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Corporate Scienter Under Section 10(b) and Rule 10b-5

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I. Introduction

Corporations are named as defendants in nearly every federal securities fraud case under 1934 Securities Exchange Act (''1934 Act'') Section 10(b) and Rule 10b-5. The most frequently litigated issue in Section 10(b) cases, especially at the pleading stage, is scienter, i.e., whether the plaintiff has pleaded facts raising a ''strong inference'' that the defendant—often, a *corporate* defendant—has acted with the required ''intent to deceive, manipulate, or defraud.'' Yet, despite the importance of this question, the federal securities laws are mostly silent on how to ascertain the intent of a corporation or other business entity, and the courts, until relatively recently, have been hesitant to offer an explicit rationale for their treatment of corporate scienter. Even today, courts continue to describe this as an open issue even in Circuits where it has been settled in practice for some time—a reticence that deprives litigants and District Courts of needed guidance.

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Despite the lack of consensus on how to describe the rule or even on which courts have adopted it, however, a review of Section 10(b) cases reveals that, in practice, the courts have adopted a *de facto* rule grounded in traditional principles of agency law as set forth in the Restatement of Agency: ***a corporation can violate Section 10(b) only when at least one of its employees or authorized agents knowingly or recklessly violates Section 10(b) in the scope of his or her employment***. The Restatement rule derives from the fact that the Section 10(b) private cause of action is an intentional tort, and an intentional tort can be committed only when the person committing the tort has the required intent. There is no basis in the statute or the case law for a rule of ''collective scienter'' under which one corporate agent's conduct can be mixed-and-matched with another corporate agent's state of mind to fabricate a corporate violation that was committed by no natural person. Such an approach has rightly been rejected, either expressly or by implication, by nearly every federal Circuit to confront the issue.

The Restatement rule is consistent with the federal courts' treatment of corporate litigants in this and other areas of law, and with background principles of agency law against which Congress is presumed to legislate. Only a minority of courts have adopted different rules for corporate knowledge under federal law, and have done so in different statutory contexts based on considerations that are not properly extended to an implied cause of action for intentional tort.

Applying the Restatement rule to Section 10(b) claims has a number of significant ramifications in practice. For example, at the pleading stage, the statutory requirement of pleading particular facts that raise a ''strong inference'' of scienter suggests that courts should—in most or all cases—require that the complaint identify one or more relevant corporate officers and connect the allegations of knowledge to those officers. At the discovery stage, identification of the individuals who are alleged to have committed the tort can help significantly focus discovery and avoid massive dragnets of the e-mails of all corporate employees who might possibly have knowledge that could be aggregated. And at settlement, releases of the wrongdoing individuals will extinguish the liability of the corporation.

II. Overview: Scienter, The Statute and The Common Law

A. Scienter Under Section 10(b) and Rule 10b–5. Section 10(b) of the 1934 Act– along with Rule 10b-5, promulgated under its authority—is a civil regulatory and criminal prohibition, from which the courts have implied a private right of action. Section 10(b) makes it unlawful ''[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance.''[1] As the U.S. Supreme Court held in *Ernst & Ernst v. Hochfelder*, by using the terms '' 'manipulative,' 'device,' and 'contrivance,' '' Congress deployed ''the commonly understood terminology of *intentional* wrongdoing''—statutory language that makes ''unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.''[2] Thus, the Court in *Ernst* rejected the ''common-law and statutory duty of inquiry'' the lower courts had imposed on an accounting firm and held instead that liability under Section 10(b) requires proof of scienter: ''a mental state embracing intent to deceive, manipulate, or defraud.''[3] The Court later made explicit that the same element of '' 'knowing or intentional misconduct' '' applies in SEC enforcement actions, because it is drawn from the language of the statute.[4] While every Circuit to consider the question has held that scienter can be shown by reckless conduct, the various definitions of recklessness adopted by different Circuits have steered close to *Ernst*'s description of recklessness as ''a form of intentional conduct'' akin to willful blindness, and have resisted any definition that would resemble the negligence liability rejected in *Ernst*.[5]

As the Court elaborated in subsequent cases, mere corporate mismanagement or misconduct does not violate Section 10(b) unless the actions at issue are fraudulent in nature: ''Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.''[6] Moreover, the intended deceit must be ''use[d] or employ[ed] in connection with the purchase or sale of [a] security,''[7] and thus specific intent is required: not merely to commit some general bad act, but rather ''intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.''[8]

