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ANTIFRAUD

Revisiting Corporate Scierter: In Search of a Middle Ground



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What does it mean for a public company to act with “intent to deceive” based on things that it says (or does not say) to its shareholders? Because a corporation is an inanimate entity that can only act or speak through a collection of human beings, the answer to that question is far from obvious, apart from the rare case of Enron-like institutionalized fraud. This philosophical question presents a central, threshold issue in almost all securities fraud cases.

In order to pursue a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission’s Rule 10b-5, a private plaintiff must sufficiently plead (and eventually prove) that a defendant acted with scienter – the “intent to deceive, manipulate, or defraud.” The scienter requirement might be relatively straightforward with respect to individual defendants, who either did or did not have reason to know that their own statements were inaccurate. But since corporations necessarily

speak or act through a number of officers, directors, or employees who do not all share the same brain, the task of determining whether a corporation knew something to be false can be far more elusive.

Courts have increasingly wrestled with the issue of corporate scienter since Congress passed the Private Securities Litigation Reform Act (“PSLRA”) in 1995. The PSLRA heightened the pleading standard in securities litigation, requiring plaintiffs to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” To comply with that statutory requirement, a court addressing a motion to dismiss a Rule 10b-5 claim must rigorously scrutinize the plaintiff’s allegations of scienter.¹ To meet that challenge, plaintiffs have sought an alternative to the traditional approach to scienter, which required the corporate official responsible for a purportedly material misstatement or omission to have knowledge of its falsity. To avoid the rigors of that requirement, plaintiffs would frequently plead that a corporation acted with “collective scienter,” attempting to impute the collective knowledge of a corporation’s employees and agents to the corporation itself, without having to tie that knowledge to statements or omissions made by the same individual.

Most federal courts of appeals have rejected the collective scienter theory and have hewed instead to some variation of the traditional approach. Only one court—the Sixth Circuit Court of Appeals—expressed tacit sup-

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¹ 15 U.S.C. § 78u-4(b)(2).

port for a collective scienter approach, making it a perceived outlier on the spectrum.

In its recent decision in *In re Omnicare, Inc. Securities Litigation*, 769 F.3d 455 (6th Cir. 2014), the Sixth Circuit attempted to clarify its earlier jurisprudence and set forth a new test for determining corporate scienter, adopting what it referred to as a “middle ground” approach. But *Omnicare*’s middle ground approach expands the scope of liability for public companies under Rule 10b-5 beyond that of any other circuit. In doing so, the Sixth Circuit shifts the focus away from management’s intent to defraud and towards a recklessness or even a negligence standard, creating tension with the PSLRA and Supreme Court precedent.

Existing Circuit Split Several federal courts of appeal have held that scienter can be imputed to the corporation only when the “maker” of the misstatement had knowledge of its falsity. In *Southland Securities Corporation v. INSpire Insurance*, the Fifth Circuit held that courts must “look 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).”² Under the traditional approach articulated in *Southland*, knowledge cannot be imputed to the corporation based on “disconnected facts known by different agents.”³ Three courts of appeals — the Third, Eleventh and D.C. circuits — have adopted this traditional approach, while three others — the Second, Seventh, and Ninth circuits — have adopted a modified version, relaxing the pleading standard in certain limited circumstances in which the plaintiff is unable to identify a specific individual defendant.⁴

The Sixth Circuit went a step further, beginning with its 2005 opinion in *City of Monroe Employees Retirement System v. Bridgestone Corp.*⁵ In *City of Monroe*, the plaintiffs brought claims under Section 10(b) and Rule 10b-5 alleging that Defendant Bridgestone Corporation’s Executive Vice President (“EVP”) knew that certain statements in the company’s annual report were false or misleading, but failed to correct them.⁶ However, the Court dismissed the claims against the EVP because the plaintiffs did not allege that he made the actionable misstatements. Nonetheless, despite the plaintiffs’ failure to link the CEO to the misstatements at issue, the Court held that the EVP’s scienter could be imputed to the corporation, and therefore the plaintiffs could pursue claims against Bridgestone.⁷ Although the Sixth Circuit did not expressly reject *Southland*’s traditional approach, *City of Monroe* has been viewed as a

tacit endorsement of collective scienter.⁸ The Sixth Circuit’s broad view of scienter thus established a clear divide among the circuits, and the Sixth Circuit remained an outlier at least until the 2014 *Omnicare* decision, which attempted to limit the reach of *City of Monroe* and redefine corporate scienter.

