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Securities fraud cases are an exception to the permissive pleading rules of federal courts. The general pleading standard for a federal case is the "plausibility" standard announced by the United States Supreme Court in *Bell Atlantic Corp v. Twombly*.[1] The fact that securities fraud cases require a deviation from the normally uniform pleading standards evidences their unique nature and the delicate balance a court must strike in considering them. On one hand, a court must weigh the important public interests in protecting shareholders from the fraudulent conduct of corporate officers and directors, and in providing purchasers with a remedy for injuries related to such conduct. On the other hand, a court must consider an equally important interest in protecting corporations from baseless strike suits filed by opportunists looking to make a quick buck.[2] Faced with the prospect of expensive discovery, reputational damage, and a potentially enormous damages award, corporate defendants have a great incentive to settle even non-meritorious cases.[3] A long line of Second Circuit precedent, culminating with the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[4] has recognized that the inherent risk of abuse in securities fraud cases is unique and that heightened pleading standards are a necessary screening mechanism to keep frivolous suits from proceeding.[5] However, in June 2008, the Second Circuit announced a rule that undermines the well-established heightened pleading standards for securities fraud cases, and threatens to upset the balance struck by prior court decisions.

In *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, the Second Circuit granted an interlocutory appeal of the district court's order in a securities fraud case, and granted, in part, the defendant's motion to dismiss.[6] Though the Second Circuit vacated the district court's order,[7] finding scienter not adequately pled against the corporate defendants,[8] the Second Circuit agreed with the district court's finding that it is possible for a plaintiff to plead a corporate defendant's scienter ("corporate scienter") without adequately pleading the scienter of any

1. 550 U.S. 544 (2007). The "plausibility" standard requires a plaintiff to plead "enough facts to state a claim to relief that is plausible on its face." *Id.* at 570.

2. A "strike suit" is "[a] suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement. Black's Law Dictionary 1475 (8th ed. 2004). *See* Novak v. Kasaks, 216 F.3d 300, 307 (2d Cir. 2000) (noting "the 'inevitable tension' between the interests in deterring securities fraud and deterring strike suits.").

3. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 921 (2003).

4. 551 U.S. 308 (2007).

5. In fact, the "strong inference" pleading standard, adopted by Congress in the Private Securities Litigation Reform Act and interpreted by the United States Supreme Court in *Tellabs*, originated in the Second Circuit. *Id.* at 320 (citing Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979)).

6. Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc. 531 F.3d 190, 197 (2d Cir. 2008).

7. *Id.* at 197.

8. *Id.*

individually named defendant.[9] The Second Circuit defines "scienter" as "intent to deceive, manipulate, or defraud,[10] or reckless conduct,"[11] and it is the state of mind necessary for liability in a securities fraud action. This case comment contends that the new "corporate scienter"[12] pleading rule establishes a lower pleading threshold for corporate scienter in contradiction to well-established, heightened standards for pleading scienter, thereby undermining legislative and judicial efforts aimed at ensuring the dismissal of meritless suits.

During March and August of 1999, defendant Merit Securities Corp. ("Merit"), through its subsidiary Dynex Capital Inc. ("Dynex"), a financial services company, issued two sets of secured bonds, the Series 12 Bonds and the Series 13 Bonds, using as collateral a pool of home loans it had made over the previous three years.[13] As the value of the collateral began to decline due to defaults on the loans, defendant Dynex was forced to make two disclosures, the first in October 2003 and the second in April 2004.[14] The first disclosure indicated that Dynex had understated its repossession rates on the loans backing the Series 13 Bonds by 34%, and the second disclosure referred to an internal control deficiency that would result in a restatement of Dynex's previously reported earnings for two periods in 2003.[15] Following these disclosures, the prices of the Series 12 and 13 Bonds decreased dramatically, some by as much as 85%.[16]

In the wake of these price drops, plaintiff Teamsters Local 445 Freight Division Pension Fund ("Teamsters"), which had invested approximately $450,000 in the Series 13 Bonds,[17] filed a class action in the United States District Court for the Southern District of New York in February 2005.[18] The complaint named both Merit and Dynex as defendants (the "corporate defendants"), as well as Stephan Benedetti, president and CEO of Merit, and Thomas Potts, president and principle executive officer of Dynex (the "individual defendants"). Teamsters alleged violations of section 10(b) of the Securities Exchange Act of 1934.[19]

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9. *Id*. at 195.

10. ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99 n.3 (2d Cir. 2007) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976)).

11. ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99 n.3 (2d Cir. 2007) (citing *In re* Carter-Wallace, Inc. Sec. Litig., 220 F.3d 36, 39 (2d Cir. 2000)).

12. *In re* Dynex Capital Inc. Sec. Litig., No. 05 Civ. 1879, 2006 WL 1517580, at *3 (S.D.N.Y. June 2, 2006).