In setting the pleading standards for scienter in the Private Securities Litigation Reform Act of 1995 (''PSLRA''), Congress made explicit that the required state of mind must be connected to the act of deception:

> [I]n any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, *with respect to each act or omission alleged to violate this chapter*, state with particularity facts giving rise to a strong inference that *the defendant acted with the required state of mind*.[9]

The statute, however, speaks only once about the intent of a corporation. The statutory safe harbor for forward-looking statements, contained both in Section 27A of the Securities Act of 1933 (''1933 Act'') and Section 21E of the 1934 Act, allows a defendant to evade responsibility for certain forward-looking statements. The safe harbor is expressly made available to both the corporate issuer and ''[a] person acting on behalf of such issuer,'' as well as an underwriter and an ''outside reviewer retained by such issuer,'' such as an auditor, and liability may be imposed only if the statement

> (i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
>
> (ii) if made by a business entity; [1] was—
>
> (I) made by *or with the approval* of *an executive officer* of that entity; and
>
> (II) *made or approved by such officer with actual knowledge by that officer* that the statement was false or misleading.[10]

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[1] 15 U.S.C. § 78j(b).

[2] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 (1976) (emphasis added).

[3] *Id.*, at 192, 193 n.12.

[4] *Aaron v. SEC*, 446 U.S. 680, 689-95 (1980) (*quoting Ernst*, 425 U.S. at 197).

[5] *See Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n. 3 (2007) (citing *Ottmann v. Hanger Orthopedic Grp., Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (collecting cases)); *Ernst*, 425 U.S. at 193 n. 12; *South Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (defining ''conscious recklessness'' as ''a state of mind approximating actual intent, and not merely a heightened form of negligence'') (italics and quotation omitted). The Supreme Court has repeatedly reserved decision on whether recklessness is actually sufficient to establish Section 10(b) liability. *See Tellabs*, 551 U.S. at 319 n. 3; *Ernst*, 425 U.S. at 193 n. 12.

[6] *See Chiarella v. United States*, 445 U.S. 222, 230, 234-35 (1980); *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977).

[7] 15 U.S.C. § 78j(b).

[8] *Ernst & Ernst*, 425 U.S. at 199 & nn. 20-21. *See Cozzarelli v. Inspire Pharmaceutical*, 549 F.3d 618, 628 (4th Cir. 2008) (not fraudulent for corporation to keep information in confidence with the ''lawful intent'' of furthering its ''competitive interests.''); *Kalnit v. Eichler*, 264 F.3d 131, 141 (2d Cir. 2001) (concealing information from proposed merger partner ''cannot be conflated with an intent to defraud the shareholders''). Moreover, a defendant must know ''that not disclosing [a fact] posed substantial likelihood of misleading a reasonable investor,'' which requires the defendant to know what disclosures *were* being made. *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1264 (10th Cir. 2001). *See also ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 202 (2d Cir. 2009) (requiring knowledge that undisclosed facts were material and required disclosure).

[9] 15 U.S.C. § 78u–4(b)(2)(A) (emphases added).

[10] 15 U.S.C. §§ 77z–2(c)(1)(B) & 78u–5(c)(1)(B) (emphases added).

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The safe harbor indicates Congress' awareness of the practical issues in proving corporate intent, and indeed it allows for the possibility that liability would otherwise arise from a statement made with scienter by some non-executive corporate officer; it imposes the additional requirement that an executive had the elevated intent of "actual knowledge" rather than recklessness. But it is of only limited value in showing Congress' reading of Section 10(b), given that the safe harbor also applied to the various express and implied causes of action (with varying intent requirements) throughout the 1933 and 1934 Acts.

To fill in the blanks, it is necessary to look to the common-law background against which Section 10(b) was enacted. Congress is generally presumed to legislate against the background of the common law.[11] The courts have repeatedly referenced the Restatements of the common law in construing federal statutes that create civil liability, including Section 10(b).[12] The Restatements and other common-law sources are not dispositive, given the Supreme Court's admonitions that "Section 10(b) does not incorporate common-law fraud into federal law" and that the implied private cause of action in particular should not be extended further without Congressional approval.[13] But they can and should inform how courts interpret the background common-law principles.[14]

