06-2902-cv

United States Court of Appeals

for the

Second Circuit

TEAMSTERS LOCAL 445 FREIGHT DIVISION PENSION FUND, on its own behalf/on behalf of all others similarly situated,

Plaintiff-Appellee,

– v. –

DYNEX CAPITAL INC. and MERIT SECURITIES CORPORATION,

Defendants-Appellants,

(For Continuation of Caption See Inside Cover)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK
CASE NO. 05-CV-1897 (HB)

BRIEF OF *AMICI CURIAE*, STATES OF MISSISSIPPI, NEW JERSEY, NEW MEXICO, AND RHODE ISLAND AND IOWA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM AND PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM, IN SUPPORT OF PLAINTIFF-APPELLEE

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STATEMENT OF INTEREST

The Amici States, as guardians of the citizenry and as fiduciaries to the public servants who entrust their retirement savings to publicly managed funds, have a paramount interest in the enforcement and proper interpretation of the securities laws. The Amici States, by their laws, also give recognition to and confer both rights and responsibilities on corporations. Thus, the method for pleading and proving corporate scienter under the securities laws is of great importance to the Amici States.

The Amici States and the Amici State investment divisions, manage an aggregrate $255 billion invested in the public markets, and their various investment divisions are among the largest public or private money managers in the United States. Combined, they manage the retirement plans for over 2.2 million active and retired public servants. Increasingly, the Amici States and investment divisions act as lead plaintiffs in securities class actions, and in the aggregate currently serve as lead plaintiffs in 22 pending securities class actions. As lead plaintiffs, Amici play a pivotal role in enforcing and deterring violations of the securities laws and in recovering losses for investors and pensioners victimized by fraud. And as large public institutional investors, Amici are especially effective lead plaintiffs, just as Congress contemplated in passing the PSLRA lead plaintiff provisions. The Court's decision in this case will greatly impact the Amici's

ability to fulfill its dual role as protectors of the public interest and fiduciaries of publicly managed funds.

SUMMARY OF ARGUMENT

This appeal presents the question whether a securities fraud complaint can survive a motion to dismiss by alleging widespread misconduct within a corporation that has admitted issuing false financial statements, but without alleging facts, prior to discovery, establishing intentional or reckless conduct by any particular high level corporate official. The District Court refused to dismiss such a complaint, holding that the plaintiffs had alleged sufficient particularized facts to raise a strong inference that the corporation had recklessly or intentionally falsified its public statements. The District Court's decision should be affirmed.

There are many reasons why investors should be allowed to plead and prove the scienter of a corporate defendant without necessarily attributing fault to any single high level official. Under the doctrine of respondeat superior, a corporation is deemed to have the scienter of agents who commit torts for the benefit of the corporation while acting within the scope of their authority. This principle is deeply embedded in American jurisprudence because it ensures that corporations will police their own employees. Moreover, it is fundamentally fair to require a corporation, which conferred on its agents the means to commit fraud, to bear the costs of that decision, rather than to require that the costs be borne by an innocent

third party. Thus, plaintiffs should be permitted to pursue securities fraud claims against a corporate defendant if they can demonstrate that the fraud was caused by the reckless or intentional actions of any of its employees, no matter what their rank, acting with apparent, implied, or actual authority.

Additionally, a corporation should be deemed to have acted recklessly or intentionally when it adopts policies that create a serious risk of harm to third parties or that betray an indifference to legal requirements. Courts, commentators, and even corporate defendants agree that a corporate "mindset" is reflected in the corporation's regular course of conduct. Therefore, plaintiffs should be permitted to satisfy the scienter element of securities fraud claims by establishing at trial that corporate policy – as evidenced both by formal rules and by actual practice – foreseeably caused the corporation to issue materially false statements.

Finally, even if corporate scienter can only be determined by examining the mental states of high level corporate officials, for pleading purposes, it should be sufficient for plaintiffs to allege facts that, if true, raise a strong inference that some corporate officer must have acted recklessly, even if that officer has not yet been identified. Prior to discovery, there may be strong evidence that fraud has occurred, but plaintiffs may simply be unable to determine which specific officers bear responsibility. Corporations should not avoid liability in such situations

merely because their idiosyncratic or anonymous division of labor is not easily ascertainable at the pleading stage from publicly available information.

ARGUMENT

The Securities Exchange Act of 1934 explicitly makes corporations liable for fraud. *See* 15 U.S.C. §§78c(a)(9), 78j(1)(b). Thus, in passing the Act, Congress must have had some notion of scienter that could be attributed to the corporation directly. Although there may be several ways in which this can be accomplished, this appeal may be resolved by evaluating corporate scienter under at least two frameworks: first, corporate scienter may be gleaned by reference to the individual mindsets of agents whose conduct caused the harm, or, alternatively, corporate scienter may be determined by an examination of the corporation's policies and regular course of dealing. Under either approach, the District Court's decision should be affirmed.