In Search of a Middle Ground In *In re Omnicare, Inc. Securities Litigation*,⁹ the plaintiff shareholders brought suit against pharmaceutical company Omnicare, Inc. for alleged material misstatements and omissions in the company’s 10-K filing regarding the company’s compliance with Medicare and Medicaid regulations. To plead scienter against the company, the plaintiffs pointed to the company’s former Vice President of Internal Audit, whose audits allegedly had flagged numerous supposed compliance deficiencies. Even though that officer did not sign the Form 10-K or otherwise make or endorse the alleged misrepresentations therein, the plaintiffs sought to impute to Omnicare his purported knowledge that the Form 10-K’s statements regarding the company’s regulatory compliance were inaccurate.

Notwithstanding the Sixth Circuit’s decision in *City of Monroe*, the district court dismissed the complaint because, among other reasons, the plaintiffs had failed to connect any of the individual defendants — who had signed the Form 10-K — to specific knowledge of fraud, and therefore could not prove that either the individuals or the corporation acted with scienter. The Sixth Circuit affirmed, but only after confirming that the former officer’s knowledge *could* be imputed to the corporation. In doing so the Court took pains to clarify and arguably recast the standard for determining corporate scienter.

Comparing the approaches taken in *Southland* and *City of Monroe*, Judge Moore identified flaws in both. The traditional approach adopted by the Fifth Circuit in *Southland* would insulate corporations from liability “‘in situations where a corporate policy, procedure, or *sub rosa* encouragement of illegal or tortious behavior results in the commission of an offense, but there is no single identifiable culpable actor.’”¹⁰ On the other hand, “reading our decision in *City of Monroe* too broadly could expose corporations to liability far beyond what Congress has authorized.”¹¹ Because “neither approach is ideal,” the Court concluded that “a middle ground is necessary.”¹²

The Court then set forth a new test for determining corporate scienter, holding that courts could look to the state of mind of any of the following actors:

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

² 365 F.3d 353, 366 (5th Cir. 2004).

³ *Id.*

⁴ Compare *In re Tyson Foods, Inc.*, 155 Fed. App’x 53, 57 (3d Cir. 2005); *Stevens v. InPhonic, Inc.*, 662 F. Supp. 2d 105, 121 (D.C. Cir. 2009); *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1017–18 (11th Cir. 2004); with *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008); *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 745 (9th Cir. 2008).

⁵ 399 F.3d 651 (6th Cir. 2005).

⁶ *Id.* at 688–90.

⁷ *Id.*

⁸ See Randall W. Bodner, et al., *Corporate Scienter After Janus*, 44 Sec. Reg. & Law Report 1639 (2012); see also Heather F. Crow, *Riding the Fence on Collective Scienter: Allowing Plaintiffs to Clear the PSLRA Pleading Hurdle*, 71 La. L. Rev. 313, 328 (2010) (“Only the Sixth Circuit, although not explicitly using the term ‘collective scienter,’ has permitted this type of theory in order to allow plaintiffs to adequately plead scienter.”).

⁹ 769 F.3d 455, 462 (6th Cir. 2014).

¹⁰ *Id.* (quoting Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 Colum. Bus. L. Rev. 81, 113–14 (2006)).