B. Agency and Respondeat Superior as a Basis for Liability. A corporation, because it is not a natural person and can act only through its agents, ordinarily can be liable in tort only for the authorized acts of its agents under the doctrine of *respondeat superior*.[15] The courts did not take a uniform approach to *respondeat superior* in Section 10(b) cases even prior to 1994.[16] In light of the Supreme Court's elimination of civil aiding and abetting liability in *Central Bank of Denver v. First Interstate Bank of Denver*,[17] and subsequent court decisions extending that ruling to conspiracy liability, some courts and commentators have suggested that *all* common law forms of "secondary liability" have been eliminated for Section 10(b) claims—even *respondeat superior*.[18] Whatever the merits of this argument—and whatever the limitations on how *respondeat superior* may apply in particular cases[19]—the courts have not ceased holding corporations responsible for the authorized acts of their agents within the scope of their employment.[20] So long as *respondeat superior* supplies the basis for liability, its requirements should conform to the common law of agency from which it derives. As Judge Gerard E. Lynch of the U.S. District Court for the Southern District of New York, now on the U.S. Court of Appeals for the Second Circuit, held in a case where the plaintiffs sought to maintain their claims against the corporation after having released all of its agents, attempts to impose corporate liability without the strictures of the common law of agency are:

> Nothing but a subtle attempt . . . to take the sweet without the bitter, to import common-law principles like *respondeat superior* into the federal securities context . . . while at the same time demanding that traditional limitations on those

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[11] *See, e.g., Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 134 S. Ct. ___, 2014 BL 80718, at *7, 9 (U.S. Mar. 25, 2014); *Staub v. Proctor Hospital*, 131 S. Ct. 1186, 1191 (2011); *Meyer v. Holley*, 537 U.S. 280, 285 (2003).

[12] *See, e.g., Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343-46 (2005) (Section 10(b) loss causation); *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 596 (2001) (Section 10(b) implied misrepresentation); *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (Section 10(b) reliance). *See also Lexmark*, 2014 BL 80718, at *10–11 (Lanham Act causation); *Bridge v. Phoenix Bond & Indemnity Co.*, 553 U.S. 639, 656-57 (2008) (RICO causation); *Beck v. Prupis*, 529 U.S. 494, 501-06 (2000) (RICO conspiracy); *American Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp*, 456 U.S. 556, 565-66 (1982) ("*ASME*") (Sherman Antitrust Act *respondeat superior* liability).

[13] *Stoneridge Invest. Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148, 161-64 (2008).

[14] Courts have assumed that the corporate scienter rules derive from federal law. While the Supreme Court has resisted applying a federal common law rule to imputing the knowledge of corporate officers to a corporation when the underlying cause of action is under state law, *see O'Melveny & Myers v. FDIC*, 512 U.S. 79, 84-85 (1994), it has applied a uniform federal rule to aspects of the 10(b) cause of action. *See Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294-96 (1993); *Lampf, Pleva, Lipkin, Prupis & Pettigrow* v. *Gilbertson*, 501 U.S. 350, 359 (1991). The Third Circuit has treated imputation of the knowledge of a corporate agent as a state-law issue in Section 10(b) cases. *See Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 494 (3d Cir. 2013). By contrast, courts have looked to both federal common law and state law to divine duties of disclosure. *See, e.g.*, *Steginsky v. Xcelera Inc.*, 741 F.3d 365, 371 (2d Cir. 2014) (federal common law); *SEC v. DiBella*, 587 F.3d 553, 565 (2d Cir. 2009) (Connecticut law); *SEC v. Tambone*, 597 F.3d 436, 448 (1st Cir. 2010) (en banc) (collecting cases); *SEC v. Cochran*, 214 F.3d 1261, 1264-65 (10th Cir. 2001) (collecting cases). In any event, courts need not distinguish between the two in the absence of an identified conflict in the outcome.

[15] *See, e.g.*, *Staub*, 131 S. Ct. at 1191-93 (Uniformed Services Employment and Reemployment Rights Act); *Meyer*, 537 U.S. at 285-86 (Fair Housing Act); *ASME*, 456 U.S. at 565-71 (Sherman Act). *See also Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985) (corporate acts such as waiving the attorney-client privilege "must necessarily be undertaken by individuals empowered to act on behalf of the corporation").

[16] *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972) ("The liability of the bank, of course, is coextensive with that of [two individual bank officers]."); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-78 & n. 27 (9th Cir. 1990) (en banc) (collecting cases); *In re Atlantic Fin. Mgmt., Inc.*, 784 F.2d 29, 31-32 (1st Cir. 1986) (Breyer, J.).

[17] 511 U.S. 164 (1994).

[18] *See, e.g.*, 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, 1328 (1997).