Even putting these approaches aside, it is undisputed that the scienter of high level officials may be attributed to a corporation, even if those officials are not, themselves, named as defendants. Here, although the plaintiffs may not have identified the officials responsible for Dynex's false statements, they have alleged particularized facts that, if true, demonstrate that the falsehoods were the product of widespread corporate misconduct. Because it is extremely unlikely, if not impossible, that such misconduct could have occurred on such a scale, for years,

without the knowledge and acquiescence of at least some senior officials, the complaint should be sustained on the ground that it creates a strong inference of scienter on the part of Dynex's management.

I. CORPORATIONS ARE, AND SHOULD BE, VICARIOUSLY LIABLE FOR THEIR AGENTS' ACTIONS

A. The Scienter of an Agent May Be Attributed to the Principal

The common law doctrine of respondeat superior holds that the torts of an agent may be attributed to the principal. *See generally* Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability under Section 10(b)*, 58 Ohio St. L.J. 1325 (1997). Respondeat superior applies to federal law generally, and to the securities laws in particular. *See New York Cent. & Hudson River R.R. Co. v. U.S.*, 212 U.S. 481, 493-94 (1909); *Marbury Mgmt. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980); *see also* Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. Cin. L. Rev. 1187, 1228 (2003) (respondeat superior and liability was a "well-understood workhorse[] of business law … when Section 10(b) was enacted"); Prentice, *supra*, at 1354-55 (Congress intended to incorporate respondeat superior concepts into §10(b)).

Because the Exchange Act explicitly makes corporations liable for fraud, *see* 15 U.S.C. §§78c(a)(9), 78j(1)(b), "this can only be by virtue of agency principles,

since a corporation can act only through its agents." *SEC v. Mgmt. Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975). Traditional principles require that the scienter of the corporation's employees be attributed to the corporation itself. *See Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001). This is a matter of fairness: as between the corporation which enabled its agent to commit fraud, and an innocent third party, the costs of fraud are more properly borne by the former. "The treasury of the business may not with impunity obtain the fruits of violations which are committed knowingly by agents of the entity in the scope of their employment. Thus pressure is brought on those who own the entity to see to it that their agents abide by the law." *U.S. v. A & P Trucking Co.*, 358 U.S. 121, 126 (1958). As the Supreme Court explained:

> We see no valid objection in law, and every reason in public policy, why the corporation, which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted authority to act in the subject-matter of making and fixing rates of transportation, and whose knowledge and purposes may well be attributed to the corporation for which the agents act.

New York Cent., 212 U.S. at 495; *see also Lyon v. Carey*, 533 F.2d 649, 653-54 (D.C. Cir. 1976**)** (in the absence of respondeat superior, "[a man] might delegate to persons pecuniarily irresponsible the care of large factories … and these persons, by the use of the extensive power thus committed to them, might inflict wanton and malicious injuries on third persons, without other restraint than that which

springs from the imperfect execution of the criminal laws. A doctrine so fruitful of mischief could not long stand unshaken in an enlightened jurisprudence.").

Neither the owners, nor the highest officers, of an organizational entity must act with scienter for respondeat superior liability to attach. *See, e.g.*, *Adams v. Kinder-Morgan*, 340 F.3d 1083, 1106-1107 (10th Cir. 2003) (scienter of corporate "agents" may be imputed to corporation; citing sources). For instance, in *U.S. ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908 (4th Cir. 2003), the Fourth Circuit imputed scienter to a corporation based on the mental state of a single employee identified only as a "manager." *See id.* at 911, 919. Similarly, scienter has been imputed to corporations on the basis of mental states harbored by cashiers, *see Grand Union Co. v. U.S.*, 696 F.2d 888, 890-91 (11th Cir. 1983), bank tellers, *see U.S. v. Bank of New England*, 821 F.2d 844, 857 (1st Cir. 1987),[1] and brokerage trainees, *see Marbury Mgmt.*, 629 F.2d at 716. "[M]any a corporation has paid heavy damages for antitrust violations committed by low-level sales managers who thought they were acting in the company's best interests." *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982); *see also U.S. v. Basic Const. Co.*, 711 F.2d 570, 571 (4th Cir. 1983) (rejecting

[1] *Bank of New England* involved criminal, rather than civil, liability; however, corporate scienter for the two is determined similarly. *See New York Cent.*, 212 U.S. at 493.

