Corporate Litigation:

Pleading Corporate Scienter: Circuits Split on Standard

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In a securities class action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, plaintiffs seeking to plead a violation must allege "with particularity facts giving rise to a strong inference" that each defendant made a material misrepresentation or omission with scienter, i.e., a "mental state embracing intent to deceive, manipulate, or defraud."[1] When the defendant is a corporate entity—with no single mind of its own—whose state of mind matters for purposes of the scienter analysis?

As the U.S. Court of Appeals for the Sixth Circuit recently asked in *In re Omnicare, Inc. Sec. Litig.*, "must the person misrepresenting a material fact in the name of the corporation have also done so with scienter, or is it enough that some person in the corporate structure had the requisite state of mind?"[2] In response, the Sixth Circuit formulated a "middle ground" approach, combining elements of the restrictive and liberal tests previously adopted by other courts of appeal over the last decade and adding its view to the existing circuit split on the issue.

The Pre-Omnicare Circuit Split

In grappling with the conceptual issues raised by corporate scienter, some courts have adopted the view that scienter may be imputed to the corporation only where the person who made the alleged misstatement attributable to the company made the statement with knowledge of its falsity. As the U.S. Court of Appeals for the Fifth Circuit explained in a 2004 opinion, "determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter" depends on "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)."[3]

In courts following this approach, "[i]t is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false"; rather, a corporate defendant is deemed to have scienter "only if the individual corporate officer making the statement has the requisite level of scienter, i.e., knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she makes the statement."[4]

In adopting this respondeat superior approach to corporate scienter, the Fifth Circuit in *Southland Sec. Corp. v. INSpire Ins. Solutions* explained that its view is consistent with the 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 imputed to that individual on general principles of agency."[5]

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The Fifth Circuit explicitly rejected the notion that corporate scienter could stem from the "collective knowledge of all the corporation's officers and employees acquired in the course of their employment," where no identified individual possessed the requisite state of mind.

The Third and Eleventh Circuits have also followed a respondeat superior approach to corporate scienter. In a 2005 opinion, the U.S. Court of Appeals for the Third Circuit ruled that the individual defendant who made the allegedly misleading statements did not act with the requisite state of mind, and it therefore concluded that the corporate defendant could not be held liable.[6] The U.S. Court of Appeals for the Eleventh Circuit similarly indicated in dictum that "the most plausible reading [of the Private Securities Litigation Reform Act (PSLRA)] in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating *each defendant's* state of mind regarding his or her alleged violations."[7]

In contrast, the Second, Seventh and Ninth Circuits have each adopted, with some variations, a broader view of collective corporate scienter. In these courts, plaintiffs may meet their pleading burden by alleging facts creating a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter, even if that person is not a named defendant. The U.S. Court of Appeals for the Seventh Circuit was the first to state, in *Makor Issues & Rights v. Tellabs*, that "it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud."[8] To illustrate the point, the court posited a stark hypothetical: If General Motors announced that it sold one million SUVs in a particular year when the actual number was zero, "[t]here 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."

The U.S. Court of Appeals for the Second Circuit agreed that at least in some cases, plaintiffs may meet the PSLRA's heightened pleading requirement without raising a strong inference of scienter with regard to any specific individual defendant. The Second Circuit in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital stated* that Congress' establishment of strict requirements for securities fraud pleading did not imply that "in no case can corporate scienter be pleaded in the absence of successfully pleading scienter as to an expressly named officer."[9]

In *Glazer Capital Management v. Magistri*, the U.S. Court of Appeals for the Ninth Circuit also suggested that "there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least some corporate officials knew of the falsity upon publication."[10] In reaching this conclusion, the court pared back a previous decision it made in an insurance case that both the Fifth Circuit in *Southland* and a California district court (later affirmed by the Ninth Circuit) relied on in adopting the respondeat superior view of corporate scienter. The court asserted that its decision in *Nordstrom v. Chubb & Son* actually "does not foreclose the possibility that, in certain circumstances, some form of collective scienter pleading might be appropriate."[11]

Interestingly, none of the appellate courts recognizing the collective corporate scienter theory relied on this theory in deciding the case before it. The Seventh Circuit in *Makor* ruled that the plaintiffs adequately pleaded scienter on the part of the CEO and that the CEO's individual liability could be imputed to the corporation. The Second Circuit in *Dynex* concluded that the plaintiffs did not allege "the existence of information that would demonstrate that the statements made to investors were misleading" and therefore failed to state a valid securities fraud claim.

Finally, the Ninth Circuit in *Glazer* held that despite the theoretical availability of the collective scienter approach, "given the limited nature and unique context of the alleged misstatements" in the case before it, the PSLRA required the plaintiffs "to plead scienter with respect to those individuals who actually made the false statements in the merger agreement." According to the court, because the merger agreement at issue disclosed the company's compliance "with all laws," allowing scienter to be imputed to the company if any employee

had knowledge of any violation of law would be "plainly inconsistent with the pleading requirements of the PSLRA."