[19] For example, a corporate agent's knowledge may not be attributed in some circumstances where the agent was not acting with an intent to benefit the corporation. *See, e.g., United States v. One Parcel of Land Located at 7326 Highway 45 North, Three Lakes, Oneida Cnty., Wis.*, 965 F.2d 311, 316-17 (7th Cir. 1992). A similar limitation can apply to a corporate agent's acts in the service of a different corporation. *See, e.g., In re Global Crossing, Ltd. Sec. Litig.*, No. 02 Civ. 910(GEL), 2005 BL 71449, at *11 (S.D.N.Y. Nov. 4, 2005) (corporation not liable for conduct of officers while they were acting as designees on another corporation's board).

[20] *See, e.g.*, *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1249 (11th Cir. 2012).

doctrines be ignored. Such selective adoption of common law principles cannot be justified.[21]

C. The Restatement, Agency and Respondeat Superior. One of the foundational rules of agency law is that an agent's ''notice of [a] fact is imputed to the principal if material to the agent's duties.''[22] Consequently, the law of agency regularly ''charges a principal with the legal consequences of having notice of a material fact'' whenever the principal's agent has notice of that fact.[23] Given this basic premise, the superficial appeal of a collective-scienter approach is apparent: One of the corporation's agents (A) announces in good faith that her employer, a public company, just completed its most profitable quarter on record. Another agent (B) knows, from her job in the company's accounting department, that there has been a significant (but innocent) bookkeeping error and that the company's last quarter actually ended in the red. Under the principles just discussed, the company ''knows'' both sets of facts at the time A makes her statement regarding the corporation's profits. Thus, the argument runs, the company ''knows,'' and therefore ''intends,'' that its announcement of profits is materially false.

The Restatement (Third) of Agency squarely rejects that view. In discussing the circumstances just described, the Restatement explains:

> [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*. Although notice is imputed to the principal of the facts known by the knowledgeable agent, *the agent who made the false statement did not do so intending to defraud* the person to whom the statement was made.[24]

In fact, the Restatement provides that even corporate liability for negligent misrepresentations turns on the conduct of the speaker: ''[i]f *the agent who made the false statement did so negligently*, the principal may be subject to liability for negligent misrepresentation.''[25] In other words, in the context of imputed knowledge, the whole is *not* greater than the sum of its parts: the legal fiction of imputation charges each principal with the knowledge of all of its agents, but that fiction does not transform that derivative knowledge into an independent, free-floating corporate intent. The same is true when a corporation sues as a plaintiff: it ''cannot rely on misrepresentations unless its agents or employees rely on those misrepresentations'' because, ''[a]s an entity, [it] acts only through its officers and employees.''[26]

The Supreme Court, in formulating the celebrated standard in *New York Times Co. v. Sullivan* for a newspaper company to be liable for defamation, effectively applied the Restatement rule to corporate ''actual malice'':

> [T]here is evidence that the Times published the advertisement without checking its accuracy against the news stories in the Times' own files. The mere presence of the stories in the files does not, of course, establish that the Times 'knew' the advertisement was false, since *the state of mind required for actual malice would have to be brought home to the persons in the Times' organization having responsibility for the publication of the advertisement*.[27]

The Court again faced a corporate defendant whose wrongful intent was ascribed to actors other than a final decisionmaker in *Staub v. Proctor Hospital*.[28] In *Staub*, an employment discrimination case, the plaintiff could show that his supervisors were motivated by discriminatory animus in giving him negative performance reviews, but not any animus on the part of the corporate officer who fired the plaintiff due in part to those reviews.[29] The Court noted that ''[i]ntentional torts . . . as distinguished from negligent or reckless torts . . . generally require that the actor intend the *consequences* of an act, not simply the act itself.''[30] The Court went on:

> Perhaps . . . the discriminatory motive of one of the employer's agents . . . can be aggregated with the act of another agent . . . to impose liability on Proctor. . . . The Restatement of Agency suggests that the malicious mental state of one agent cannot generally be combined with the harmful action of another agent to hold the principal liable for a tort that requires both. Some of the cases involving federal torts apply that rule. But another case involving a federal tort, and one involving a federal crime, hold to the contrary.[31]

Ultimately, the Court in *Staub*, noting that the statutory language in question referred to discriminatory intent as ''a motivating factor'' in an adverse employment decision, resolved the question by permitting the subordinate supervisors' acts to be the basis of liability so long as they proximately caused the plaintiff's firing.[32] But that approach is plainly unavailable in Section 10(b) cases: the Court has repeatedly held that the deceptive act creating liability under Section 10(b) must be the act upon which the plaintiff relied, and that ''making'' a statement under Rule 10b-5 means having control over its final content.[33] And Congress has expressly provided a separate and distinct remedy, with its own state-of-mind requirement, for the ''control person'' behind the throne.[34] Thus, the statutory language does not offer the same solution the Court chose in *Staub*.

