

# Securities Litigation & Regulation

COMMENTARY

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## When Does a Company Intend to Lie?

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Although *scienter* — the intent to defraud — is heavily litigated in securities cases, the circumstances in which it will be imputed to a corporation are not well defined. The issue has generated substantial scholarship,<sup>1</sup> but, with very limited exceptions, was not addressed by courts until the U.S. Court of Appeals for the 5th Circuit decided *Southland Securities Corp. v. INSpire Insurance Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004).

In *Southland* the 5th Circuit held that it would evaluate corporate *scienter* on an agent-by-agent basis and would not look “generally to the collective knowledge of all the corporation’s officers and employees acquired in the course of their employment.”<sup>2</sup> The parties had not briefed the issue of corporate *scienter*, and the decision highlights the virtues of the adversarial process, since the court’s *sua sponte* analysis almost certainly got it wrong.

Since *Southland* defendants have argued in a number of cases that under Section 10(b) of the Securities Exchange Act of 1934 plaintiffs are required to identify a particular management-level individual who possessed the intent to deceive the investing public in order to plead *scienter* against the business entity.

While this argument has been squarely rejected in several district court decisions, it has been endorsed in passing by the 4th and 9th Circuits, and the 2nd Circuit recently granted interlocutory appeal in a case where the district judge found substantial ground for difference of opinion on the proper scope of corporate *scienter*, *In re Dynex Capital Inc. Securities Litigation*, No. 05 Civ. 1897 (HB), 2006 WL 1517580, at \*3 (S.D.N.Y. June 2, 2006).

The 5th Circuit failed to recognize the consequences of its *Southland* holding and also neglected to consider alternative standards. While the court drew corporate *scienter* too narrowly by tying it to a particular officer or employee, it was right to reject the alternative “collective knowledge” principle it articulated, which would have cast the net of corporate *scienter* far too broadly.

The correct approach, by contrast, would determine whether a company’s statements evince intentional fraud or recklessness on the part of senior management, taking into account particularized allegations as to facts widely known within the firm and knowledge possessed by one or more senior executives. Notably, dozens of decisions implicitly adopt this approach and cannot be reconciled with the rule set forth in *Southland*.

### Framing the Issue

Although Congress clearly contemplated corporate liability under Section 10(b),<sup>3</sup> the Exchange Act does not provide guidance on when an entity will be deemed to have acted with *scienter*. No one apparently takes issue with the narrowest basis for corporate *scienter*: the intent of an individual who publicly speaks on behalf of a company. With limited exceptions, courts (including the 5th Circuit) also accept that the intent of non-speaking senior managers, and perhaps more junior employees involved in issuing a public statement, will support corporate *scienter*.<sup>4</sup>

Far less developed is the case law addressing the point raised in *Southland*: whether an entity can possess *scienter* if the plaintiff fails to adequately allege it against a particular, identified agent.

### Rationale for Restrictive, Single-Agent *Scienter*

The 5th Circuit itself did not articulate a rationale for its holding in *Southland*, instead relying on several earlier decisions it found relevant. Defendants argue that because “[a] corporation can only act through its employees and agents,”<sup>5</sup> finding *scienter* without identifying a particular individual who possessed fraudulent intent would create an unjustified legal fiction.

Defendants subsequently have also argued that finding corporate *scienter* without naming a particular individual would enable plaintiffs to allege fraud without establishing fault by combining the knowledge of one agent with the innocent false statement of a second agent.

### Scope of Corporate *Scienter*

The response to these arguments and the rationale for imposing liability on an entity in the absence of an identified, individual agent are best understood by reference to the specific circumstances in which such liability should exist:

- *First*, where a number of individuals, such as an audit team, collectively accomplish a fraud;
- *Second*, where a company manifests an organizational indifference to appropriate monitoring and communication that rises to the level of recklessness or willful blindness; or
- *Third*, where fraud by a company’s senior management is evident, but insufficient access to the relevant evidence prevents the plaintiff from tying the fraud to particular individuals.

Outside these limited circumstances, corporate *scienter* should ordinarily depend on the intent of an individual agent. For example, in situations where liability is asserted based on a statement by a particular officer and that officer concedes to having all relevant facts, the *scienter* inquiry should be limited to the state of mind of that officer.