¹¹ *Id.*

¹² *Id.*

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 issuance¹³

The Court opined that “this formulation of the rule largely prevents corporations from evading liability through tacit encouragement and willful ignorance, as they potentially could under a strict *respondeat superior* approach,” while at the same time “protect[ing] corporations from liability—or 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.”¹⁴

Applying this standard to the facts before it, the Court held that the knowledge of the former officer—who had conducted the audits at issue—could be imputed to Omnicare for purposes of determining corporate scienter, as he “was both an ‘individual agent who . . . [allegedly] furnished information for, . . . [and] reviewed . . . the statement in which the misrepresentation was made before its utterance or issuance’ and potentially a ‘high managerial agent . . . who ratified . . . or tolerated the misrepresentation after its utterance or issuance[.]’ ”¹⁵

The ‘Omnicare’ Standard in Practice In theory, the *Omnicare* standard represents an appealing compromise between the traditional approach to corporate scienter first adopted by the Fifth Circuit in *Southland* and a pure collective scienter approach.¹⁶ In practice, however, *Omnicare*’s “middle ground” standard is overly broad, difficult to apply, and inconsistent with the PSLRA and Supreme Court precedent.

First, *Omnicare* describes as “probative” for purposes of determining whether the corporation acted with scienter the state of mind of any individual agent who, among other things, “furnished information for” or “reviewed” the statement at issue. Read literally, this

¹³ *Id.* (citation omitted). *Omnicare* borrowed this test from a 2006 Columbia Business Law Review article by two legal academics, Patricia S. Abril and Ann Morales Olazábal. See Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 Colum. Bus. L. Rev. 81, 113–14 (2006). *Omnicare* modified the test set forth by Abril and Olazábal by eliminating the second prong, which referred to scienter of “the corporation itself,” and which the Sixth Circuit dismissed as “highly theoretical.” *In re Omnicare, Inc. Sec. Litig.*, 769 F.3d at 476 n.2.

¹⁴ *Id.* at 477.

¹⁵ Ultimately, though, the Court determined that in light of other relevant factors, such as the large time lapse between *Omnicare*’s public disclosures and the whistleblower action alleging Medicare and Medicaid violations, the Court concluded that the plaintiffs failed to plead sufficient facts that would give rise to a strong inference of scienter. *Id.*

¹⁶ And, to be fair to the *Omnicare* panel, it was not at liberty to reverse the Sixth Circuit’s prior holding in *City of Monroe*, as it pointed out itself. The *Omnicare* holding could accordingly be viewed as a thoughtful attempt to reconcile *City of Monroe*’s endorsement of collective scienter with the more traditional holdings from other federal courts of appeal.

means that a court could potentially impute to the corporation the state of mind of any employee who was emailed (and thus presumably “reviewed”) a draft of the 10-Q or 10-K, as well as any employee who supplies information for use in the disclosure, no matter how removed the employee is from the actual preparation of the Q or K itself. Most public company annual and quarterly disclosure statements consolidate information taken from hundreds of sources. This could include region-specific sales figures, information about new or existing product lines, the status of internal audits, expenses incurred, inventory fluctuations, or countless other data points provided by non-management employees. The scope of liability for any large public company could be immense if the knowledge of any employee who furnishes information for a public disclosure could be imputed to the corporation.

In addition, this prong of the analysis — at least as styled by the law review article relied upon by the *Omnicare* panel — extends beyond corporate employees and encompasses third parties such as lawyers, accountants, public relations specialists, and other professionals.¹⁷ Thus, not only does the Sixth Circuit’s test seemingly pull in all levels of employees, but it also potentially allows for a finding of corporate scienter based on the knowledge of individuals who may have little day-to-day interaction with the company itself.

Second, the final prong of the *Omnicare* standard allows plaintiffs to prove scienter by looking to a “high managerial agent’s” failure to rectify the problem *after* uncovering it—with no need to prove knowledge or intent when the statement was made. The bar is lowered further by requiring only that such person “recklessly disregarded” or “tolerated” the statement after it was made. That standard goes well beyond Rule 10b-5’s prohibition of fraudulent misrepresentations by imposing an affirmative duty on the manager to investigate the veracity of a wide range of potential public statements, even if he or she had no reason to doubt the veracity of the statement when made.