The minority position represented by the two Circuit decisions noted in *Staub* is likewise a feature of the particular statutory contexts at issue. The chief case often cited for the doctrine of ''collective knowledge'' is the U.S. Court of Appeals for the First Circuit's decision in *United States v. Bank of New England*, a currency-structuring case against a bank in which the head tellers—the corporate agents directly involved in the transactions—acted willfully with ''flagrant indifference'' to reporting requirements.[35] The U.S. Court of Appeals for the Fourth Circuit's decision in *United*

[21] *In re Global Crossing, Ltd. Sec. Litig.*, No. 02 Civ. 910, 2006 WL 1628469, at *4-5 (S.D.N.Y. June 13, 2006) (citing Restatement (Third) of Torts).
[22] Restatement (Third) of Agency § 5.03 cmt. b (2006).
[23] *Id.*
[24] *Id.* § 5.03 cmt. d(2) (emphases added).
[25] *Id.*
[26] *Bank of China v. NBM LLC*, 359 F.3d 171, 179 (2d Cir. 2004). A fraud plaintiff faces a somewhat different analysis than a defendant because the requirement of *reasonable* reliance makes it relevant what information a decisionmaker could have accessed, but the same principles of attribution are at issue.

[27] 376 U.S. 254, 287 (1964) (emphasis added).
[28] 131 S. Ct. 1186, 1191-92 (2011).
[29] *Id.* at 1191-94.
[30] *Id.* at 1191 (quotations omitted).
[31] *Id.* at 1191-92 (citations omitted).
[32] *Id.* at 1192-94.
[33] *See Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011); *Stoneridge*, 552 U.S. at 159-62.
[34] 15 U.S.C. § 78t.
[35] 821 F.2d 844, 856-57 (1st Cir. 1987).

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States ex rel. Harrison v. Westinghouse Savannah River Co. held that it was sufficient in a False Claims Act case for one corporate officer to know that a company was seeking a bid on a federal contract and that it had conflicts of interest requiring disclosure; the officer did not need to further know that the company actually submitted a certification without that disclosure.[36] In each of these cases, the courts still required one or more responsible corporate employees to act with the prohibited intent; the difference was that the nature of the regulatory reporting requirements at issue were treated as effectively creating a disclosure obligation on the lower-level corporate officer.[37] This contrasts with Section 10(b), which is an anti-fraud statute rather than a regulation of specific disclosures, and which imposes no duty on lower-level employees to overrule the financial disclosures made by senior management.

III. Proving Scienter

A. Collective Scienter and the Restatement Rule in the Courts. The Restatement rule requires that, in a Section 10(b) suit against a corporation, the plaintiff must identify one or more specific officers or employees who individually satisfy the requirements of Section 10(b) liability. It is not necessary that these corporate agents be named as defendants, but there must be *some* individual who committed a complete violation of Section 10(b) with the relevant intent. Every Circuit to consider the question explicitly has done so, and every Circuit except (arguably) the Sixth has at least implicitly accepted it.

At least three Circuits have expressly considered and rejected collective scienter, and embraced the Restatement rule. The U.S. Court of Appeals for the Fifth Circuit, in *Southland Securities Corp. v. Inspire Insurance Solutions, Inc.*, relied on the Restatement (Second) of Agency to conclude that it was ''appropriate to look to the state of mind of the individual corporate official or officials who make or issue the [challenged] statement.''[38] The Fifth Circuit relied on the general common law rule that where, as in fraud, an essentially subjective state of mind is an element of a cause of action also involving some sort of conduct, such as a misrepresentation, the required state of mind *must actually exist in the individual making (or being a cause of the making of) the misrepresentation*, and may not simply be imputed to that individual on general principles of agency.[39]

The Second Circuit, considering the question squarely on an interlocutory appeal after a district court had permitted the pleading of a Section 10(b) claim under the collective scienter theory, adopted the Restatement rule in *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*:

> To 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.[40]

The U.S. Court of Appeals for the Seventh Circuit, on remand from the Supreme Court in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, followed *Southland*:

> Suppose a clerical worker in the company's finance department accidentally overstated the company's earnings . . . . Even if senior management had been careless in failing to detect the error, there would be no corporate scienter. Intent to deceive is not a corporate attribute—though not because ''collective intent'' or ''shared purpose'' is an oxymoron. It is not. A panel of judges does not have a single mind, but if all the judges agree on the decision of a case, the decision can properly be said to represent the collective intent of the panel, though the judges who join an opinion to make it unanimous may not agree with everything said in it.
>
> The problem with inferring a collective intent to deceive behind the act of a corporation is that the hierarchical and differentiated corporate structure makes it quite plausible that a fraud, though ordinarily a deliberate act, could be the result of a series of acts none of which was both done with scienter and imputable to the company by the doctrine of *respondeat superior*. Someone low in the corporate hierarchy might make a mistake that formed the premise of a statement made at the executive level by someone who was at worst careless in having failed to catch the mistake. A routine invocation of *respondeat superior* . . . . would, if applied to a securities fraud that requires scienter, attribute to a corporation a state of mind that none of its employees had.[41]

The U.S. Court of Appeals for the Eleventh Circuit, in *Mizzaro v. Home Depot, Inc.*, apparently endorsed the view of these three Circuits, while emphasizing that the responsible corporate officer need not be a named defendant:

> Even though it failed to plead scienter adequately for any of the individual defendants, the amended complaint could, in theory, still create a strong inference that the corporate defendant . . . acted with the requisite state of mind. Corporations, of course, have no state of mind of their own. Instead, the scienter of their agents must be imputed to them.
>
> Here, however, [plaintiff] does not argue that any Home Depot officials were responsible for the company's financial statements other than the named individual defendants. In other words, [plaintiff] does not argue that, even if the amended complaint fails to raise a strong inference of scienter as to any of the individually named defendants, it does raise a strong inference that *somebody* responsible for

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[36] 352 F.3d 908, 918-19 & n. 9 (4th Cir. 2003). The D.C. Circuit, by contrast, has expressly rejected ''collective knowledge'' in the False Claims Act context, noting that the Fourth Circuit in *Harrison* had ''recognized the theory's troubling implications''. *See United States v. Sci. Application Intern. Corp.*, 626 F.3d 1257, 1274-76 (D.C. Cir. 2010).

[37] As the D.C. Circuit noted, *Bank of New England* held that ''proscribed intent (willfulness) depend[s] on the wrongful intent of specific employees;'' it was not a case of pure aggregation of knowledge, given the state of mind of the tellers. *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 670 n.6 (D.C. Cir. 1996); *see also* Thomas A. Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 Geo. Wash. L. Rev. 210, 224-37 (1996) (''collective knowledge'' doctrine is applied only in cases in which responsible corporate officials were ''willfully blind'' to the violations).

[38] 365 F.3d 353, 366 (5th Cir. 2004).

[39] *Id.* at 366-67 (emphasis added; collecting cases).

[40] 531 F.3d 190, 195 (2d Cir. 2008) (''*Dynex*'') (emphasis added).

[41] 513 F.3d 702, 708 (7th Cir. 2008) (Posner, J.) (''*Makor*'') (italics added). *See also City of Livonia Empl. Ret. Sys. & Local 295/Local 851 v. Boeing Co.*, 711 F.3d 754, 759 (7th Cir. 2013); *Pugh v. Tribune Co.*, 521 F.3d 686, 697-98 (7th Cir. 2008).

> the allegedly misleading statements must have known about the fraud. For that reason alone we need not pursue this issue further.[42]

At least two other Circuits—the Fourth[43] and Eighth[44]—have endorsed the views of these Circuits and rejected collective scienter in practice, albeit without explicitly explaining their reasons for doing so. The U.S. Court of Appeals for the Ninth Circuit has repeatedly declined to adopt a theory of collective scienter, but without conclusively ruling out the possibility.[45] The U.S. Court of Appeals for the Third Circuit has at least twice treated the question as an open one, unsettled under Circuit precedent.[46] But on at least two other occasions, the Third Circuit has specifically refused to aggregate the knowledge of one or more corporate employees with the actions of another.[47]

The First Circuit has also taken the position that a corporation did not commit fraud when new management made statements that *prior* management would have known to be false.[48] This is arguably a rejection of collective scienter—if the company was charged with the knowledge of all its agents, it would be charged with the knowledge of its prior senior management—but it is a slightly different situation because the statements were not made at a time when the prior management was still with the company.