Finally, years before addressing the corporate scienter issue in *Omnicare*, the Sixth Circuit employed the most lenient approach of any circuit. In its 2005 decision in *City of Monroe Employees Retirement System v. Bridgestone Corp.*, the Sixth Circuit found that the plaintiffs adequately alleged that the executive vice-president of the corporate defendant was aware that the statements at issue were false or misleading and held that his knowledge could be attributed to the corporation even though the complaint did not link the executive to the issuance of the statements.[12]

'In re Omnicare'

In *Omnicare*, the Sixth Circuit clarified the position it took in *City of Monroe* and "qualifie[d] some of that opinion's overly broad language."[13] *Omnicare* involved allegations that Omnicare, Inc. and some of its current and former officers made material misrepresentations and omissions "in public and in SEC filings regarding Omnicare's compliance with Medicare and Medicaid regulations." Specifically, the plaintiffs pointed to internal audits performed by John Stone, Omnicare's former vice president of internal audit, that revealed "pervasive fraud" and other compliance deficiencies. The plaintiffs, who did not name Stone as a defendant, alleged that Omnicare and the individual defendants knew of the allegations of fraud or non-compliance but routinely made material misrepresentations about the company's legal compliance.

Faced with the challenge of formulating a legal standard for assessing the corporate defendant's mental state, the Sixth Circuit opted for a "middle ground" approach under which the state(s) of mind of any of the following people are probative for determining whether a misrepresentation made by a corporation was made with the requisite intent:

a. The individual agent who uttered or issued the misrepresentation;

b. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance;

c. Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.[14]

In the case before it, the Sixth Circuit determined that under its "formulation of collective corporate scienter, the knowledge of Stone can be imputed to Omnicare" since Stone was both an individual agent who allegedly furnished information for and reviewed the statement in which the misrepresentation was made before its issuance and was potentially a "high managerial agent" who ratified or tolerated the misrepresentation after it was made. Nonetheless, the court held that the plaintiffs failed "to plead sufficient facts that would give rise to a strong inference that Omnicare acted to defraud the public." According to the court, the countervailing inferences based on the facts alleged were too strong to allow for finding a strong inference of scienter, thus warranting the complaint's dismissal.

Significance of Approach

The "middle ground" approach to determining corporate scienter represents an attempt to mitigate the potential unfairness to corporate defendants stemming from the respondeat superior and collective scienter models. On the one hand, the respondeat superior approach seems to accord with the PSLRA's objective of curtailing abuses of private securities litigation by allowing actions against corporate defendants to proceed

only where the plaintiffs can demonstrate that the individual who made the misrepresentation acted with the requisite state of mind.

As the Omnicare court recognized, however, where there is no identifiable culpable actor, the respondeat superior approach could allow corporations that condone illegal activity to escape liability. This could incentivize companies inclined to commit fraud to isolate the individuals speaking on the company's behalf from any facts that may contradict their public statements. *Omnicare* noted that as a result, the respondeat superior standard could undermine the "attitude of full disclosure by publicly traded corporations," replacing this hallmark of the U.S. securities framework with a "philosophy of caveat emptor for securities buyers."

Conversely, while a broader view of collective corporate scienter would likely discourage managers of companies from deliberately separating the employees making public statements from those with knowledge of the company's misdeeds, the Sixth Circuit appreciated that a more expansive approach "could expose corporations to liability far beyond what Congress has authorized." The Sixth Circuit explained that "[i]f the scienter of any agent can be imputed to the corporation, then it is possible that a company could be liable for a statement made regarding a product so long as a low-level employee, perhaps in another country, knew something to the contrary." This result would conflict with the PSLRA, which raised the scienter pleading requirements in an attempt to discourage frivolous securities litigation; under the collective scienter approach, plaintiffs would be able to pass the motion to dismiss stage all too easily, increasing their chances of reaching large settlements with corporate defendants—undermining the purpose of the PSLRA.

According to the Sixth Circuit, its "middle ground" formulation of corporate scienter strikes the right balance: It "largely prevents corporations from evading liability through tacit encouragement and willful ignorance, as they potentially could under a strict respondeat superior approach," while—in the spirit of the PSLRA—protecting corporations from strike suits "when one individual unknowingly makes a false statement that another individual, unrelated to the preparation or issuance of the statement, knew to be false or misleading."

The Omnicare decision brought clarity to the Sixth Circuit's moderate approach to determining corporate scienter; however, it only compounds the divergent approaches of the federal appellate courts. Unless the Supreme Court resolves the circuit split, the jurisdiction in which a private securities action is brought could be outcome determinative given the circuits' materially different views on whose state of mind may be imputed to the corporate defendant. In certain cases, the jurisdiction in which the lawsuit is filed could have far-reaching implications on the plaintiffs' chances of surviving a motion to dismiss and their settlement posture.

Endnotes:

1. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).
2. 769 F.3d 455, 473 (6th Cir. 2014).
3. *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004).
4. *In re Apple Computer, Inc. Sec. Litig.*, 243 F.Supp.2d 1012, 1023 (N.D. Cal. 2002), aff'd 127 Fed. Appx. 296 (9th Cir. 2005) (citing *Nordstrom v. Chubb & Son*, 54 F.3d 1424, 1435-36 (9th Cir. 1995)).
5. *Southland*, 365 F.3d at 366.
6. See *In re Tyson Foods*, 155 Fed. Appx. 53, 57 (3d Cir. 2005).
7. *Phillips v. Scientific-Atlanta*, 374 F.3d 1015, 1018 (11th Cir. 2004) (emphasis added).
8. 513 F.3d 702, 710 (7th Cir. 2008).
9. 531 F.3d 190, 196 (2d Cir. 2008).
10. 549 F.3d 736, 744 (9th Cir. 2008)

11. Id.; see also *Nordstrom*, 54 F.3d at 1435-36; *In re Apple Computer*, 127 Fed. Appx. at 303; *In re Apple Computer*, 243 F.Supp.2d at 1023.

12. See 399 F.3d 651, 688-89 (6th Cir. 2005).

13. *In re Omnicare*, 769 F.3d at 476.

14. Id