As discussed in the cases cited above,<sup>6</sup> corporate *scienter* is also properly limited to situations involving intentional or reckless conduct by senior management.

Contrary to the view suggested by some defendants, finding *scienter* without a single, identified agent does not eliminate the requirement that a plaintiff show fraudulent intent or recklessness. Rather, it simply allows a plaintiff to prove *scienter* by reference to the knowledge and conduct of multiple or unidentified agents, instead of by reference only to specific, identified individuals.

### Rationale for the Broader Rule

#### **Organizational Culture**

First, the importance of organizational culture supports finding corporate *scienter* without establishing a particular agent’s intent. As articulated in a leading work in the field of organizational behavior, “The organizational and social environment in which the decision-maker finds himself determines what consequences he will anticipate, what ones he will not; what alternatives he will consider, what ones he will ignore.”<sup>7</sup>

In an article addressing the relationship between corporate culture and fraud, one commentator concludes, “If we are seriously interested in deterring corporate deception, then fraud liability should not turn on conscious awareness by the specific senior executives responsible for corporate communications of the misleading nature of their misstatements or omissions.”<sup>8</sup> Two other commentators, in an article setting out a comprehensive model of corporate *scienter* in securities fraud litigation, also ascribe a leading role to corporate culture.<sup>9</sup>

In addition, the single-agent approach would tie the hands of judges faced with frauds that do not involve highly immoral personal conduct. Experience teaches that judges sometimes make Solomonic rulings in securities cases, dismissing individual wrongdoers while retaining corporate defendants where they conclude that individual culpability is limited. The drafters of the Model Penal Code observed this phenomenon in criminal verdicts, noting that juries “have held the corporate defendant criminally liable while acquitting the obviously guilty agents who committed the criminal acts.”<sup>10</sup> The drafters attribute this to “a recognition that the social consequences of a criminal act may fall with a disproportionately heavy impact on the individual defendants where the conduct involved is not of a highly immoral character.”<sup>11</sup>

#### **Compliance Programs and the Danger Of Compartmentalization**

The single-agent approach would also allow companies to avoid liability by compartmentalizing knowledge and would thereby undermine effective corporate compliance programs.

Congress and the U.S. Department of Justice have both recognized the essential role of compliance programs in deterring fraud. DOJ guidance places substantial weight on the quality of a business organization’s compliance program in determining whether to indict.<sup>12</sup>

Similarly, when Congress enacted the Sarbanes-Oxley Act of 2002, it directed a review of the U.S. sentencing guidelines to ensure they were “sufficient to deter and punish organizational criminal misconduct.”<sup>13</sup> The U.S. Sentencing Commission responded with detailed guidelines for corporate compliance programs.<sup>14</sup>

A rule that bases corporate liability solely on the fault of a particular employee discourages compliance programs because such programs, by design, increase the likelihood that an individual corporate manager can be charged with actual knowledge in making or approving a false statement. By contrast, a company that limits oversight, compartmentalizes information and encourages a policy of “see no evil, hear no evil” reduces the chances of tracing relevant information to an individual officer on whom single-agent corporate *scienter* could be based.

Many cases and commentators emphasize exactly this danger of compartmentalization in reaching their decision to impose liability without naming a specific, individual wrongdoer.<sup>15</sup> For example, in *United States v. Philip Morris USA Inc.*, 449 F. Supp. 2d 1, 897 (D.D.C. 2006), the court cautioned that under a strict single-agent approach, “defendants could avoid liability by simply dividing up duties to ensure that fraudulent statements were only made by uninformed employees.”

### **Problems of Attribution**

Finally, a single-agent rule would also preclude liability, even when fraud is evident, if a plaintiff is unable to identify a particular, responsible corporate agent. To state this differently, even where it is clear that *someone* in senior management intended a fraud, a single-agent rule would eliminate corporate liability unless the injured investor was able to plead *who*.

### **Several Courts Since *Southland* Have Expressly Rejected Its Single-Agent Rule**

Several courts since *Southland* have considered and squarely rejected the agent-by-agent approach to corporate *scienter* that the 5th Circuit adopted.