The Tenth and D.C. Circuits have not squarely addressed the collective scienter question in the Section 10(b) context, but both have indicated a disposition towards the Restatement rule. The Tenth Circuit, explaining why it based a corporation's liability on the scienter of its senior officers, held that ''[t]he scienter of the senior controlling officers of a corporation may be attributed to the corporation itself to establish liability as a primary violator of § 10(b) and Rule 10b-5 when those senior officials were acting within the scope of their apparent authority.''[49] The D.C. Circuit has rejected vari-

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[42] 544 F.3d 1230, 1254 (11th Cir. 2008) (emphasis in original) (citation omitted) (quoting *Southland Secs.*, 365 F.3d at 366; also citing *Dynex*, 531 F.3d at 195-196, and *Makor*, 513 F.3d at 708-10). *See also Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 635 (11th Cir. 2010); *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1263-67 (11th Cir. 2006) (scienter not pleaded where complaint did not allege that officers who signed Sarbanes-Oxley-required certifications were presented with reasons to doubt the financial statements, even though a ''management level employee'' notified outside auditors of revenue recognition problems).

[43] The Fourth Circuit has cited the Seventh Circuit's decision in *Makor* with approval. *See Matrix Cap. Mgmt. Fund, L.P. v. BearingPoint, Inc.*, 576 F.3d 172, 182 (4th Cir. 2009) ('' '[C]orporate liability derives from the actions of its agents.' To the extent a plaintiff alleges corporate fraud, the plaintiff 'must allege facts that support a strong inference of scienter with respect to at least one authorized agent of the corporation.' '') (quoting *Teachers' Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 184 (4th Cir. 2007)). *See also In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 388-89 (4th Cir. 2005) (refusing to attribute to a company's senior officers the knowledge of a confidential witness not alleged to be a director or officer making public statements); *Nolte v. Capital One Fin. Corp.*, 390 F.3d 311, 315-16 (4th Cir. 2004) (scienter not pleaded by alleged widespread knowledge within company of problems without an allegation that problems were known to the managers who made public statements; refusing to attribute to all management the views of one officer).

[44] The Eighth Circuit has cited *Dynex* with approval. *See Detroit Gen. Ret. Sys. v. Medtronic, Inc.*, 621 F.3d 800, 808-09 (8th Cir. 2010) (''[Plaintiff] attempts to show collective scienter of Medtronic by pointing out individual pieces of information held within the company that should have (and eventually did) lead to the conclusion there was a problem with [its product]. However, the complaint fails to allege any one individual or group of individuals had, or even had access to, all those pieces of information collectively at the time the allegedly misleading statements were made. . . . [Plaintiff] alleges Medtronic had in its possession the data that indicated there was a problem with [its products] at the time it was still reassuring doctors that [they] were a viable product. That is true. *However, mere possession of uncollected data does not indicate Medtronic was aware of the implications of that data*.'' (emphasis added)). *See also In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1085-86 (8th Cir. 2005) (rejecting claim that sales forecasts were fraudulent based on knowledge of a regional sales manager); *Kushner v. Beverly Enterprise, Inc.*, 317 F.3d 820, 827-30 (8th Cir. 2003) (holding that scienter could not be inferred from the fact that individual employees involved in a fraudulent scheme ''reported'' to one named officer).

[45] *See Glazer Cap. Mgmt., LP v. Magistri*, 549 F.3d 736, 744-45 (9th Cir. 2008) (''Our circuit has not previously adopted a theory of collective scienter. . . . We are . . . not faced with whether, in some circumstances, it might be possible to plead scienter under a collective theory.''); *Knollenberg v. Harmonic, Inc.*, 152 Fed. Appx. 674, 680 (9th Cir. 2005) (complaint ''fail[s] to allege that the same person who read these internal reports was the person who released the alleged misleading statements''); *In re: Apple Computer, Inc.*, 127 Fed. Appx. 296, 303 (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. We have squarely rejected the concept of 'collective scienter' . . . .'' (citation omitted)); *In re Nordstrom, Inc. v. Chubb & Son., Inc.*, 54 F.3d 1424, 1435 (9th Cir. 1995).

[46] *See Rahman v. Kid Brands, Inc.*, 736 F.3d 237, 246 (3d Cir. 2013) (dismissing complaint as insufficiently pleaded even under a collective scienter theory); *City of Roseville Empl. Ret. Sys. v. Horizon Lines, Inc.* 442 Fed. Appx. 672, 676-77 (3d Cir. 2011) (same).

