HUNTON& WILLIAMS

CASE HIGHLIGHT

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Hunton & Williams Wins Securities Suit Involving Collective Scienter Theory; Second Circuit Raises Bar for Subprime Securities Litigation

On June 26, 2008, the U.S. Court of Appeals for the Second Circuit issued its opinion in *Teamsters Local 445 v. Dynex Capital, Inc.*, an appeal of a securities class action that analysts had predicted would reach the U.S. Supreme Court. The Second Circuit rejected the theory of collective scienter; to wit, the theory that a plaintiff could plead fraudulent intent on the part of a corporation without tying that intent to an individual agent of the corporation. The court held further that the inference of fraud urged by the plaintiff-investor was weaker than the competing inference that the suboptimal performance of certain asset-backed securities was the result of general market malaise. The opinion should prove significant in the many subprime mortgage-related lawsuits that have been filed in the wake of the credit crisis.

Background

Dynex is a financial services company that invests in loans and securities consisting principally of single-family residential and commercial mortgage loans. In 1999, Merit, an indirect subsidiary of Dynex, issued two series of bonds backed by manufactured housing loans. When the market for manufactured housing took a turn for the worse, these bonds lost value.

The plaintiff filed a class action against Dynex, Merit and two of Dynex's individual officers. According to the plaintiff, these four defendants violated Section 10(b) of the Securities Exchange Act by, among other things, "conceal[ing] the loans' faulty underwriting."

The district court dismissed the claims against the two individual officers. It held that those claims were based solely on generic allegations that the two officers "must have" known of the alleged fraud given their positions in the corporate hierarchy. With respect to the two corporate defendants, however, the court held that the plaintiff had alleged adequately that they had acted with scienter. The court held that "[a] plaintiff . . . may allege scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation."

Dynex and Merit sought, and the Second Circuit agreed to hear, an interlocutory appeal.

The Second Circuit's Opinion

The Second Circuit tacitly rejected the district court's expansive theory of collective scienter; i.e., the theory that a plaintiff could plead scienter on the part of a corporation without tying that scienter to any individual agent of the corporation. The Second Circuit held that "[t]o prove liability against a corporation . . . , a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation." It held further that to state a claim against a corporation, "the pleaded facts must create a strong infer-

ence that someone whose intent could be imputed to the corporation acted with the requisite scienter." Although "the most straightforward way to raise such an inference . . . will be to plead it for an individual defendant," the court noted that a plaintiff need not do so in certain rare and extreme cases. For example, if "General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero," a court might be justified in finding a strong inference of scienter even if the allegations fail to establish that a particular officer of General Motors uttered this misstatement with the specific intent to mislead investors.

More important for the wave of subprime litigation, however, the court held that the plaintiff in *Dynex* had not come close to satisfying this standard. The court found that the plaintiff "fail[ed] to allege the existence of information that would demonstrate that the statements made to investors were [even] misleading, e.g., information showing that the primary cause of the bonds' poor performance was *not* the general weakness in the mobile homes market." As an example, the plaintiff claimed that Dynex's officers had access to unspecified "collection data" concerning the loans, but failed to allege that "these data had been collected into reports that demonstrated that loan origination practices were undermining the collateral's performance." The court noted further that the plaintiff "failed to allege that anyone at Dynex or Merit had a compelling motive to mislead investors regarding the bonds." The defendants' alleged motive to "maintain the appearance of profitability" was insufficient for purposes of "securities fraud pleading."

In sum, the court held that the inference of fraud urged by the plaintiff was not "at least as compelling" as the competing inference that "no one at Dynex or Merit found the statements misleading because [those statements] identified the cause of the bonds' performance as accurately as possible."

Conclusion

More than 100 subprime-related securities class actions have been filed in the last year. Given the continued stress in the financial markets, the future probably holds more. These suits often involve general claims that senior officials knew that their company was originating, securitizing or otherwise dealing in bad loans.

The *Dynex* opinion raises the bar on these allegations. It holds that in the vast majority of cases, a plaintiff must tie the alleged misstatements to a specific individual defendant at the pleading stage. In addition, in all cases a plaintiff must plead facts giving rise to an inference of fraud that is at least as compelling as a competing inference that the statements were either truthful, or, if false, made unintentionally.

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The litigation team was led by Hunton & Williams partner Edward J. Fuhr with the assistance of Terence J. Rasmussen.