argument that liability should not attach for actions taken "by two relatively minor officials … done without the knowledge of high level corporate officers"). The defendants do not dispute this principle: cases on which they rely similarly assess corporate scienter by reference to the mental states of lower-level employees. *See Saba v. Campagnie Nationale Air France*, 78 F.3d 664, 670 (D.C. Cir. 1996) (Def. Br. 21) (air cargo packers); *Tutton v. Olsen & Ebann*, 232 N.W. 399, 402 (Mich. 1930) (Def. Br. 21 n.8) (credit manager in branch store operated by a large corporation). [2]

Therefore, for a complaint to survive a motion to dismiss, it is necessary only to allege with particularity that corporate agents recklessly or intentionally caused the false statements to be made. Here, according to plaintiffs, branch and regional vice presidents waived underwriting standards to meet loan volume quotas and agreed to purchase "bad paper" to capture larger segments of the business. ¶¶59-60. Dynex collection employees reported that Dynex had a large number of

[2] Even if there existed a requirement that an agent exercise some minimum level of authority before his scienter could be imputed to the corporation, respondeat superior liability would attach for agents who occupy a supervisory or managerial position. *See, e.g., U.S. v. Koppers Co., Inc.*, 652 F.2d 290, 298 (2d Cir. 1981) (approving district court's instruction that respondeat superior liability attaches for the conduct of "managerial agents"; refusing to limit liability to actions taken by "high managerial agents"). Here, as discussed below, the plaintiffs have alleged with particularity that branch managers, supervisors, and corporate officers engaged in reckless conduct.

unstable "Buy For" loans, and a significant number of defaults, ¶¶62-63. Dynex collectors are alleged to have falsified delinquency rates. ¶64. If these agents acted recklessly, or with willful blindness, as to the danger that the loans would ultimately be uncollectible, their scienter may be imputed to Dynex. [3]

It is irrelevant that the employees described in the complaint may not have been personally responsible for issuing the allegedly false statements. A corporation will be liable if one of its agents, harboring the requisite scienter, *causes* a misrepresentation to be made, even if the agent did not personally issue the false statement. *See, e.g., Am. Soc'y of Mech. Eng'Rs (ASME) v. Hydrolevel Corp.*, 456 U.S. 556, 571-72 (1982);; *U.S. v. Shortt Accountancy Corp.* 785 F.2d 1448, 1454 (9th Cir. 1986); *Grand Union*, 696 F.2d at 890-91.[4] This rule,

[3] Amici Securities Industry and Financial Markets Assoc. et al (SIFMA) incorrectly state that there is no violation of the securities laws unless the plaintiff proves that the defendant intended to "defraud" investors by manipulating a security's price. SIFMA Br. at 6. In fact, the required scienter is merely an intent to issue a *false statement*, not an intent to cause harm. *See Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989); *see AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 222 (2d Cir. 2000) ("The district court was concerned that E&Y lacked the motivation to commit fraud. … This, however, inappropriately makes the scienter issue one of 'what did the defendant want to happen' as opposed to 'what could the defendant reasonably foresee as a potential result of his action.'").

[4] Notably, in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), the Supreme Court pointed out that one way in which Exchange Act liability differs from liability under Section 11 of the Securities Act of 1933 is that Section 11 liability covers only signatories of allegedly false registration statements, whereas Exchange Act liability more broadly encompasses other persons who may have

described in the *Restatement (Second) of Agency* §268 comment d and §275 comment b,[5] was endorsed by the Fifth Circuit in *Southland Sec. Corp. v. INSpire Ins. Solutions*, 365 F.3d 353, 366 (5th Cir. 2004).[6] In other words, although *Southland* rejected the concept of corporate scienter – a misguided conclusion, *see* Part III, *infra* – even there, the court accepted that the scienter of a nonspeaking agent may be imputed to the corporation.[7]

Consequently, a corporation cannot avoid liability for intentional or reckless falsehoods by segmenting the offices responsible for making statements from the

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"play[ed] a part in preparing" the statement without actually signing it. *Id*. at 386 n.22; *see also McConville v. SEC*, 465 F.3d 780, 786-87 (7th Cir. 2006).

[5] The *Restatement (Third) of Agency* does not appear to address scenarios where one agent intentionally or recklessly causes another to make a false statement; instead, it merely discusses scenarios where one agent has *knowledge* that another does not have, which, presumably, only involves situations where the agents' failure to communicate is faultless, or merely negligent. *See Restatement (Third) of Agency* §5.03 cmt d.

[6] Though §§ 268 and 275 only explicitly discuss torts involving "actual knowledge" or "purpose," presumably, for torts that are effectuated via recklessness, scienter will be imputed if the agent similarly acted recklessly. *Cf. Restatement (Second)* § 268 cmt. d ("If the agent consciously and purposely fails to reveal the information, the principal may be liable because, under the circumstances, *the conduct of the agent has the same effect as if the agent had personally acted and were himself guilty of the fraudulent or other tortious conduct*." (emphasis added)).

