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Being of One Mind: Corporate Scienter and Securities Fraud Liability

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If a corporate official makes a statement to investors and another corporate official knows the statement is false, can the company be liable for securities fraud? Federal appellate courts have struggled with this question in assessing what must be plead and/or proven to establish the requisite scienter (or fraudulent intent) for a corporate defendant facing claims brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. Recent Supreme Court jurisprudence, however, strongly suggests that only the scienter of corporate officials who "made" the alleged false statements should be imputed to the company.

BACKGROUND

Rule 10b–5 prohibits the "mak[ing] any untrue statement of a material fact" in connection with the purchase or sale of securities. 17 CFR 240.10b-5(b) (2010).[1] It is the most common basis for federal securities fraud claims brought against publicly-traded companies. Typically, the plaintiffs allege that they purchased the company's common stock at a price that was artificially inflated due to false or misleading statements made by the company and its officers. The plaintiffs seek to recover the difference between that purchase price and the actual value of the stock had the truth been known at the time of the purchase.

In response to concerns that these suits were potentially abusive, Congress enacted the Private Securities Litigation Reform Act of 1995 ("Reform Act") for the express purpose of creating heightened pleading standards for securities fraud cases that would restrict the ability of plaintiffs to bring meritless claims.[2] The key provision of the Reform Act requires plaintiffs to adequately plead a "strong inference" of scienter as to *each* defendant before a case will be allowed to proceed.[3] Scienter is

1. This article only addresses claims based on false and misleading statements of fact brought pursuant to Section 10(b) and subsection (b) of Rule 10b-5(b). It does not address other types of securities fraud claims, including claims based on scheme liability or an affirmative duty to disclose.
2. As noted by the Supreme Court, "extensive discovery and the potential for uncertainty and disruption in a [securities fraud] lawsuit could allow plaintiffs with weak claims to extort settlements from innocent companies." *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 149 (2008).
3. 15 U.S.C. § 78u-4(b)(2).

defined as a "mental state embracing intent to deceive manipulate or defraud."[4]

Companies can be defendants in securities fraud actions, but the scope of their liability is circumscribed by the requirement that a defendant must have acted with scienter.[5] A company, of course, does not have its own mental state in the way that a person does. To assess whether a company possesses scienter, then, it is necessary to determine *whose* mental state can be imputed to the company. While the Supreme Court has not incorporated every common law principle into Section 10(b), it is widely accepted that "the doctrines of respondeat superior and apparent authority remain applicable to suits for securities fraud." *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008) (*citing AT & T v. Winback & Conserve Program, Inc.,* 42 F.3d 1421, 1429–33 (3d Cir. 1994)). Applying these doctrines, courts have found that a corporate defendant can only have acted with scienter if the corporate official who made the alleged false statement acted with scienter.[6] As a matter of liability, this rule comports with the general principles of agency law, which hold that "a principal may not be subject to liability for fraud if one agent makes a statement, believing it to be true, while another agent knows facts that falsify the other agent's statement." Restatement (Third) of Agency § 5.03 cmt. d (2006); *see also* Restatement (Second) of Agency § 275 cmt. b (1958).

DIVERGING VIEWS AMONG THE CIRCUIT COURTS

In applying this general rule, however, courts have gone off in several directions that now appear ill-advised in light of recent Supreme Court decisions.

First, in assessing a company's scienter, courts have looked to the mental state of corporate employees other than those who directly made the statement. In a decision that has been widely followed, the Fifth Circuit held that it is "appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (or

4. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).
5. Section 10(b) and Rule 10b-5 prohibit any person from engaging in certain forms of securities fraud, and "person" is a statutorily defined term that includes corporations. Exchange Act § 3(a)(9), 15 U.S.C. §78c(a)(9) (2008).
6. *See, e.g., In re Apple Computer, Inc.*, 127 Fed. App'x 296, 303-305 (9th Cir. 2005); *In re Tyson Foods, Inc. Sec. Litig.*, 155 Fed. App'x 53, 56-57 (3d Cir. 2005); *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004).

order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like)." *Southland Securities Corp. v. INSpire Ins. Solutions, Inc.,* 365 F.3d 353, 366 (5th Cir. 2004) (footnote omitted); *see also United States v. Philip Morris USA Inc.*, 566 F.3d 1095, 1118 (D.C. Cir. 2009); *Makor,* 513 F.3d at 708; *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1254 (11th Cir. 2008). The key addition is the phrase "or who furnish information or language for inclusion therein." In other words, corporate scienter can be based on the state of mind of a corporate official who provides false information that becomes the basis for the misrepresentation, even if that person did not make the statement themselves. *See Makor,* 513 F.3d at 708 (discussing scope of *Southland* standard).[7]