13. *Dynex*, 531 F.3d at 192.

14. *Id*. at 192–93.

15. *Id*. at 193.

16. *Id*.

17. *Id*.

18. *Id*.

19. *In re* Dynex Capital Inc. Sec. Litig., No. 05 Civ. 1879, 2006 WL 314524, at *1 (S.D.N.Y. Feb. 10, 2006).

Section 10(b) sets out the basic cause of action for securities fraud and provides: "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative . . . device or contrivance."[20] The Securities and Exchange Commission has further defined the prohibited conduct under section 10(b) by promulgating Rule 10b-5, which states:

> It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[21]

The requirement of scienter has been read into securities fraud actions under section 10(b) by the United States Supreme Court.[22]

Plaintiffs' allegations of fraud under section 10(b) fell into two general categories: (1) Dynex's failure to disclose its practice of buying high-risk loans to use as collateral for the bonds, and (2) defendants' misrepresentations relating to the true reason for the collateral's decrease in value.[23] Defendants moved to dismiss, alleging, *inter alia*, that plaintiffs failed to adequately plead scienter.[24]

In considering the motion to dismiss, the district court reiterated the well-established rule that in order to plead scienter by alleging reckless conduct, plaintiffs must specifically identify documents that defendants had access to that demonstrate the falsity of defendants' public statements.[25] The court held that scienter was not adequately pled as to the individual defendants because plaintiffs had alleged a scheme of corporate recklessness, but failed to connect that recklessness to either of the individual defendants. Specifically, the court found that plaintiffs failed to allege facts showing that the individual defendants had access to information or documents that demonstrated Dynex's public statements were false.[26] However, the court also held that a plaintiff need not plead scienter of a corporation's individual agents in order to successfully plead scienter of the corporation.[27] The court concluded that plaintiffs had sufficiently alleged a systematic corporate scheme to issue defective loans, and that the scheme constituted strong circumstantial evidence of recklessness on the part of Dynex and Merit.[28] Thus, the court held that scienter was adequately pled as to the corporate defendants.[29]

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20. 15 U.S.C. § 78j (2006).

21. 17 C.F.R. § 240.10b-5 (2009).

22. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

23. *Dynex*, 2006 WL 314524, at *1.

24. *Id*.

25. *Id*. at *9 (citing Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000)).

26. *Dynex*, 2006 WL 314524, at *9.

27. *Id*.

28. *Id*. at *9–10.

29. *Id*. at *10.

The corporate defendants subsequently moved for reconsideration of the district court's order, or alternately, for leave to bring an interlocutory appeal.[30] Defendants argued that the district court's approval of the so-called "corporate scienter" pleading theory was improper.[31] The court held that defendants had demonstrated that the issue of pleading corporate scienter was a "controlling question of law as to which there is [a] substantial ground for difference of opinion [and] . . . an [immediate] appeal . . . [may] materially advance the [ultimate] termination of [the] litigation"[32] and that the issue was thus ripe for interlocutory appeal.[33] The court granted leave for such appeal pursuant to 28 U.S.C. § 1292(b).[34]

On interlocutory appeal, the Second Circuit agreed with the district court that, as a matter of law, a plaintiff may plead corporate scienter without successfully pleading the scienter of named individuals within the corporation whose scienter may be ascribed to the corporation.[35] The court noted that under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), a complaint must give rise to a "strong inference" of scienter or face dismissal.[36] This "strong inference" was interpreted by the United States Supreme Court in *Tellabs* to mean that an inference of scienter must be at least as strong and compelling as any opposing inference.[37] Plaintiffs contended they had adequately pled scienter based on a theory of recklessness by (1) alleging that Dynex had access to information contradicting its public statements, and (2) alleging that defendants neglected information that they had a duty to monitor.[38] The court dismissed both arguments as inadequate for the same reason: the complaint did not specifically identify the particular documents that contained information showing the falsity of Dynex's public statements as required by the Second Circuit in *Novak v. Kasaks*[39] in order to plead recklessness.[40] Concluding that the inference of recklessness was not at least as strong as any opposing inferences of non-fraudulent intent, the court found that the *Tellabs* standard had not been satisfied and held that since the complaint did not adequately plead scienter on the part of the corporate defendants, the complaint must be dismissed under the PSLRA.

In *Dynex*, the Second Circuit held that, as a matter of law, it is possible for a plaintiff to adequately plead scienter on the part of a corporation without pleading

30. *Id.* at *1.

31. *Id.* at *2.

32. *Id.* at *3 (citation and quotations omitted).

33. *Id.*

34. *Id.*

35. Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc. 531 F.3d 190, 192 (2d Cir. 2008).

36. *Id.* at 194.

37. 551 U.S. at 314.

38. *Dynex*, 531 F.3d at 196.