[7] Significantly, the Fifth Circuit held that scienter would be attributed to a corporation on the basis of intent harbored by a particular "director, officer or *employee*." *Id.* at 367 (emphasis added); *see also id.* at 366 n.9 (vicarious liability will be determined "under general rules of agency").

rest of the organization. "Indeed, if it were otherwise, Defendants could avoid liability by simply dividing up duties to ensure that fraudulent statements were only made by [] uninformed employees." *U.S. v Philip Morris*, 449 F. Supp. 2d 1, 189 (D.D.C. 2006). As the Fourth Circuit explained in the context of a qui tam action alleging that a government contractor had submitted false certifications:

> [W]e decline to adopt Westinghouse's view that a single employee must know both the wrongful conduct and the certification requirement. If we established such a rule, corporations would establish segregated 'certifying' offices that did nothing more than execute government contract certifications, thereby immunizing themselves against FCA liability. Instead, [the relevant issue is] whether there was at least one Westinghouse employee who knew or should have known that GPC was submitting a bid seeking government funds and that this bid was tainted by an [organizational conflict of interest].

Westinghouse, 352 F.3d at 919.

The case of *AUSA Life Ins. Co. v. Ernst & Young* provides an insightful parallel. As a result of individual auditors' repeated acquiescence to their client's bullying, an accounting firm falsely certified corporate financial statements. *See id.* at 205. In concluding that the firm had acted recklessly, this Court did *not* focus on high management (no individuals were even named as defendants), but instead concentrated on the behavior of lower-level accountants – none of whom had personally made any public statements. As this Court put it, scienter exists "when a large entity, firm, institution, or corporation is acting in a manner that easily can be foreseen to result in harm…. Had the E&Y accountants contemplated

for a moment the results to which their questionable accounting could lead, they could have imagined that saddling the investors with an undisclosed risk would harm the investors…. Therefore, we can easily find that E & Y possessed the requisite intent to deceive, manipulate, or defraud." *Id.* at 221.

Here, based on the pleadings, Dynex agents would have been aware that the bad loans would be used as collateral for bond issuances, for this was the fundamental nature of Dynex's business (JA344). Dynex is liable for any reckless or intentional actions of its employees that foreseeably would result in materially false public statements.[8]

B. Respondeat Superior Liability Should Not Be Artificially Narrowed

Without citing relevant authority, the defendants' amici argue for what appears to be a modified version of respondeat superior. They would only consider the scienter of those agents "authorized to participate in securities disclosures," SIFMA Br. at 21, or only the scienter of the agents who

[8] Significantly, this Court found that scienter had been properly pled against a corporation where facts suggesting the falsity of its accounting were known throughout the company. *See Rothman v. Gregor*, 220 F.3d 81, 90-92 (2d Cir. 2000). Though the knowledge of individual management-level officials was also mentioned, this Court treated corporate scienter as a distinct concept. Similarly, in *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005), the Sixth Circuit found that scienter had been pled against a corporation in part because of information known and circulated within the company.

communicated the allegedly false statement, Brief of Washington Legal Foundation at 12-13. These amici argue that if liability turned on the scienter of "far-flung" "rogue" employees, corporate management would be paralyzed. They thus ignore blackletter doctrine and exaggerate the real-world consequences of the ordinary application of respondeat superior.

Respondeat superior liability "is a foundational principle of tort law," Prentice, *supra*, at 1415, and has been for a century – all without leaving businesses paralyzed for fear that rogue employees will bring about the ruin of the company. Notably, corporations are strictly liable for false statements in their registration statements under Section 11, and yet they continue to offer their securities to the public.

Moreover, a large corporation is extremely unlikely to allocate responsibility so that a single, low-level, nonpolicymaking employee will have sufficient power, acting alone and without oversight – but within his scope of authority, and with the intent to benefit the corporation – to have such a material impact on his employer's financial statements as to expose his employer to significant securities fraud liability. And if a corporation's internal controls are so deficient that such a scenario could occur, there is no injustice in holding the corporation liable

"because of the knowledge and intent of its agents to whom it has intrusted authority to act in the subject-matter." *New York Cent.*, 212 U.S. at 495.[9]

The allegations here illustrate the point. Presumably, a single employee would not have had sufficient power and responsibility to have waived so many limits, and purchased so many bad loans, as to single-handedly cause the plaintiffs' losses. Instead, it allegedly took the combined actions of employees in several regional offices, not to mention branch and regional vice presidents, and officers in corporate headquarters, all of whom exercised the discretion and authority conferred upon them by Dynex over a period of years, to waive underwriting standards and direct the falsification of delinquency rates.