Second, a handful of courts have gone beyond the Fifth Circuit's standard, at least for pleading purposes, and held that under some circumstances it is not necessary to establish that any particular corporate official acted with fraudulent intent. According to the Second, Seventh, and Ninth Circuits, if the false statement is sufficiently "dramatic," it may be clear that it "would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false." *Makor,* 513 F.3d at 710 (describing hypothetical where General Motors announces it sold 1 million SUVs in a particular year, when it actually sold none); *see also Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195-96 (2d Cir. 2008); *Glazer Capital Management, LP v. Magistri*, 549 F.3d 736, 744 (9th Cir. 2008). Although it appears that these courts would continue to require proof that a corporate official who made the false statement acted with scienter before actually finding a company liable, some of the

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7. Interestingly, and more consistent with the common law, *Makor* interpreted *Southland's* "furnish" language as holding that corporate scienter can be imputed from a corporate agent who "knowingly supplied the false information intending to help the company." *Makor*, 513 F.3d at 708. The "intending to help the company" is an important addition because "deliberate wrongs by an employee are not imputed to his employer unless they are not only within the scope of his employment but in attempted furtherance of the employer's goals." *Id.* (citing decisions from the Fifth, Seventh, and Tenth Circuits). Lower courts in the Fifth Circuit, however, have tended to simply apply the bald language in the *Southland* decision. *See, e.g.*, *Kerr v. Exobox Technologies Corp.*, 2012 WL 201872, at *14 (S.D.Tex. Jan. 23, 2012) ("Plaintiffs need only assert that Sonfield furnished the information or language for inclusion in order to attribute his scienter to Exobox.").

language in the decisions is subject to differing interpretations. [8] For example, the Ninth Circuit states it may be possible to adequately allege corporate scienter where "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." *Glazer*, 549 F.3d at 744 (emphasis in original). The decision cites the Seventh Circuit's holding in *Makor*, but absent from the text is *Makor's* important limiting reference to corporate officials who "approved" the alleged false statement.

Finally, the Sixth Circuit, in its recent decision in *In re Omnicare, Inc. Sec. Litig*, has held that the mental state of a wide variety of corporate employees is "probative" of a company's scienter (both for pleading and liability purposes). 769 F.3d 455 (6th Cir. 2014). The court rejected the strict application of the respondeat superior doctrine, concluding that it potentially allows companies to avoid "liability through tacit encouragement and willful ignorance." The court also found, however, that the imputation of any agent's knowledge to the corporation was problematic because "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." *Id.* at 476-77.[9] Instead, the court adopted a "middle ground," holding, without citation other than to a law review article, that the mental state of any of the following individuals can be probative of a company's scienter: "(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

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8. *See Makor,* 513 F.3d at 708 (quoting Fifth Circuit standard with approval); *Dynex* 531 F.3d at 195 ("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").
9. The *Omnicare* decision appears to confuse the issues of pleading and liability. In defending its departure from the Fifth Circuit's corporate scienter standard, the court claimed that "the Second, Seventh, and Ninth Circuits weighed in, though none of these circuits sided fully with either camp in this circuit split [between the Fifth and Sixth Circuits]." 769 F.3d at 474. In fact, as discussed *supra*, the cited decisions by the Second, Seventh, and Ninth Circuits merely address what must be *plead* as to a corporate defendant's scienter to meet the "strong inference" requirement. To the extent that the decisions say anything about what *proof* is necessary to establish corporate scienter for purposes of liability, they expressly agree with the Fifth Circuit. *See* n. 7 and accompanying text.

statement in which the misrepresentation was made before its utterance or issuance; or (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." *Id.* at 476.

While categories (a) and (b) basically track the Fifth Circuit's standard, category (c) represents a significant expansion. The Sixth Circuit offered no guidance, however, as to how lower courts are supposed to determine whether a plaintiff has adequately plead that an agent "ratified, recklessly disregarded, or tolerated" the misstatement. Nor did it explain the significance of a corporate official recklessly disregarding or tolerating the misstatement *after* it was issued. Scienter is usually assessed as of the time of the alleged misstatement. *See, e.g., Pugh v. Tribune Co.*, 521 F.3d 686, 696 (7th Cir. 2008) (dismissing allegations against one defendant because the allegations did not show that he was aware his allegedly false statement was false at time it was made).

THE ARGUMENT FOR A UNIFORM "MAKER" STANDARD

The different approaches to corporate scienter adopted by the appellate courts are confusing and unnecessary. Instead, there is a persuasive legal and prudential argument in support of a uniform approach that limits the assessment of corporate scienter, both for pleading and liability purposes, to the mental state of the "maker" of the alleged false statement.