In *In re WorldCom Inc. Securities Litigation*, 352 F. Supp. 2d 472 (S.D.N.Y. 2005), the court considered claims against WorldCom’s auditor, Arthur Andersen. Rejecting Andersen’s argument that *scienter* had to be alleged with respect to a particular employee, the court said: “To carry their burden of showing that a corporate defendant acted with *scienter*, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with *scienter*. Proof of a corporation’s collective knowledge and intent is sufficient.”<sup>16</sup>

Accordingly, the court ruled that: “Andersen’s argument that the lead plaintiff must show that at least a single Andersen employee acted with the requisite *scienter* can be swiftly rejected. ... The lead plaintiff is entitled to show reckless misconduct through a cumulative pattern of decisions and inaction by several Andersen auditors that encompassed a multitude of important accounting issues.”<sup>17</sup>

Similarly, in *Dynex*, the case now on appeal to the 2nd Circuit, the District Court held that the plaintiff had “aptly described a pattern of reckless corporate behavior” with respect to fraudulent misrepresentation of loan underwriting practices by alleging that the defendant company had “systematically originated defective loans, despite clear signs that borrowers were not creditworthy.”<sup>18</sup> Because the plaintiff had not tied the fraud to the named senior executives, the court dismissed the claims against them, but held that “[a] plaintiff may, and in this case has, alleged *scienter* on the part of a corporate defendant without pleading *scienter* against any particular employees of the corporation.”<sup>19</sup>

In a third recent decision, the court in *In re Marsh & McLennan Cos. Securities Litigation*, No. 04-CV-8144 (SWK), 2006 WL 2057194, at \*23 (S.D.N.Y. July 20, 2006), cited *WorldCom* and *Dynex* and endorsed their holdings, noting the “important function” of a rule that allows plaintiffs to plead *scienter* without identifying a particular wrongdoer “in situations where widespread corporate fraud cannot be connected to individual defendants at the pleading stage.”

### **Many Decisions Implicitly Reject Single-Agent *Scienter***

The explicit holdings of *WorldCom*, *Dynex* and *Marsh & McLennan* are implicit in the many other decisions upholding securities claims against corporate entities alone, either where no individual defendant had been named or where all named individuals were dismissed. These cases are incompatible with a rule that would require intent on the part of a particular, individual agent. A survey of district court decisions in the 2nd Circuit in just the past three years found 10 decisions in which Section 10(b) claims were allowed to proceed against entities alone.<sup>20</sup>

Several 2nd Circuit decisions are also contrary to a single-agent rule. In *AUSA Life Insurance Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000), the court considered Section 10(b) claims by debt holders against an auditor. No individual associated with the auditor was named. The 2nd Circuit nonetheless “address[ed] whether E&Y had the requisite intent to sustain the fraud claims.” Focusing exclusively on the intent of the auditor itself, the court

held that “we can easily find that E&Y possessed the requisite intent to deceive, manipulate or defraud.”<sup>21</sup>

Reflecting the entity-wide nature of its inquiry, the court further said: “We have presumed, in different factual circumstances, that the requisite intent exists ‘[w]hen it is clear that a scheme, viewed broadly, is necessarily going to injure.’ Such a presumption is appropriate in circumstances such as these, where a large entity, firm, institution or corporation is acting in a manner that easily can be foreseen to result in harm.”<sup>22</sup>

Other 2nd Circuit cases implicitly rejecting narrow, single-agent *scienter* include *Levitt v. Bear Stearns & Co.*, 340 F.3d 94 (2d Cir. 2003) (reversing dismissal of fraud claims against a corporate entity, although only the firm and its corporate parent were named as defendants), and *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (*scienter* adequately pleaded against broker-dealers, although only the entities themselves were named).

Courts in other circuits also implicitly reject a restrictive, single-agent *scienter* rule. In *City of Monroe Employees Retirement System v. Bridgestone Corp.*, 399 F.3d 651, 687, 690 (6th Cir.), *cert. denied*, 126 S. Ct. 423 (2005), the 6th Circuit upheld Section 10(b) claims against a tire manufacturer based on a “divergence between internal reports and external statements on the same subject,” without reference to the intent of any individual officer or employee, and it dismissed claims against both corporate officers named in the complaint. Courts similarly dismissed individual defendants while retaining their corporate employers in *In re Motorola Securities Litigation*, No. 03-CV-287 (RRP), 2004 WL 2032769 (N.D. Ill. Sept. 9, 2004), and *In re NUI Securities Litigation*, 314 F. Supp. 2d 388, 410-15 (D.N.J. 2004).