Moreover, the defendants' amici overlook the devastating consequences of refusing to hold corporations liable under ordinary respondeat superior principles. If corporations are not liable for the actions of lower-level employees, higher-level officials will insulate the corporation from liability by "segmenting information flow or instructing agents to keep bad news to themselves." Langevoort, *supra*, at

[9] Agency doctrine places natural limits on the degree to which a large corporation is required to supervise lower-level employees. For example, there may be a circumstance where a small subsidiary of a larger conglomerate, operating an independent and unrelated business, might not be considered to be the parent's agent; thus, its employees might not be agents of the parent, either. Here, Dynex issued its bonds through a subsidiary that allegedly had no separate corporate personality, *e.g.*, ¶26, but this will not always be true.

1223 and sources cited at n.66. Such limitations on liability would not only create an environment that would allow fraud to flourish, but they would encourage corporations to adopt inefficient and unnecessary corporate structures solely for the purpose of maintaining plausible deniability.

Additionally, respondeat superior liability – especially for offenses based on intentional or reckless conduct – is the most economically efficient method of allocating risk. *See* Prentice, *supra*, at 1387-1396. Any other system might inhibit investors from purchasing securities, for investors alone would be responsible for determining whether the issuer had hired trustworthy agents – something that investors are in no position to research for themselves. *See id.* at 1393. Moreover, respondeat superior liability provides an incentive for corporations to police themselves and thus serves as an effective deterrent against future violations. *See ASME*, 456 U.S. at 572-73.[10]

[10] The Model Penal Code's test for corporate scienter is also informative. Although it has not been adopted by most states, *see Corporate Criminal Intent*, *supra*, at 1295, and has been heavily criticized for overemphasizing official actions (and thus encouraging management to shield itself from negative information), *see, e.g.*, *id.* at 1295-96; Pamela H. Bucy, *Corporate Ethos*, 75 Minn. L. Rev. 1095, 1105 (1991), it, too, would impose respondeat superior liability for securities fraud, while allowing corporations an affirmative defense that "high management" acted with due diligence to prevent the offense. *See* Model Penal Code §2.07; *see generally* Kathleen Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 Rutgers L.J. 593, 621, 626 & n.131 (1988) (explaining the scienter structure of the MPC and offering a critique). Significantly, even when the MPC based liability solely on the actions of high management, it did so in the

Finally, respondeat superior liability is not a stealth form of negligence, as defendants suggest. *See* Def. Br. at 25-27. Any concept of a corporate "mind" is a legal construct; liability turns on the actions and mental states of employees. *See Suez Equity*, 250 F.3d at 101. The employees on which a court chooses to focus is, ultimately, a policy question; there is no necessary reason why some employees should be deemed to have mindsets coextensive with the corporation, while other employees are disregarded. In other words, it is just as legitimate to look to the mindset of lower-level employees when attempting to determine the "corporate" mind as it is to look to the mindset of the corporation's officers; and history has shown that laws are more effectively enforced when *all* employees' mindsets are fair game for consideration. Though respondeat superior liability may, in some cases, lie where the CEO of a corporation was only negligent, it is not the *CEO* who is being held responsible;[11] rather, it is the *corporation as a whole*, and it cannot be said that the *corporation* was merely negligent if an agent – who is,

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expectation that respondeat superior liability would still exist for civil, rather than criminal, actions. *See id.* at 623.

[11] Under traditional agency principles, liability will lie against the corporate principal for the acts of its agents, but not against the corporate officers. *See Meyer v. Holley*, 537 U.S. 280, 286 (2003). This is one reason why the Exchange Act imposes liability for "controlling persons"; individual directors of a corporation would not, under the common law, be liable for frauds committed by lower-level employees. *See generally* Prentice, *supra*, at 1409-10.

himself, a part of the corporation – committed fraud to further of corporate interests.

II. CORPORATIONS ARE, AND SHOULD BE, DIRECTLY LIABLE FOR THEIR POLICIES

In addition to being vicariously liable for torts committed by their agents, organizations can be directly liable for regular protocols and courses of dealing that betray a reckless disregard for the law.[12] In *Bank of New England*, the First Circuit approved a jury instruction that allowed a finding of "willfulness" against a corporate defendant if the jury determined that the corporation's failure to comply with the law "was the result of some flagrant organizational indifference." 821 F.2d at 855. The instruction directed the jury to consider defendant's actual – rather than formal – policies, including its efforts to inform employees of the law, monitor their compliance, and so on. *See id.* This standard, or permutations thereof, has been endorsed by commenters. *See, e.g.*, William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 Emory L.J. 647, 678-79 (1994); Comment, *Corporate Criminal Intent: Toward a Better Understanding of Corporate*

[12] The defendants contend that a rule permitting scienter to be attributed to the corporation as a whole would contravene the purposes of the PSLRA. Def. Br. at 25. The PSLRA did not change the substantive element of scienter for a securities fraud claim. *See Novak v. Kasaks*, 216 F.3d 300, 307-09 (2d Cir. 2000) (discussing scienter by reference to pre-PSLRA caselaw). To the extent that this matter implicates the substantive standard for imputing scienter to a corporation, the PSLRA has no relevance.

