liable in a private securities fraud action under Section 10(b) for helping or participating in alleged misstatements in the mutual fund's prospectus.[44] To the extent the Supreme Court in *Janus Capital* further illuminates what it means to ''make'' a statement, that may have significant implications not only for individuals and secondary actors, but also for corporations that may be named as securities fraud defendants.

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dinal principle of judicial restraint is that if it is not necessary to decide more, it is necessary not to decide more'' (internal quotation marks and citations omitted)).

[37] Rule 10b-5(b) makes it unlawful, in connection with the purchase or sale of any security, ''[t]o make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading.'' 17 C.F.R. § 240.10b-5(b).

[38] *See supra* n. 21.

[39] *Pacific Investment Management Company LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (''*PIMCO*''). *See also id*. at 155; *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (applying ''bright line'' public attribution test); *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Anixter* v. *Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (bright line).

[40] *Howard v. Everex Sys. Inc.*, 228 F.3d, 1057, 1061 n.5 (9th Cir. 2000).

[41] *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 75-76 (2d Cir. 2001). *See also PIMCO*, 603 F.3d at 152, 155; *id.* at 161 (Parker, J., concurring).

[42] *PIMCO*, 603 F.3d at 162.

[43] No. 09-525, *cert. granted* June 28, 2010.

[44] *See* Petition for Certiorari, *Janus Capital Group Inc. v. First Derivative Traders*, No. 09-525 (Oct. 30, 2009).