39. 216 F.3d at 309.

40. *Dynex*, 531 F.3d at 196.

scienter on the part of a specific officer or employee of the corporation whose scienter could be imputed to the corporation.[41] This rule contradicts existing heightened standards for pleading scienter by announcing a lower threshold for plaintiffs to meet in order to plead corporate scienter and therefore undermines legislative and judicial efforts to encourage dismissal of frivolous suits at the pleading stage.

The PSLRA establishes a high standard for pleading scienter, requiring that a plaintiff "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind."[42] In *Tellabs*, the United States Supreme Court interpreted a "strong inference" of scienter as one that is at least as strong and compelling as any plausible opposing inference of non-fraudulent intent that could be drawn from the facts.[43] The Second Circuit recognizes recklessness as a sufficient state of mind to constitute scienter.[44] Reckless conduct is defined as:

> [A]t the least, conduct which is "highly unreasonable" and which represents "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[45]

A plaintiff can plead recklessness by showing that defendant either (1) "knew facts or had access to information suggesting that his or her public statements were not accurate," or (2) "failed to check information he or she had a duty to monitor."[46] Additionally, in order to plead recklessness in either of these two ways, a plaintiff must: (a) specifically identify the particular documents to which defendant had access that show defendant's public statements were false,[47] and (b) demonstrate that an individual defendant's knowledge is based on more than merely his position as a corporate officer or director.[48]

The corporate scienter pleading theory allows a plaintiff to plead scienter on the part of a corporation without successfully pleading scienter against any of the individual agents of the corporation who act on its behalf.[49] This rule plainly contradicts Second Circuit pleading requirements. Courts in the Second Circuit have not allowed plaintiffs to plead recklessness simply by alleging that an *individually named* defendant had a position in the corporate hierarchy and therefore must have known enough to know the statement was false.[50] The corporate scienter pleading

41. *Id*. at 192.

42. 15 U.S.C. § 78u-4(b)(2) (2000) (emphasis added).

43. *Tellabs*, 551 U.S. at 323–24.

44. *ATSI Commc'ns, Inc.,* 493 F.3d at 99 n.3.

45. *Novak,* 216 F.3d at 308 (citation omitted).

46. *Id*. at 311.

47. *Id*. at 309.

48. *In re* Health Mgmt. Sys., Inc. Sec. Litig., No. 97 Civ. 1865, 1998 WL 283286, at *6 (S.D.N.Y. June 1, 1998).

49. *Teamsters*, 531 F.3d at 192.

50. *In re Health Mgmt. Sys.*, 1998 WL 283286, at *6.

rule goes one step further than the situation the courts have already disallowed: it allows a plaintiff to plead recklessness by alleging that some *unnamed* individual within the corporate hierarchy must have known enough to know the statement was false. Clearly, this rule does not comply with the particularity requirements that a plaintiff identify documents to which defendant had access that show the defendant's statements were false, and that defendant's knowledge (of falsity) be based on more than simply his particular position in the corporate hierarchy.[51]

As its primary reasoning in support of its adoption of the corporate scienter pleading rule, the Second Circuit quoted a Seventh Circuit hypothetical example demonstrating a situation where the rule would be appropriate:

> [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. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There 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.[52]

It may be true that in a factual situation such as the one set forth by the Seventh Circuit, there is a strong inference of corporate scienter. But there are several flaws in the Second Circuit's use of the hypothetical in support of its adoption of the corporate scienter pleading rule. First, the Second Circuit gives no explanation of why it is possible to draw a strong inference of scienter in the hypothetical situation—except to assert that the announcement would be so "dramatic" it must have been known by corporate officials—and thus no guidance as to when the corporate scienter pleading rule may apply. Second, the hypothetical relies on the very reasoning that the Second Circuit scienter pleading rules have disallowed. By arguing that GM's announcement would be so "dramatic" that it must have been approved by officials sufficiently knowledgeable to know that it was false, the Seventh Circuit uses exactly the sort of "someone-must-have-known" reasoning that the Second Circuit has expressly prohibited.

Therefore, post *Dynex*, when deciding whether to bring a securities fraud suit, plaintiffs must hazard a guess as to whether the statements at issue in their cases are sufficiently "dramatic" to warrant an exception from the particularity pleading requirements. And if they guess incorrectly, their complaints will be dismissed for the same reason the complaint in *Dynex* was dismissed. In *Dynex*, despite the fact that the district court found that plaintiffs had sufficiently alleged a systematic corporate scheme to issue defective loans, that the scheme constituted strong circumstantial evidence of recklessness on the part of Dynex and Merit,[53] and the

51. *Id.*

52. *Dynex*, 531 F.3d at 195–96 (quoting Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008)).