Misconduct, 78 Cal. L. Rev. 1287, 1307 (1990); Comment, *Developments in the Law-Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 Harv. L. Rev. 1243, 1257 (1979); *see also* Patricia S. Abril and Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 Colum. Bus. L. Rev. 81, 151 (2006) (recommending that corporate policy be evaluated as part of mens rea determination); Bucy, *Corporate Ethos*, *supra*, at 1099 (same). Whatever debates may rage about where to locate the corporate "mind," it is incontestable that corporate scienter can be determined from the actual, ordinary, regular practices that the organization has adopted, whether formally or informally. *Cf. Philip Morris*, 449 F. Supp. 2d at 189 (intent may be proved by circumstantial evidence, including a "cumulative pattern" of corporate decisions and actions). Indeed, corporate defendants frequently urge courts to examine corporate policies to gauge scienter as an alternative to respondeat superior liability (although courts prefer to rely on respondeat superior principles). *See, e.g.*, *U.S. v. Basic Const. Co.*, 711 F.2d 570, 573 (4th Cir. 1983). Corporate policy is also regularly considered to determine whether an agent was acting within the scope of his authority or to benefit the corporation. *See id.*; *U.S. v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979). In the context of certain Title VII sexual harassment claims, for instance, an employer may establish that the offender was acting on his own, and not to benefit the corporation, by taking reasonable care to correct harassing behavior – including

by establishing effective anti-harassment policies. *See Faragher v. City of Boca Raton*, 524 U.S. 775, 807 (1998).

In several oft-cited cases addressing corporate intent as a construct distinct from the minds of individual agents, courts ultimately found liability by reference to patterns and practices of conduct – i.e., policies – that caused the violation. In *Riss & Co. v. U.S.*, 262 F.2d 245 (8th Cir. 1958), a corporate defendant was found to have willfully violated ICC regulations. The fault lay with a single clerk who had failed in her duties, coupled with the fact that no one monitored her work because no procedures existed requiring it. In concluding that the defendant's conduct evidenced scienter, the Eighth Circuit explained, "[t]he omissions and failures did not occur in a few isolated situations, but in so many cases in a comparatively short period of time, that it demonstrates a conscious disregard of, or indifference to, the performance of the duty enjoined upon defendant." *Id.* at 251. In other words, scienter was gleaned from standard corporate practices that resulted in regular noncompliance with the law.

A similar conclusion was reached in *U.S. v. T. I. M. E.-D. C., Inc.*, 381 F. Supp. 730 (D. Va. 1974). A corporation was charged with violating ICC regulations by allowing drivers to operate trucks while ill. The district court found that the corporation had acted willfully in part because it had implemented a new sick leave policy in a way likely to coerce drivers into operating their trucks while

ill. *See id.* at 739-40. Once again, corporate practices – including both formally adopted procedures and their less formal implementation – were taken as evidence of corporate intent. Indeed, it is this notion of policy, both formal and informal, that may have informed this Court's holding that scienter would be established "where a large entity, firm, institution, or corporation is acting in a manner that easily can be foreseen to result in harm." *AUSA Life Ins.*, 206 F.3d at 221.

These cases establish that corporate policy is an appropriate indicator of scienter, and that any assessment of corporate policy must consider the company's actual course of dealing in addition to formally approved procedures. Otherwise, corporate management has an incentive to intentionally blind itself to the actual operations of the organization. So, for example, in the sexual harassment context, courts look not only to the employer's stated harassment policy, but also to its manner of implementations. *See, e.g.*, *Miller v. Kenworth of Dothan, Inc.*, 277 F.3d 1269, 1280 (11th Cir. 2002); *Brown v. Perry*, 184 F.3d 388, 396 (4th Cir. 1999); *see also Skelton v. Am. Intercontinental Univ. Online*, 382 F. Supp. 2d 1068, 1074 (N.D. Ill. 2005) (examining both the employee handbook and the employer's actual practices to determine overtime pay policy). The company's actual policy and practice is a determination for the fact-finder. *See Hafford v. Seidner*, 183 F.3d 506, 514 (6th Cir. 1999).

Here, the complaint creates a strong inference that Dynex adopted a systematically reckless approach to underwriting and collections that can fairly be characterized as corporate policy. Loan limits were regularly waived; Dynex officers accepted high risk loans to obtain business as part of the business model; employees were directed to conceal default rates; and employees regularly failed to take basic precautions to ensure that loans would be collectible. ¶¶60-66. These actions are alleged to have been widespread and taken for the specific purpose of enabling Dynex's bond offerings to the public. Dynex even admitted that its internal controls were deficient. ¶112. The complaint thus alleges facts that, if true, would allow a fact-finder to conclude that the allegedly false statements were caused by policies "demonstrat[ing] a conscious disregard of, or indifference to" legal requirements. *Riss*, 262 F.2d at 251.