### Criminal Law Supports Broader Corporate *Scienter*

Criminal law also supports a rule that extends corporate *scienter* beyond the intent of any single agent. In *United States v. Bank of New England*, 821 F.2d 844 (1st Cir. 1987), the court considered a bank’s appeal from a conviction for failure to report currency transactions. The bank objected to the trial judge’s instruction that it could be convicted if the jury found “that the bank was flagrantly indifferent to its obligations.”<sup>23</sup>

The 1st Circuit affirmed, holding that “willfulness could be found via flagrant indifference by the bank toward its reporting obligations” and, in light of such willfulness, the “collective knowledge” of its employees was properly imputed to the bank. *Bank of New England* is recognized as the “seminal” case on this issue.<sup>24</sup>

Two commentators analyzing *Bank of New England* note that the 1st Circuit’s treatment of “collective knowledge” has sometimes been misconstrued as a “bogeyman” that could “creep up on [executives] and convict their companies of criminal acts that neither they nor any employee had any intention of committing.”<sup>25</sup> In fact, they note: “[N]o court has ever used knowledge aggregation in such a frightening way. ... Before courts will collectivize knowledge, they will first demand a showing that corporations deliberately attempted somehow to compartmentalize or avoid inculpatory information.”<sup>26</sup>

*Southland’s* rejection of a rule based on the “collective knowledge of all the corporation’s officers and employees acquired in the course of their employment” suggests that the 5th Circuit misinterpreted *Bank of New England* in this way, erroneously concluding that a broader rule would allow knowledge to be aggregated and liability imposed without fault.

The government’s recent RICO litigation alleging fraud by tobacco companies and related organizations regarding the health effects of smoking indicates the proper use of “collective knowledge” in Section 10(b) cases, consistent with the approach outlined above.

In *United States v. Philip Morris USA Inc.*, 449 F. Supp. 2d 1 (D.D.C. 2006), the court noted that the harmful effects of smoking were known to researchers employed by the defendant companies and that contrary statements had been made by senior officers of the companies. Based on these facts, the court held, “Specific intent of individual [defendant companies] and their employees can be inferred from the collective knowledge of each defendant company itself and the reckless disregard of that knowledge evidenced in statements made by, and on behalf of, each defendant company.”<sup>27</sup>

### *Southland* Fails to Justify Its Holding

*Southland* established its single-agent *scienter* rule without discussing why that rule was desirable or superior to the alternatives. Rather, it justified the rule by citing a number of earlier decisions, mostly non-securities cases, in which courts refused to impute one agent’s knowledge to a second agent who innocently made a false statement as a basis for fraud — the no-fault “collective knowledge” approach rightly rejected by the 5th Circuit. As discussed below, none of the decisions cited — except a single district court ruling — actually supports the 5th Circuit’s single-agent rule.

The District Court decision that *Southland* cited, *In re Apple Computer Inc. Securities Litigation*, 243 F. Supp. 2d 1012 (N.D. Cal. 2002), like *Southland* itself, contained no



analysis. After *Southland* was issued, the District Court's decision in *Apple* was indirectly affirmed by the 9th Circuit, reviewing dismissal of an amended complaint in the action. The 9th Circuit's unpublished opinion, *In re Apple Computer Inc. Securities Litigation*, 127 F. App'x 296 (9th Cir. 2005), repeated the District Court's corporate *scienter* rule verbatim, holding that a corporation can possess *scienter* "only if the individual corporate officer making the statement has the requisite level of *scienter* at the time he or she makes the statement."<sup>28</sup>

As noted above,<sup>29</sup> no other court (including the 5th Circuit) has adopted such a narrow rule, and for good reason; taken literally, it would allow a company to avoid liability for any statement simply by shielding its spokesperson from contrary knowledge. The only authority cited by the 9th Circuit was an earlier 9th Circuit decision (discussed below), which it, like the District Court, misquoted.<sup>30</sup>

Excepting *Apple*, the few pre-*Southland* decisions addressing corporate *scienter* in securities cases considered the issue in the context of collateral disputes and recognized that corporate *scienter* can exist without identifying a particular wrongdoer.

