

Second Circuit Heightens Standard for Establishing Corporate Scier in Securities Fraud Cases

The lynchpin of many securities fraud cases is whether a plaintiff can establish with particularity that a defendant acted with scienter (i.e., fraudulent intent). Where the defendant is an individual person, this question may be relatively straightforward. Where the defendant is a corporation, however, it can be more complicated: a plaintiff must demonstrate the misconduct was not the result of mismanagement of lower-level employees but rather the *corporation's* fraudulent conduct.

On May 27, 2020, in *Jackson v. Abernathy*,¹ the United States Court of Appeals for the Second Circuit, in a *per curiam* decision, clarified the standard for pleading corporate scienter. Specifically, a plaintiff must adequately plead that the individuals who made or disseminated the alleged misstatements were responsible for making or disseminating the corporations' alleged misstatements and either acted with the requisite fraudulent intent or that the statement was so dramatic that fraudulent intent may be inferred.² The plaintiff in *Jackson* failed to meet that exacting standard because he relied solely on the testimony of lower-level employees of the defendant corporations in which those employees raised concerns about the accuracy of some of the defendant corporations' alleged misstatements. The Second Circuit held that was insufficient to plead corporate scienter because the plaintiff failed to adequately plead that the corporate officials actually responsible for making or disseminating the corporations' alleged misstatements knew of those employees' alleged concerns.³ The decision heightens the already heavy burden plaintiffs have in securities fraud cases in pleading that corporations acted with the requisite scienter.

I. Background

In many securities fraud actions, such as those brought under Section 10(b) of the Securities and Exchange Act of 1934, plaintiffs must adequately plead a strong inference of scienter.⁴ Ordinarily, this involves pleading "with particularity facts giving rise to a strong inference that" the maker⁵ of an alleged misstatement acted with the intent to deceive, manipulate, or defraud.⁶ However, a corporate entity has no state-of-mind and cannot speak for itself, so demonstrating that a corporation acted with the requisite scienter becomes more complicated.

The United States Courts of Appeals have taken somewhat varied approaches to the pleading requirements for corporate scienter. The Fifth and Eleventh Circuits follow a *respondeat superior* approach, whereby courts "look to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather

¹ No. 19-1300-cv, 2020 WL 2755690 (2d Cir. May 27, 2020), available at https://www.ca2.uscourts.gov/decisions/isysquery/caf59294-7fd7-48eb-a05a-73a6cc84c680/20/doc/19-1300_opn.pdf#xml=https://www.ca2.uscourts.gov/decisions/isysquery/caf59294-7fd7-48eb-a05a-73a6cc84c680/20/hilite/.

² *Id.* at *3.

³ *Id.* at *3-4.

⁴ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322-23 (2007).

⁵ The "maker" of a statement is the person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

⁶ 15 U.S.C. § 78u-4(b)(2)(A).

than generally to the collective knowledge of all the corporation’s officers and employees.”⁷ In other words, courts in these Circuits may only impute scienter from the individuals who made⁸ the misstatement at issue.⁹

In contrast, the Second, Seventh, and Ninth Circuits have adopted a somewhat broader corporate scienter pleading standard. In these Circuits, adequately pleading scienter 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.”¹⁰ Under this standard, courts examine the roles of the personnel connected to the alleged misrepresentation and whether their knowledge can be imputed to a corporate defendant.¹¹ Unlike the *respondeat superior* approach, it is possible for a plaintiff in these Circuits to plead a strong inference of corporate scienter “without doing so with regard to a specific individual defendant.”¹²

II. The Second Circuit’s Decision in *Jackson v. Abernathy*

In *Jackson v. Abernathy*, the Second Circuit made clear the heavy burden that plaintiffs face in satisfying the collective corporate scienter standard. The plaintiff, Ronald Jackson, brought a securities fraud action against two corporations and individual executives at those companies for allegedly misleading investors as to the quality and effectiveness of a surgical gown that defendants manufactured and sold.¹³ Defendants designed and marketed the surgical gown for use in the treatment of patients with highly infectious diseases, such as HIV and Ebola.¹⁴ The plaintiff alleged that the defendants misled investors by representing the surgical gown as having met certain safety standards, “despite the companies’ senior executives knowing that the gown had failed numerous quality-control tests.”¹⁵

On March 30, 2018, the district court dismissed the plaintiff’s complaint for failure to allege scienter adequately against the individual and corporate defendants.¹⁶ The plaintiff moved to set aside the judgment and file an amended complaint. The district court denied that motion as futile, and plaintiff appealed. On appeal, plaintiff

⁷ *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004); *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1254 (11th Cir. 2008).