III. OTHER CIRCUITS HAVE NOT REJECTED THE CONCEPTS OF VICARIOUS LIABILITY OR CORPORATE SCIENTER

Contrary to the arguments of the defendants and their amici, other circuits have not foreclosed the possibility of either vicarious liability or liability based on corporate policy with respect to securities fraud claims.

For instance, Amici SIFMA cites *Nolte v. Capital One Fin. Corp.*, 390 F.3d 311 (4th Cir. 2004), as rejecting the concept that a corporation can have its own scienter. In fact, the Fourth Circuit decided the case based on falsity alone and expressly declined to address scienter. *Id*. at 317. Similarly, Amici SIMFA rely on

Ezra Charitable Trust to argue that the First Circuit has rejected corporate scienter. Before the district court, however, the plaintiffs made "no independent claims regarding [the corporation's] scienter." *Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 2005 WL 2127619, at *4 (D.N.H. 2005). Consequently, the appeals court did not consider the scienter of the corporation.

Other cases similarly do not address corporate scienter. For instance, in *Kushner v. Beverly Enter.*, 317 F.3d 820 (8th Cir. 2003), the Eighth Circuit limited its discussion to the scienter of the individual defendants and did not address the scienter of the corporation itself. And in both *In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137 (3d Cir. 2004) and *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006), the courts concluded that the facts alleged did not give rise to a strong inference of scienter, but said nothing about whether, if sufficiently pleaded, scienter might have been attributed to the corporation irrespective of a particular individual.

Nor should *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995) be interpreted to foreclose scienter based on corporate misconduct. There, a securities fraud claim had been brought against Nordstrom and its officers and directors. After discovery, the parties settled. Because the corporate insurance policy covered only directors and officers, the insurer argued that it was not obligated to pay portions of the settlement attributable solely to the corporation's

wrongdoing. In this context, the Ninth Circuit was called upon to determine whether there was any possibility of liability against the corporation that was not traceable to the actions of covered individuals. *See id.* at 1429-30. Based upon the facts that developed *in that case*, the Ninth Circuit concluded that there was not. *See id.* at 1436 ("*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." (emphasis added)). Critically, in a similar situation, the Seventh Circuit refused to foreclose the possibility of corporate scienter, distinguishing *Nordstrom* on the ground that *Nordstrom* had settled at a later stage in the proceedings than had the Seventh Circuit action. As the Seventh Circuit explained, "*Nordstrom* rejected the possibility of finding corporate scienter without finding that scienter on the part of any particular director or officer. .. *Nordstrom* thus differs from this case in its particulars, not in its analysis; in *Nordstrom*, extensive discovery was already underway … whereas [the defendant here] moved for partial summary judgment before discovery even began." *Caterpillar, Inc. v. Great Am. Ins. Co.,* 62 F.3d 955, 963 n.9 (7th Cir. 1995). The Seventh Circuit observed that the corporation in that action might ultimately have been vicariously liable for the actions of lower-level employees, or might have been liable collectively. *See id.* at 963.

The defendants also rely upon *Southland* for the proposition that a corporation cannot have scienter distinct from the scienter of individual employees. Southland's conclusions regarding corporate scienter should not be followed by this Court. In that decision, the Fifth Circuit rejected both the concept of corporate scienter, and the concept of group pleading. Those conclusions, taken together, create nearly insurmountable hurdles to bringing securities fraud actions and thus threaten to allow guilty defendants to escape liability.

First, in *Southland*, the Fifth Circuit rejected the "group pleading" doctrine. 365 F.3d at 365. "Group pleading" – which has been accepted in this circuit both before and after the passage of the PSLRA, *see DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1248 (2d Cir. 1987); *Cosmas*, 886 F.2d at 12; *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001) – is a pleading presumption that statements in "prospectuses, registration statements, annual reports, press releases, or other group-published information, are the collective work of those individuals with direct involvement in the everyday business of the company." *In re Oxford Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 142 (S.D.N.Y. 1999) (quotation omitted). The doctrine is used to demonstrate that defendants "spoke" for §10(b) purposes when "corporate" statements have not been attributed to them personally. *See DiVittorio*, 822 F.2d at 1248. The presumption is appropriate because, prior to discovery, a plaintiff is unlikely to

know which insiders are responsible for which corporate statements. *See Degulis v. LXR Biotechnology*, 928 F. Supp. 1301, 1311-1312 (S.D.N.Y. 1996).

