SECURITIES LAW360

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Court To Weigh If Co. Can Have Scienter If Execs Don't

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Monday, Jan 28, 2008 --- In an important case for scienter, a federal appeals court will hear arguments Wednesday over a district court's decision to dismiss a securities fraud action against two corporate officers accused of misrepresenting information to investors while upholding a claim against the officers' employer.

The central question of Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc. et al. is this: At the pleading stage, can a company be held to have possessed sufficient scienter under the Private Securities Litigation Reform Act of 1995 to be liable for fraud under Section 10(b) of the Securities Exchange Act in a situation where none of the company's employees can?

Or as defense counsel Edward J. Fuhr of Hunton & Williams LLP put it: “Can a corporation act with scienter with regard to public statements when it has already been established that none of the individuals who had responsibility for the public statements had any intent to deceive?”

“This is one of the first rulings that we have seen that has said a corporation can have an intent separate and different and apart from any individuals,” Fuhr added.

But Joel Laitman of Schoengold Sporn Laitman & Lometti PC, which is representing the lead plaintiff, disagreed, saying: “They're trying, in our view, to impose a requirement that in every Section 10(b) case, you have to plead the scienter of a corporate officer in order to plead a claim. And that's nowhere in the PSLRA.”

The proposed class action ended up in the U.S. Court of Appeals for the Second Circuit on an interlocutory appeal three years after it was first filed, in February 2005 in the U.S. District Court for the Southern District of New York.

In February 2006, the district judge granted the defendants' motion to dismiss concerning the two individual defendants, Dynex officers Thomas H. Potts and Stephen J. Benedetti, but denied the motion concerning the company itself.

The defendants have asked the court to reverse the part of the district court decision denying the motion to dismiss and to remand the case so that those

charges may be dismissed with prejudice.

“It has long been settled throughout the United States that a corporation has no mind. Accordingly, while a corporation can be responsible for the tortious acts committed by an employee, the requisite state of mind must necessarily be that of the employee,” Dynex argued in its brief.

It added, “A corporation can act only through its agents. Accordingly, as courts have held repeatedly, a corporation can perpetrate an intentional act only when one of its agents perpetrates an intentional act.”

The plaintiff is requesting that the district court order be upheld — including, according to Laitman, the part of it dismissing the two individual defendants from the litigation.

The district court's “detailed findings of particularized allegations of corporate fraud based on specifically identified sources demonstrate that this circuit’s and the PSLRA’s heightened pleading requirements were implemented in the order,” the plaintiff said. “Dynex’s new pleading requirement is not needed to enforce the PSLRA standards, nor is the pleading against Dynex so vague that corporations will be 'chilled' from making corporate disclosures.”

“Dynex ignores that pleading corporate motive and opportunity requires sufficient allegations of motive specific to the corporation and alleged fraud rather than isolated individuals,” it added.

The allegations center around statements Dynex made about bonds from defendant Merit Securities Corp., which were allegedly materially false and misleading, according to court documents.

The district court judge ruled that “these allegations are sufficient to infer that officers and employees of the corporate defendants had the motive and opportunity to commit fraud.”

The district court ruling came amid a climate in which the U.S. Supreme Court had narrowed the scope of federal securities cases.

Most recently, in its Stoneridge decision last month, the High Court rejected the theory of “scheme liability,” which sought to hold companies that committed deceptive acts in furtherance of another company's securities fraud responsible for the fraud itself.

The justices' subsequent decision to decline to hear a similar case concerning Enron Corp.'s underwriters confirmed the breadth of their decision.

In the Tellabs decision, issued last year, the Supreme Court held that a pleading of scienter, as required by the PSLRA, must be, in the majority's words, “more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

Pointing to several amicus curiae briefs that have been filed in favor of the defendants, Laitman said, “They realize that if in every securities case you have to show that a corporate officer had knowledge, that's a very difficult thing to do — not necessarily in this case, but certainly in many cases involving auditors or investment bankers, where it's very difficult to sort out who participated on the audit, let alone if that particular auditor had knowledge of the scheme.”

Meanwhile, Fuhr argued that if the district court order is approved, “it's really gonna blow open the barn doors to securities litigation, and it will undo, in our judgment, almost all the recent Supreme Court rulings that have limited securities litigation.”

The lead plaintiffs are represented in the matter by Schoengold Sporn Laitman & Lometti PC.

Dynex is represented by Hunton & Williams LLP.

The case is Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc. et al., case number 06-cv-2902, in the U.S. Court of Appeals for the Second Circuit.