In doing so, the Sixth Circuit has adopted a highly fact-intensive inquiry that is likely to generate a wide range of outcomes. In a recent case before the Ninth Circuit, the plaintiffs sought to impute scienter to the defendant company, NVIDIA Corp., under Rule 10b-5 by pointing to the state of mind of the Vice President of Investor Relations, the Chief Scientist, a senior engineering manager, a sales director, and a Director of Quality.¹⁸ While the Ninth Circuit rejected pleadings of scienter in that case because of a disconnect between the corporate agents and the alleged misstatements, the *Omnicare* standard might have permitted a different court to find that the corporation acted with scienter on the ground that its agents “tolerated” the alleged misrepresentations.

Third, *Omnicare* threatens to transform corporate scienter into a negligence standard, if not something even less forgiving for corporate defendants. The Supreme Court has interpreted Section 10(b) to “make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence,” and has rejected the notion that the statute creates any duty of in-

¹⁷ Abril & Olazábal, 2006 Colum. Bus. L. Rev. at 137.

¹⁸ *In re NVIDIA Corp. Sec. Litig.*, 2014 BL 282506 (9th Cir. Oct. 2, 2014).

quiry for public companies.¹⁹ But *Omnicare* threatens to do just the opposite by imposing liability on a corporation for not consulting with an expanded range of employees and third parties before making a public disclosure, or for the post-hoc failure of management to root out knowledge of potential misconduct or false statements by other employees.

The law review article relied upon by the *Omnicare* court suggests an even lower standard, proposing that plaintiffs should be able to establish “a corporation’s guilty knowledge through an analysis of its preventative and reactionary systems surrounding the offense”—i.e., by pleading that the corporation did not have adequate fraud-screening measures in place, or did not take sufficient measures to investigate potential misconduct or misstatements.²⁰ That approach would impose new compliance obligations on public companies, drastically converting an anti-fraud statute into something approaching strict liability for any material misstatements, potentially subject to an affirmative defense about the adequacy of the defendant corporation’s compliance efforts.

Fourth, *Omnicare*’s expansive view of Rule 10b-5 is in tension with the Supreme Court’s decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). In *Janus*, the Court narrowed the class of persons or entities who can be held liable for misstatements under Rule 10b-5, holding that “the maker of a statement is the person or entity with *ultimate au-*

thority over the statement, including its content and whether and how to communicate it.”²¹

While *Omnicare* involves the separate element of scienter, it undermines the limitations of *Janus* by potentially rendering a corporation liable in fraud for statements that the speaker did not have reason to know were incorrect. To the extent it allows a court to impute to the corporation as a whole the knowledge of employees who, though “connected” to them, did not themselves make or approve the challenged public misrepresentation or omission, *Omnicare* is inconsistent with the Supreme Court’s admonition to be “mindful that we 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.’ ”²²

Conclusion The self-described purpose of the Sixth Circuit’s decision in *Omnicare* was to rein in some of the sweeping language in *City of Monroe* while still preserving a modified version of the collective scienter doctrine. In this respect, the Court accomplished its goal. However, if the ultimate objective is to develop a workable solution that stays true to the purposes of PLSRA and Supreme Court precedent, then the *Omnicare* standard falls far short. This “middle ground” approach dispenses with bright-line rules in favor of a fact-intensive inquiry that invites creativity from the plaintiffs’ bar and leaves this area of the law uncertain and unpredictable. Given the importance of this issue to federal securities laws and the continued dissonance among federal courts, it should be only a matter of time before the Supreme Court weighs in. When that time comes, the *Omnicare* standard is unlikely to survive Supreme Court review.

¹⁹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

²⁰ *Abril & Olazábal*, 2006 Colum. Bus. L. Rev. at 137.; see also *Bilotta v. Novartis Pharm. Corp.*, No. 11 Civ. 0071 (PGG), 2014 BL 276520, at *14 (S.D.N.Y. Sept. 30, 2014) (holding that plaintiffs adequately pled corporate scienter by, *inter alia*, alleging that Novartis “violated its own internal policies governing speaker programs” and “created incentives for its sales representative to hold more sham events” to entice medical professionals to do business with Novartis).

²¹ *Janus Capital Group, Inc.*, 131 S. Ct. at 2302.

²² *Janus Capital Grp., Inc.*, 131 S. Ct. at 2302.