Contrary to this Court's precedent, however, the Fifth Circuit held that the plaintiffs must allege – in their complaint, and prior to discovery – an individual officer's precise role in drafting a corporate document unattributed to them. *See Southland*, 365 F.3d at 365. In the absence of such allegations, the only "speaker" would be the corporation itself (not the individual officer), and only the corporation as a whole could be liable for the document. *See id*.

The Fifth Circuit next turned to the question of scienter, and – apparently unconcerned with the catch-22 – rejected the notion that a corporation, collectively, could harbor a mental state. *See id.* at 366-67. Combined with its rejection of "group pleading," the effect of the Fifth Circuit's approach is that, at least for documents unattributed to particular individuals (such as press releases and auditor certifications), plaintiffs must identify in their complaint which corporate officials were responsible for their contents, and allege facts demonstrating those individuals' scienter. It is difficult to imagine how plaintiffs could obtain such information prior to discovery, and these requirements go far beyond what was intended by the PSLRA. As the Fifth Circuit itself recognizes, the PSRLA "may have changed federal securities law; it did not eliminate it." *ABC Arbitrage v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002). The Fifth Circuit's

rule encourages corporations to issue statements without attribution, safe in the knowledge that arcane pleading requirements will prevent plaintiffs from holding them responsible for any falsehoods.

IV. PLAINTIFFS SHOULD BE PERMITTED TO PLEAD SCIENTER AGAINST UNNAMED CORPORATE OFFICIALS

Finally, none of the cases cited by the defendants require that the individual whose scienter is attributed to the corporation actually be named as a defendant in the action. Indeed, there are many reasons why a plaintiff might choose to name only the corporation. Individuals may have unique defenses, or may be in bankruptcy proceedings, or may have fled the country, or may simply be judgment-proof. *Cf. AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202 (scienter imputed to accounting firm; no individual defendants named). In a case such as this, where widespread wrongdoing is alleged – including recklessness on the part of regional officers and managers – the court may infer for pleading purposes that such conduct could not have occurred without the knowledge and acquiescence of at least one higher level corporate official, even if the plaintiffs are not in a position to identify that official at pleading. *See, e.g.*, *In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 2006 WL 2057194, at *23 (S.D.N.Y. 2006) (where fraud is "readily perceivable" from a complaint, plaintiffs need not "match a culpable employee with a public misstatement" at pleading).

Nor would such an inference be at odds with the general rule that scienter cannot be established from a corporate official's title alone. At pleading, plaintiffs may not have enough information about how responsibilities are allocated within a corporation in order to show that a *particular* corporate official was aware of an alleged fraud, but, depending on the facts, there may be a strong inference that *some* corporate official must have known of the alleged wrongdoing because the activities were too large scale, too long term, or required too much cooperation with higher level officials to have occurred completely under management's radar.

Although courts may refuse to infer scienter solely from an officer's title, facts regarding the typical responsibilities of corporate officers need not be entirely ignored, either. A CEO, for example, may not know every minute aspect of a large business, but a court need not adopt an initial presumption that the CEO is completely ignorant of the basic workings of the corporation. This is why most courts will allow an inference that corporate officials are at least familiar with large-scale matters of significant importance. *See, e.g., Kinder-Morgan,* 340 F.3d at 1106; *Cosmas,* 886 F.2d at 13; *In re CINAR Corp. Sec. Litig.*, 186 F. Supp. 2d 279, 317 (E.D.N.Y. 2002).

Obviously, the strength of any inference that corporate executives are aware of problems will vary. Some matters are of such importance to the corporation that an inference of knowledge is inescapable. *See Nathenson v. Zonagen, Inc.*, 267

F.3d 400, 424-425 (5th Cir. 2001). In some instances, the alleged fraud may be so small relative to the corporation's business that no inference can be drawn. *See Chill v. GE Co.*, 101 F.3d 263, 270 (2d Cir. 1996). And sometimes, an officer's position, the size and importance of the fraud, considered with other facts, contribute to an inference of scienter. *See In re Cabletron Sys.*, 311 F.3d 11, 40 (1st Cir. 2002). "The vitality of the inference to be drawn depends on the facts, and can range from marginal to strong." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999) (discussing insider trading). At bottom, there are no facts that a court must *ignore* when determining whether scienter has been properly alleged, including facts regarding officers' positions in the company and the basic matters of which they would be expected to be aware.

V. CONCLUSION

Though there are many potential ways of conceiving of corporate scienter, at minimum, a corporation may be held responsible for practices that rise to the level of corporate policy and that either encourage the making of false statements or that evidence a reckless indifference as to whether false statements are made. Additionally, a corporation may be held vicariously liable for the actions and mental states of its employees. Under either method, the complaint in this action pleads scienter. The District Court's decision should be affirmed.

Dated: New York, New York
February 22, 2007

Respectfully Submitted,

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