As a legal matter, it appears clear that the Supreme Court would likely reject any other standard, based on a pair of 2011 decisions that address (a) corporate scienter, and (b) the scope of Rule 10b-5 liability. In *Staub v. Proctor Hospital*, the Court considered the issue of corporate scienter in the context of a discrimination case brought under the Uniformed Services Employment and Reemployment Rights Act (USERRA). 562 U.S. 411, 131 S. Ct. 1186 (2011). The Court noted that agency law forms the general legal background against which federal tort laws (like USERRA and Section 10(b of the Exchange Act)) are enacted. *Id.* at 1191-92. On the issue of corporate scienter, agency law normally holds "that the malicious mental state of one agent cannot generally be combined with the harmful action of another agent to hold the principal liable for a tort that requires both." *Id.* The Court then found that this rule should be applied if it is clear from the statute that liability only exists if the actor who commits the prohibited conduct has the requisite mental state. *Id.* While it is possible that the mental state of an agent who did not

directly engage in the necessary act can be imputed to a company, that agent must have been a *proximate cause* of the act. *Id.* at 1192-93[10]

The clear lesson of *Staub*, as applied to Rule 10b-5 claims, is that unless a corporate agent is a proximate cause of the alleged false statement, the agent's scienter cannot be imputed to the company. So which corporate official can be a proximate cause of a false statement issued by the company? Just a few months later, in *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court implicitly addressed this issue. 131 S. Ct. 2296 (2011). Under Rule 10b-5, liability as a "maker" of a false statement is limited to "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* at 2302. Indeed, the Court held, "[w]ithout such authority, it is not 'necessary or inevitable' that any falsehood will be contained in the statement." *Id.* at 2303. It is therefore clear that "a person who provides the false or misleading information that another person then puts into the statement" cannot be held liable. *Id.* at 2303 (internal quotations omitted). Providing false or misleading information is merely an "undisclosed act preceding the decision of an independent entity to make a public statement." *Id.* at 2304; *see also id.* at 2302 ("This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it.")

To put it in terms of proximate causation, *Janus* clarifies that the maker of the false statement – who is an "independent entity" – is the only person whose actions bear a direct relation to the necessary act. Merely participating in the creation of the false statement is "too remote, purely contingent, or indirect." *Hemi Group, LLC v. City of New York,* 559 U.S. 1, 9 (2010) (discussing common law standard for proximate causation). Therefore, under the corporate scienter analysis in *Staub*, it seems unlikely that the Court would ever find that the mental state of non-makers, who are not a proximate cause of the necessary act, can be imputed to the corporate defendant for purposes of Rule 10b-5 liability.[11] Moreover, this conclusion

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10. In *Staub*, the Court found that this requirement was satisfied because supervisors at the Company had issued a report, motivated by the necessary discriminatory animus, which led to the plaintiff's termination. 131 S. Ct. at 1192.
11. A pair of district courts have found that the *Janus* decision did not alter the Fifth Circuit's corporate scienter standard (in particular, its willingness to impute the mental state of individuals who furnished false information), but neither court considered the impact of the combination of the *Staub* and *Janus* holdings. *See*

comports with the Court's general view regarding Rule 10b-5 claims by private litigants, which is that the Court must give "narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law." *Stoneridge*, 552 U.S. at 167; *see also Janus*, 131 S.Ct. at 2302 (same).

Nor is there a strong public policy justification for creating any disconnect between individuals who made the false statement and corporate scienter (either as a matter of pleading or liability). The Sixth Circuit's rationale – that a broader corporate scienter standard would create liability for "corporations that willfully permit or encourage the shielding of bad news from management," *In re Omnicare, Inc. Sec. Litig.*, 769 F.3d at 477– seems aspirational at best. In most publicly-traded companies there are a large number of employees who are involved, at least tangentially, in the preparation of public statements. If any one of them provides false information that is then conveyed to investors, why is it reasonable to assume that this was the result of the company's willful action as opposed to the individual's desire to gain a personal benefit? Moreover, in the latter scenario, the real issue is the employee's liability, not that of the corporation. While the employee would not be subject to primary fraud liability under Rule 10b-5, there are a number of other possible claims that could be brought, including an action under Section 20(b) of the Securities Exchange Act for engaging in a securities fraud "through or by means of any other person." 15 U.S.C. § 78t(b).

Limiting the imputation of corporate scienter to the official who made the alleged false statement also is unlikely to have a significant effect on the ability of plaintiffs to bring securities fraud claims. As the Second Circuit has recognized, "[i]n most cases, the most straightforward way to raise [an inference of scienter] for a corporate defendant will be to plead it for an individual defendant." *Dynex*, 531 F.3d at 195. Moreover, as a matter of common sense, it is far more likely that the official who made the statement knew (or should have known) whether it was true or false than that some other employee duped the official. As for cases where a plaintiff is unable to adequately plead or prove scienter as to any corporate official who made an alleged false statement, courts should not be in the business of frustrating the PSLRA and overriding Supreme Court precedent by allowing such cases to proceed against the company.

Lee v. Active Power, Inc., 29 F. Supp. 3d 876, 881-83 (W.D. Tex. 2014); *Exobox Techs. Corp.*, 2012 WL 201872 at *14.

NOTES