In *In re Warner Communications Securities Litigation*, 618 F. Supp. 735 (S.D.N.Y. 1985), the court was faced with a motion for approval of a class settlement. Rejecting an argument that a greater share of liability should have been attributed to corporate officers, the court said: "[T]he requisite degree of *scienter* is likely to be easier to attribute to Warner than to the individual defendants. As to Warner, plaintiffs arguably need only show ... that Warner management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace."<sup>31</sup>

The 9th Circuit decision relied on in the *Apple* rulings was *Nordstrom Inc. v. Chubb & Son Inc.*, 54 F.3d 1424, 1435 (9th Cir. 1995), which addresses whether a corporation's D&O liability insurance carrier could avoid paying a portion of the corporation's securities fraud settlement because the settlement should have been allocated between the corporation's covered officers and the corporation itself (which was not covered). The court cited and distinguished *Warner Communications*, holding that on the facts before it, there was no basis for attributing fault to anyone other than a covered officer: "[T]here is no evidence in this case to support 'collective *scienter*' without a concurrent finding that a defendant director or officer also had the requisite intent," and "On this record, we see no way that [the insurer] could show that the corporation, but not any individual defendants, had the requisite intent to defraud. Thus, any direct corporate liability would be derivative of,

or concurrent with, D&O liability."<sup>32</sup>

Thus, the 9th Circuit acknowledged that corporate *scienter* could exist on appropriate facts in the absence of a particular, individually responsible agent.<sup>33</sup>

The 9th Circuit's holding in *Nordstrom* was echoed by the 7th Circuit in *Caterpillar Inc. v. Great American Insurance Co.*, 62 F.3d 955 (7th Cir. 1995), which presented a similar dispute between a D&O carrier and a corporation involving a securities fraud class-action settlement. The court observed, "Indeed, there are conceivable situations where the individual actors would not be liable but their corporate employer would be, for example where a case depends on the collective *scienter* of its employees or where defenses are available to individuals but not the corporation."<sup>34</sup> The court then remanded to allow the insurer an opportunity to prove direct corporate liability based on "collective *scienter*" or other grounds.<sup>35</sup>

Likewise, the other authorities cited by the 5th Circuit in *Southland* did no more than properly refuse to find fraud in situations where plaintiffs sought to impose liability for innocent misstatements by aggregating the knowledge of separate agents. The court in *Southland* first cited sections of the Restatement (Second) of Agency addressing imputation of knowledge. Like its predecessor, the updated Restatement (Third) of Agency, published last year, correctly states 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."<sup>36</sup>

At the same time, the Reporter's Notes to the Restatement (Third) cite with approval a case in which corporate malice was established based on knowledge imputed from one agent to a second (unnamed) agent under circumstances suggesting "reckless disregard" or "conscious indifference" by the company. *Fleming v. U-Haul Co.*, 541 S.E.2d 75, 77-78 (Ga. Ct. App. 2000).

The Restatement (Third) also emphasizes the need to impute knowledge due to the dangers of compartmentalization and willful blindness. It observes: "[I]mputation encourages a principal to develop effective procedures for the transmission of material facts, while discouraging practices that isolate the principal or co-agents from facts known to an agent. ... Imputation thus reduces the risk that a principal may deploy agents as a shield against the legal consequences of facts the principal would prefer not to know."<sup>37</sup>

The Restatement further notes: "A principal may also implicitly encourage reticence through the incentives it provides to agents and other mechanisms of control

that the principal deploys. ... Imputation creates strong incentives for principals to design and implement effective systems through which agents handle and report information."<sup>38</sup> Accordingly, the Restatement (Third) of Agency actually endorses an approach that would prevent a company from evading liability through compartmentalization.

The other cases cited in *Southland* similarly do not support its holding. In *Woodmont Inc. v. Daniels*, 274 F.2d 132, 136-38 (10th Cir. 1959), the court held that the knowledge of senior executives could not be imputed to field representatives who made honest but incorrect statements, and the court ultimately imposed liability on the company for misrepresentations made directly by senior executives. Similarly, in *Gutter v. E.I. du Pont de Nemours*, 124 F. Supp. 2d 1291, 1311 (S.D. Fla. 2000), the court rejected fraud liability for discovery abuses "based on disconnected facts known by different agents" but proceeded to impose liability based on individual attorneys' fraudulent intent.