53. *Id.* at 194.

arguably highly "dramatic" announcement that Dynex had understated its repossession rates by 34%, the Second Circuit did not allow plaintiffs to rely on the corporate scienter pleading rule. Instead the court applied the particularity pleading rules and found that the complaint did not specifically identify the particular documents that contained information contradicting Dynex's public statements.[54] Therefore, the court found the inference of corporate scienter insufficient to satisfy the *Tellabs* strong inference standard.[55] The court reasoned: "Teamsters would have us infer that *someone* whose scienter is imputable to the corporate defendants and who was responsible for the statements made was at least reckless toward the alleged falsity of those statements."[56] The court went on to say that such an inference is not at least as compelling as the opposing inference that the statements were simply careless mistakes by management based on incorrect information it received from below.[57]

The Second Circuit's reasoning on this point was correct, but the court did not address the fact that, by definition, the corporate scienter pleading rule allows plaintiffs to rely on the very inference the court found inadequate. By allowing plaintiffs to plead scienter on the part of the corporation without pleading scienter against any corporate agents, the corporate scienter rule asks courts to infer that some unidentified agent of the corporation, whose scienter could be imputed to the corporation, and who was responsible for the statements made, was at least reckless toward the falsity of the statements. The court ignores the necessary implication that in the majority of cases where a plaintiff relies on the rule to plead a corporation's scienter—without identifying the specific individuals whose scienter can be imputed to the corporation—the inference of corporate scienter will be tenuous. There may be an exception for a very narrow set of situations such as the one put forth by the Seventh Circuit in which the corporation's statement is sufficiently "dramatic" or extreme that a strong inference of corporate scienter arises without pleading scienter against specific individuals. But the Second Circuit does not acknowledge the corporate scienter pleading rule as an exception, or as inconsistent with the existing pleading rules, and gives little guidance as to when a plaintiff may rely on the rule.

By not delineating the corporate scienter pleading rule as applicable only in exceptional cases and defining what those cases are, the Second Circuit ruling encourages plaintiffs to bring cases attempting to rely on the rule by asserting only general allegations of scienter; in other words, exactly the kind of cases the stringent pleading rules are aimed at eliminating. By encouraging these types of cases, the corporate scienter pleading rule ignores the strong policy consideration behind the heightened pleading rules: that baseless suits are detrimental to the American capital markets system in general, and that they abuse and damage a tool—the private

54. *Id.* at 196.

55. *Id.* at 197.

56. *Id.*

57. *Id.*

securities suit—that is vital to maintaining integrity in the capital markets system.[58] The Second Circuit's stringent pleading requirements help to avoid abuses such as "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action."[59] As a matter of simple fairness, the Second Circuit's stringent pleading requirements prevent plaintiffs who have alleged no specific facts that suggest liability on the part of an agent of the corporation from going on a fishing expedition through discovery.[60]

The corporate scienter pleading rule announced in *Dynex* is incompatible with the rest of the Second Circuit's case law establishing strict rules for pleading scienter on a theory of recklessness. In *Dynex*, the Second Circuit encourages plaintiffs to rely on the corporate scienter pleading rule to file complaints asserting only general allegations, while giving little guidance as to when, if ever, such a case could actually raise a strong inference of recklessness without satisfying the particularity pleading requirements. *Dynex* itself demonstrates that most of those complaints attempting to rely on the corporate scienter pleading rule will be analyzed under the particularized recklessness pleading requirements and will necessarily be dismissed for failure to satisfy them.

58. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.); *see Tellabs*, 551 U.S. at 313 (recognizing the usefulness of meritorious private securities fraud suits as a supplement to criminal and civil penalties, as well as the danger that such suits will be "employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."); Perino, *supra* note 3, at 922–23 (noting that the purpose of the PSLRA was to create procedural hurdles, including the heightened pleading standard for scienter, designed to reduce the damage done by frivolous suits without restricting useful meritorious cases); Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1466–67 (2004) (contrasting the usefulness of securities suits as a means of disciplining corporate agents against the danger of frivolous suits filed by plaintiffs' attorneys solely for settlement money).

59. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.); *see* Perino, *supra* note 3, at 920 ("Often cases were brought within days of a significant stock price drop, with apparently very little investigation into their merits."); *see* Choi *supra* note 58, 1466–67 (2004) (describing frivolous lawsuits to encompass both suits filed with no expectation of finding any evidence of culpable behavior by the defendant and suits that are filed solely in an attempt to extract settlement money since the cost of a trial would clearly exceed any possible damages award).

60. H.R. Rep. No. 104-369, at 37 (1995) (Conf. Rep.) (quoting a witness describing a scheme where "once the suit is filed, the plaintiff's law firm proceeds to search through all of the company's documents and take endless depositions for the slightest positive comment which they can claim induced the plaintiff to invest and any shred of evidence that the company knew a downturn was coming.").