⁸ Again, it is important to remember that the “maker” of a misstatement is a term of art in securities fraud cases, as defined by *Janus* and its progeny.

⁹ The Sixth Circuit, in *In re Omnicare, Inc. Securities Litigation*, 769 F.3d 455 (6th Cir. 2014), proscribed a defined list of persons whose states of mind are probative of corporate scienter. *Id.* at 476 (this list includes: “The individual agent who uttered or issued the misrepresentation Any individual agent who authorized, requested, commanded, furnished information for, prepared . . . reviewed, or approved the statement Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.”).

¹⁰ *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008).

¹¹ *Jackson*, 2020 WL 2755690, at *3.

¹² *Dynex*, 531 F.3d at 195; see also *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (“[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.”); *Glazer Capital Management, LP v. Magistri*, 549 F.3d 736, 744 (9th Cir. 2008) (“[T]here 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.”).

¹³ *Jackson*, 2020 WL 2755690, at *1.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at *2.

challenged whether the proposed amended complaint failed to raise a strong inference of scienter against the corporate defendants.¹⁷

Plaintiff argued that the proposed amended complaint sufficiently alleged scienter because it included new allegations, based on testimony from three low-level employees of the corporate defendants in a related California consumer fraud action.¹⁸ In that action, employees of the corporate defendants testified that the “gown’s compliance problems were well known at the companies,” and that the CEO of one of the corporate defendants received documents “that detailed manufacturing problems and resulting product compliance failures.”¹⁹

The Second Circuit was unpersuaded and affirmed the district court’s denial of plaintiff’s motion for leave to amend. Building off the Second Circuit’s decision in *Dynex* and the Seventh Circuit’s decision in *Makor*, the Court explained that in cases of collective corporate scienter, “a plaintiff must show that the misstatement was not a case of mere mismanagement, but rather the product of collective fraudulent conduct.”²⁰ This could be done: (i) by imputing scienter from the maker of the alleged misstatement; (ii) by imputing scienter from other officers and directors, who were not makers of the misstatement but were involved in disseminating the alleged misstatements; or (iii) where a misstatement is so “dramatic” that a court can infer corporate scienter.²¹

In *Jackson*, the crux of the Court’s decision was plaintiff’s failure to provide any “connective tissue between those employees [in the California action] and the alleged misstatements.”²² The plaintiff failed to show that the testifying employees in the California action were involved in crafting or reviewing the alleged misstatements at issue.²³ Further, the plaintiff “offer[ed] only general allegations of warnings made to unidentified senior executives.”²⁴ The Court held that these unparticularized allegations failed to raise a strong inference of scienter against the corporate defendants.²⁵

Finally, the Second Circuit rejected plaintiff’s argument that the surgical gown at issue was so “key” to the corporate defendants’ business that senior management must have known the statements at issue were false or misleading.²⁶ On this, the Court again held that such “naked assertion[s], without more,” were insufficient to plead corporate scienter.²⁷

III. Takeaways

Jackson confirms that, to establish corporate scienter, the state of mind that matters is that of those responsible at the company for making or disseminating the alleged misstatements. In doing so, the Second Circuit

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at *1.

²¹ *Id.* at *3.

²² *Id.* at *4.

²³ *Id.*

²⁴ *Id.* at *3.

²⁵ *Id.* at *4.

²⁶ *Id.*

²⁷ *Id.*

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heightened the already heavy burden plaintiffs have to establish corporate scienter. A plaintiff can no longer plead securities fraud simply by relying on the concerns of low-level employees. Rather, plaintiffs must tie the concerns of those low-level employees to those at the company who actually made the alleged misstatements.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Adam Mintz at 212.701.3981 or amintz@cahill.com; or William McCaughey at 202.862.8946 or wmccaughey@cahill.com; or publications@cahill.com.

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