In *First Equity Corp. v. Standard & Poor's Corp.*, 690 F. Supp. 256 (S.D.N.Y. 1988), *aff'd*, 869 F.2d 175 (2d Cir. 1989), the court rejected an effort to "attribute to Standard & Poor's the combined knowledge of several of its employees in order to hold the corporation liable for fraud" after finding that "inconsistencies in the understandings" of various employees "[did] not nearly show" recklessness on the part of the company. Notably, the judge later held an auditor liable under Section 10(b) although no individual employee was identified.<sup>39</sup>

In the final case *Southland* cited, *United States v. LBS Bank-New York Inc.*, 757 F. Supp. 496 (E.D. Pa. 1990), the court considered a split verdict of the type discussed by the Model Penal Code drafters quoted above: The jury convicted a corporation while acquitting its sole agent. While the court noted in the margin that "at least one agent" was required to possess the requisite intent, it also upheld the corporation's conviction, observing that acquittal of the chairman "simply could be a product of juror lenity."<sup>40</sup> Thus, *LBS Bank* illustrates the wisdom of a rule that imposes corporate liability in some situations without corresponding agent fault.

### **Cases Have Approved *Southland*, But Not Applied Its Narrow Rule**

While several cases outside the 5th Circuit have endorsed *Southland*, none has actually applied its single-agent rule to reject corporate *scienter* on facts that would have supported *scienter* under the broader rule outlined above.

In *Higginbotham v. Baxter International Inc.*, No. 04 C 4909, 2005 WL 1272271, at \*5, \*8 (N.D. Ill. May 25, 2005), the

court cited *Southland* and rejected the plaintiffs' attempt to impose liability on a U.S. corporation for accounting fraud by subordinate managers in Brazil. Consistent with the broader rule above, however, the court refused to impute the knowledge of lower-level managers to the company's senior management in the absence of any showing of intent or recklessness on their part.

In *Kinsey v. Cendant Corp.*, No. 04 Civ. 0582 (RWS), 2004 WL 2591946, at \*13 (S.D.N.Y. Nov. 16, 2004), an employment case, the court similarly held that knowledge possessed by the employer's board of directors could not be imputed to a supervisor who innocently gave inaccurate information to the plaintiff, a former executive. There was no allegation of recklessness or willful blindness on the part of the supervisor or board.

In *In re Tyson Foods Inc. Securities Litigation*, 155 F. App'x 53, 57-58 (3d Cir. 2005), the court correctly refused to look for corporate *scienter* beyond the speaker where he (the company's general counsel) had all relevant facts. As noted above, when all relevant knowledge and statements are concentrated in a single, identified, senior-level manager, there is no basis to look beyond that individual's state of mind.

Most recently, the 4th Circuit expressly approved *Southland* in *Teachers' Retirement System of Louisiana v. Hunter*, 2007 WL 509787, at \*18 (4th Cir. Feb. 20, 2007), holding that "if the defendant is a corporation, the plaintiff must allege facts that support a strong inference of *scienter* with respect to at least one authorized agent of the corporation, since corporate liability derives from the actions of its agents." However, the 4th Circuit also agreed with the lower court that a "probing *scienter* inquiry was rendered moot" because the complaint failed to adequately plead a misleading statement or omission, so the court's discussion of *scienter* was dicta, and the case provided no occasion to squarely evaluate the proper scope of corporate *scienter*.

### **Conclusion**

In sum, a rule that restricts corporate *scienter* to situations where fraudulent intent is alleged against a particular agent would allow companies to escape liability by compartmentalizing negative information, discourage effective corporate compliance programs, ignore the important role of organizational culture in fostering fraud, prevent courts from dismissing individuals even when they determine that a company itself is the principal wrongdoer and preclude liability, even in the face of clear wrongdoing, when the particular responsible individual cannot be identified. At least three recent decisions in the Southern District of New York have rightly rejected this approach,

and such a rule is inconsistent with numerous trial and appeals court decisions.

Under the correct approach to corporate *scienter*, courts would evaluate whether a company's statements reflect intentional fraud or recklessness by senior management, and their analysis would consider specific allegations of widespread knowledge and conduct within the firm, as well as information possessed by one or more senior executives.

