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Corporate Scierter: Is a Corporation More Than the Sum of its Director and Officer Defendants?

For any corporation, securities litigation is extremely disruptive and expensive. If companies were to consistently face “frivolous” lawsuits—those without a realistic chance of plaintiff success—business would stall. Accordingly, in 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), in part to establish uniform pleading standards that separate the wheat from the chaff.

The most important part of winning a lawsuit is sustaining it. Defendants almost always attempt to dismiss the lawsuit in its earliest stages—the pleadings—when each party sets out the facts and allegations. One major element of the standards established under the PSLRA is the element of “scierter” or state of mind. In order to withstand a motion to dismiss, plaintiffs must demonstrate that the defendant knew that a statement was false at the time it was made, or, alternatively that the defendant made the statement with reckless disregard for the truth. The law requires that the complaint must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind” 15 USC § 78u-4(b)(2).¹

Generally speaking, if intent is established as to an individual defendant, then that same intent may be imputed to the corporate entity defendant itself. What happens, however, if scierter cannot be established against an individual defendant? Does the lack of individual scierter always preclude the possibility of establishing corporate scierter? This issue was recently addressed by the Second Circuit Court in the case of *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc. Dynex*. (“*Dynex*”).

The *Dynex* litigation was a putative class action brought by a Teamsters pension fund, alleging that the company failed to disclose that highly questionable debt was backing certain bonds that were purchased by the fund. The defendants attempted to dismiss the litigation based on insufficient pleadings, arguing that the plaintiffs did not adequately meet the scierter requirements under the PSLRA.

The district court dismissed the complaint with respect to the individual defendants, finding that plaintiffs failed to plead scierter. However, the court refused to dismiss the litigation against the corporate defendants, holding that despite the lack of individual scierter, the plaintiffs did indeed plead sufficient facts for recklessness on behalf of the corporate defendant.

¹ The 2007 landmark Supreme Court decision, *Tellabs v. Makor*, addressed how one can recognize a strong inference. Such an inference “must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.” (See Integro’s white paper, *Tellabs: The Supreme Court Decision – How High a Hurdle?*)

On appeal, the corporate defendants, Dynex and Merit, argued that this state of affairs—scienter existing with respect to the entity separate and apart from the individuals—could not stand.

The court rejected this argument, stating:

“Congress has imposed strict requirements on securities fraud pleading, but we do not believe that they have imposed the rule urged by defendants, that in no case can corporate scienter be pleaded in the absence of successfully pleading scienter as to an expressly named officer.”

Thus, according to the Second Circuit, a claim for corporate scienter may stand despite the dismissal of claims against individual defendants.

In addition, further to the Tellabs Supreme Court decision in 2007 regarding a strong inference requirement, as well as the remanded Seventh Circuit Tellabs decision, the court went on to say that:

“When the defendant is a corporate entity, this means that the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter. In most cases, the most straightforward way to raise such an inference for a corporate defendant will be to plead it for an individual defendant. But it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant.”

While the plaintiffs won their conceptual argument, they did not succeed on their merits. The court held that Teamsters failed to establish a strong inference of scienter with respect to the corporate defendant.

Any decision that empowers a securities plaintiff’s ability to withstand motions to dismiss during the pleading stage is notable and germane to D&O underwriters. Naturally, the volume and success of securities litigation directly impacts the D&O marketplace. Indeed, a consistent decrease in securities class action filings over the last several years has coincided with, if not helped drive, the recent soft D&O market. However, the subprime credit crisis has begun a potential reverse in the downward trend for securities class action filings and 2008 is on pace for significant filings increases above 2007 levels.

As *Dynex* could lead to corporate defendant liability even in the absence of individual defendant liability, buyers of D&O insurance should review the entity coverage provisions of their policies. If the Dynex litigation had moved forward, it is possible that its D&O policy could have covered Dynex’s corporate liability—defense costs and an ultimate settlement—stemming from the litigation. This would have diluted the D&O insurance proceeds otherwise available to the directors and officers of Dynex.

To be sure, it is only in rare circumstances that a securities litigation claim would proceed against a corporate defendant without also proceeding against the corporation's directors and/or officers. But this decision raises questions regarding the structure of a public company's D&O program, particularly with respect to entity coverage. We suggest that buyers of D&O insurance closely examine this issue with their brokers at renewal.

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