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## Second Circuit Vacates Decision Denying a Motion To Dismiss Securities Fraud Claims Against Corporate Defendants and Holds that Plaintiff Failed Adequately To Plead Scierter on the Part of Those Corporate Defendants

The Second Circuit's recent decision in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc. & Merit Securities Corp.*, 2008 U.S. App. LEXIS 13449 (2d Cir. June 26, 2008), represents an important clarification of the requirements for pleading "corporate scierter" in connection with claims for securities fraud under the PSLRA. The Second Circuit held that, in order to plead scierter adequately, a plaintiff must allege that at least one corporate agent had the requisite scierter, but that a plaintiff may under some circumstances survive a motion to dismiss even if he does not identify the particular person having the necessary state of mind. While the Second Circuit declined to hold categorically that a plaintiff's failure adequately to plead scierter on the part of a specific agent of the corporation *precludes* a finding that plaintiff has adequately pleaded scierter on the part of the corporate defendants, the decision nevertheless is one that should prove helpful to corporate defendants seeking to dismiss claims of securities fraud for failure to plead scierter adequately.

*Dynex* was a putative securities fraud class action brought by purchasers of poorly performing bonds backed by pools of loans for the purchase of manufactured homes. The bonds were issued by Dynex Capital Inc. ("Dynex"), and the complaint named as defendants Dynex and a subsidiary as well as two Dynex officers. Plaintiff alleged that defendants had concealed that Dynex had faulty underwriting practices and had misrepresented the reason for the poor performance of the collateral underlying the bonds.

Defendants moved to dismiss, contending that plaintiff had failed adequately to allege scierter on the part of either the individual or the corporate defendants. The district court agreed with respect to the individual defendants, holding that plaintiff's allegations of scierter on the part of the individual defendants were insufficient, because those allegations were based on nothing more than the individual defendants' corporate positions. The district court, however, sustained the complaint as against the corporate defendants, concluding that plaintiff's allegation that they had systematically originated defective loans despite clear signs that the borrowers were not creditworthy was sufficient to plead motive and opportunity to commit fraud on the part of the

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corporate defendants. The district court denied defendants' motion for reconsideration but certified an interlocutory appeal.

On appeal, defendants argued that the district court's holding that plaintiff had not adequately pleaded scienter on the part of any specific corporate employee, officer or director necessarily precluded a finding that plaintiff had adequately pleaded scienter on the part of the corporate defendants. The Second Circuit rejected this position, but nevertheless vacated the opinion of the district court and remanded the case, holding 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."

Hewing closely to the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504-05 (2007), the Second Circuit explained that, to survive a motion to dismiss a securities fraud claim under the PSLRA against a corporate defendant, a plaintiff must plead facts supporting a strong inference "that *someone* whose intent could be imputed to the corporation acted with the requisite scienter" (emphasis supplied). The appeals court then considered whether plaintiff here had raised the required strong inference of scienter, and concluded that plaintiff had failed to plead facts raising a strong inference that anyone at the defendant companies acted with the necessary intent:

- Plaintiff alleged that the corporate defendants had access to information allegedly showing that the collateral had performed poorly as a result of faulty underwriting practices and that thus demonstrated the falsity of the public statements about the reasons for the underperformance of the collateral. (The company had attributed the poor performance of the collateral to a general weakness in the market for manufactured homes.) The Second Circuit found plaintiff's allegation insufficient to support a strong inference of scienter, because plaintiff had not alleged that anyone at the company had aggregated the information in a way that would have shown that loan origination practices undermined the performance of the collateral.
- Plaintiff also alleged that the defendants failed to review information that they had a duty to monitor. The Second Circuit found this allegation was similarly insufficient to support a strong inference of scienter, because plaintiff had never identified any reports "that would have come to light in a reasonable investigation and that would have demonstrated the falsity of the allegedly misleading statements."
- Finally, plaintiff alleged that certain unnamed agents of the corporate defendants were motivated to commit fraud by a desire to avoid disclosing the impaired value of the collateral. The Second Circuit concluded that this allegation too could not support a strong inference of scienter: the appeals court explained that it routinely rejects this proffered motivation, which applies equally to all corporate insiders, as insufficient to plead scienter in securities fraud cases.

The appeals court concluded that plaintiff had failed to allege the existence of information that would show that defendants' public statements had been misleading or that anyone at the company had possessed a "compelling motive" to mislead investors. The court explained that plaintiff's factual allegations therefore raised numerous competing inferences regarding scienter. The Second Circuit was unable to conclude that plaintiff's requested inference – that someone who was responsible for the allegedly misleading statements and whose scienter could be imputed to the corporate defendants had acted at least recklessly with regard to those statements – was at least as compelling as the competing inference – that the statements were not misleading or were the result of carelessness that did not rise to the level of recklessness.

The requirement that a plaintiff plead facts creating a strong inference that someone whose scienter can be imputed to the corporate defendant has the requisite scienter should put an end in the Second Circuit to the practice by some district courts of permitting plaintiffs to state a claim for securities fraud based on a theory of "collective scienter" – aggregating all knowledge held by any corporate agent and imputing that knowledge (and all its implications) to the corporate defendant. Under the theory of collective scienter, a plaintiff could be found to have pleaded scienter adequately even if he failed to allege that any one corporate agent had the requisite state of mind.

The appeals court did, however, instruct the district court to allow plaintiff to replead, and it did leave an opening for plaintiffs seeking to plead corporate scienter without identifying any *particular* corporate agent as having the requisite intent. The Second Circuit expressly stated that a plaintiff need not in all cases name the individual whose scienter is being imputed to the corporation. While the appeals court observed that, "in most cases, the most straightforward way to raise such an inference [of scienter] for a corporate defendant will be to plead it for an individual defendant," the court also stated that "it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant."

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