## Notes

<sup>1</sup> See Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81; Craig L. Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934*, 1989 B.Y.U. L. REV. 1227; Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003) [hereinafter Langevoort, *Agency Law*]; Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Misdemean Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 130 (1997) [hereinafter Langevoort, *Organized Illusions*]. For the related topic of corporate intent under criminal law, see Kathleen Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 RUTGERS L.J. 593 (1988); Comment, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287 (1990); Thomas A. Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 GEO. WASH. L. REV. 210 (1997); William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647 (1994).

<sup>2</sup> *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d at 366 (5th Cir. 2004).

<sup>3</sup> See Exchange Act § 10, 15 U.S.C. § 78j (prohibiting "any person" from engaging in the proscribed acts), and § 3(a)(9), 15 U.S.C. § 78c(a)(9) (defining "person" to include a "company").

<sup>4</sup> E.g., *Adams v. Kinder-Morgan Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003) (corporate *scienter* depends on "[t]he *scienter* of the senior controlling officers"); *Southland*, 365 F.3d at 366 (corporate *scienter* can be based on "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]"). See generally Abril & Olazábal, *supra* note 1, at 135; Griffin, *supra* note 1, at 1231-35. See also *In re Marsh & McLennan Cos. Sec. Litig.*, No. 04-CV-8144 (SWK), 2006 WL 2057194, at \*22 (S.D.N.Y. July 20, 2006) (noting that "[w]hile there is no simple formula for how senior an employee must be in order to serve as a proxy for corporate *scienter*, courts have readily attributed the *scienter* of management-level employees to corporate defendants"); *In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 627 (S.D.N.Y. 2005) (imputing *scienter* from senior, non-speaking officers and noting that "nothing in Rule 9(b) or the PSLRA requires a plaintiff to allege that the same individual who made an alleged misstatement on behalf of a corporation personally possessed the required *scienter*"); *Higginbotham v. Baxter Int'l Inc.*, No. 04 C 4909, 2005 WL 1272271, at \*8 (N.D. Ill. May 25, 2005). But see *In re Apple Computer Inc. Sec. Litig.*, 127 F. App'x 296 (9th Cir. 2005) ("A corporation is deemed to have the requisite *scienter* for fraud only if the individual corporate officer making the statement has the requisite level of *scienter* at the time that he or she makes the statement."); *In re Tyson Foods Inc. Sec. Litig.*, No. Civ.A. 01-425-SLR, 2004 WL 1396269, at \*12 (D. Del. June 17, 2004)

("For a corporation to have primary liability under Section 10(b) and Rule 10b-5, *scienter* must be present with respect to at least one of the officers or agents who made a false or misleading statement.").

<sup>5</sup> *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001).

<sup>6</sup> See note 4 and related text.

<sup>7</sup> JAMES G. MARCH & HERBERT A. SIMON, *ORGANIZATIONS* 160 (2d ed. 1993), quoted in Langevoort, *Organized Illusions*, *supra* note 1, at 130.

<sup>8</sup> Langevoort, *Organized Illusions*, *supra* note 1, at 158.

<sup>9</sup> See Abril & Olazábal, *supra* note 1, at 160-64.

<sup>10</sup> Model Penal Code § 2.07 cmt. c (1985), quoted in Abril & Olazábal, *supra* note 1, at 126.

<sup>11</sup> *Id.*

<sup>12</sup> See Memorandum From Larry D. Thompson to Heads of Department Components *et al.* (Jan. 20, 2003), [http://www.usdoj.gov/dag/ctff/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/ctff/corporate_guidelines.htm).

<sup>13</sup> Pub. L. No. 107-204, § 805(a)(5).

<sup>14</sup> See U.S. Sentencing Guidelines Manual § 8B2.1 & background cmt. (2006).

<sup>15</sup> See Griffin, *supra* note 1, at 1244 ("A requirement that corporate liability may lie only where all culpable knowledge exists in a single individual would allow a corporation to engage freely in conscious ignorance by keeping lines of communication between different departments closed."); Abril & Olazábal, *supra* note 1, at 144 (proposing a rule of corporate *scienter* to address the situation where "although many corporate agents 'touched' the alleged misrepresentation, it might be quite difficult to locate a single corporate agent who both engaged in the misrepresentation and possessed the requisite demonstrable *scienter*"); *In re WorldCom Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) (limiting corporate *scienter* to the *scienter* of individual agents would be inappropriate because "[c]orporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components" [citation omitted]).

<sup>16</sup> *WorldCom*, 352 F. Supp. 2d at 497.

<sup>17</sup> *Id.* at 499-500.

<sup>18</sup> *In re Dynex Capital Inc. Sec. Litig.*, No. 05 Civ. 1897 (HB), 2006 WL 314524, at \*9-10 (S.D.N.Y. Feb. 10, 2006).

<sup>19</sup> *Id.* at \*9.

<sup>20</sup> *In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428, 438, 443 (S.D.N.Y. 2006); *Lapin v. Goldman Sachs Group Inc.*, No. 04-CV-2236 (KMK), 2006 WL 2850226, at \*15, \*21 (S.D.N.Y. Sept. 29, 2006); *In re Global Crossing Ltd. Sec. Litig.*, No. 02-CV-910 (GEL), 2006 WL 1628469, at \*6, \*15 (S.D.N.Y. June 13, 2006); *WorldCom*, 352 F. Supp. 2d 472; *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 452 (S.D.N.Y. 2005) (dismissing Section 10[b] claims against all officers based on overlooking of goodwill); *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 409 (S.D.N.Y. 2005) (longer class period for entity than for individual defendants); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 302, 312 (S.D.N.Y. 2005); *AIG Global Sec. Lending Corp. v. Banc of Am. Sec.*, No. 01-CV-11448 (JGK), 2005 WL 2385854, at \*13

(S.D.N.Y. Sept. 26, 2005); *In re IPO Sec. Litig.*, 358 F. Supp. 2d 189, 223 (S.D.N.Y. 2004); *In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 488 (S.D.N.Y. 2004). Some of these decisions retained individual defendants in the case on the basis of secondary, control-person liability under Section 20(a) of the Exchange Act.

<sup>21</sup> *AUSA Life Insurance Co. v. Ernst & Young*, 206 F.3d at 220-21 (2d Cir. 2000).

<sup>22</sup> *Id.* at 220-21 (citations omitted).

<sup>23</sup> *United States v. Bank of New England*, 821 F.2d at 855-56 (1st Cir. 1987).

<sup>24</sup> Hagemann & Grinstein, *supra* note 1, at 210.

<sup>25</sup> *Id.* at 237.

<sup>26</sup> *Id.* at 237-38. See also Langevoort, *Agency Law*, *supra* note 1, at 1222-23 (noting that "if we look closely at most fact situations where piecemeal attribution [of knowledge from multiple agents] is applied, there does seem to be fault inside the firm").

<sup>27</sup> *United States v. Philip Morris USA Inc.*, 449 F. Supp. 2d at 897 (D.D.C. 2006).

<sup>28</sup> *In re Apple Computer Inc. Sec. Litig.*, 127 F. App'x at 306 (9th Cir. 2005).

<sup>29</sup> See note 4 and related text.

<sup>30</sup> See Abril & Olazábal, *supra* note 1, at 90 n.28 and related text (noting the *Apple* court's error).

<sup>31</sup> *In re Warner Comm'cns Sec. Litig.*, 618 F. Supp. at 752 (S.D.N.Y. 1985).

<sup>32</sup> *Nordstrom Inc. v. Chubb & Son Inc.*, 54 F.3d at 1435-36 (9th Cir. 1995) (emphasis added).

<sup>33</sup> See Abril & Olazábal, *supra* note 1, at 90 n.28 (discussing *Nordstrom*).

<sup>34</sup> *Caterpillar Inc. v. Great Am. Ins. Co.*, 62 F.3d at 962 (7th Cir. 1995) (emphasis added).

<sup>35</sup> *Id.* at 963-64.

<sup>36</sup> Restatement (Third) of Agency § 5.03 cmt. d(2) (2006).

<sup>37</sup> *Id.* at § 5.03 cmt. b (2006).

<sup>38</sup> *Id.* at § 5.03 cmt. b (2006).

<sup>39</sup> *Philip Servs. Corp.*, 383 F. Supp. 2d at 469-76.

<sup>40</sup> *United States v. LBS Bank-New York Inc.*, 757 F. Supp. at 501 n.7, 502 (E.D. Pa. 1990).

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