[47] *See In re Tyson Foods, Inc.*, 155 Fed. Appx. 53, 56-58 (3d Cir. 2005) (finding that company general counsel did not act with scienter in making statements, and senior executives did not make statements, and thus company had no liability under *Southland* and *Nordstrom*); *In re Alpharma, Inc. Sec. Litig.*, 372 F.3d 137, 149-53 (3d Cir. 2004) (holding that ''the mere fact that [allegations of accounting irregularities were] sent to [the corporation's] headquarters and therefore w[ere] available for review by the individual defendants is insufficient to'' plead scienter against the company).

[48] *Ezra Charitable Trust v. Tyco Int'l Ltd.*, 466 F.3d 1, 5-11 (1st Cir. 2006) (examining knowledge of corporate managers who made statements to determine whether corporation had scienter in understating prior misconduct within corporation). The First Circuit has since found that a corporate defendant lacked scienter where its ''top managers may have been negligent if they were not aware'' of certain sales and underwriting practices at subsidiary, *Automotive Indus. Pension Trust Fund v. Textron, Inc.*, 682 F.3d 34, 39 (1st Cir. 2012), and justified considering confidential witness allegations because ''[s]cienter involves wrongdoing by high-level company officials; low-level employees . . . may well know of the wrongdoing . . .''. *New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC, Inc.*, 537 F.3d 35, 52 (1st Cir. 2008).

[49] *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106-07 (10th Cir. 2003) (collecting cases). In an earlier common law case, the Tenth Circuit noted that ''while in some cases, a corporation may be held constructively responsible for the composite knowledge of all its agents, whether acting in unison or not, we are unwilling to apply the rule to fix liability where, as here, intent is an essential ingredient of tort liability as for deceit.'' *Woodmont , Inc. v. Daniels*, 274 F.2d 132, 137 (10th Cir. 1959) (citation omitted).

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ants of collective knowledge or collective scienter in several other contexts.[50]

The lone Circuit-level decision to arguably support collective scienter is the U.S. Court of Appeals for the Sixth Circuit's decision in *City of Monroe Empl. Ret. Sys. v. Bridgestone Corp.*, which imputed to the corporation the knowledge of its executive vice president—who also was chief executive officer of the subsidiary whose operations were the subject of the statement—but dismissed the claims against that officer for failure to allege his involvement in making the misstatements.[51] Even leaving aside *Bridgestone*'s distinct facts, the decision does not set forth any analysis supporting its conclusion, and it has not been widely followed. At least one subsequent Sixth Circuit case declined to aggregate the knowledge of lower-level corporate employees.[52] The Sixth Circuit's most recent pronouncement on scienter treated *Bridgestone* simply as creating liability of a corporation for its officers' acts with scienter.[53]

B. Types of Scienter. The types of allegations frequently made in Section 10(b) cases illustrate why the collective scienter approach would greatly expand corporate liability. For example, complaints often challenge a statement of opinion or prediction (*e.g.*, generally accepted accounting principles accounting, technical feasibility, marketing plans, the anticipated success of a drug, or other business judgments) that turned out to be wrong. In such cases, there are frequently internal differences of opinion that can be exploited to give the appearance of fraud from simple disagreement. As the Ninth Circuit explained in holding that corporate scienter could not be based on the doubts of ''lower-level employees'' that a new product would work:

> [I]n any large corporation there will be differences of opinion expressed. The key fact that the district court found undisputed was that Kenetech reasonably relied on its senior engineering personnel, and that ''no reasonable jury could find defendants' reliance unreasonable.'' This . . . represents our settled law that looks to whether there was a reasonable basis for Kenetech's predictive statements of belief.[54]

Moreover, to say that a corporation has misrepresented its opinions or its plans for the future, one must first determine whose opinions or plans are those of the corporation. The Second Circuit, for example, has held that ''plans'' not yet adopted by the Board of Directors do not constitute plans of the company, and has looked to the individuals expressing opinions publicly on behalf of a corporation to determine whether their opinions were genuinely believed; other Circuits have taken a similar approach.[55]

In cases involving errors in financial or proxy statements, where management has misstated a fact, a collective scienter approach presents an even greater problem: it will almost always be the case that if the knowledge of all the company's agents is aggregated, someone will have known the true state of affairs, at least when combined with what everyone else knew. Judge Henry Friendly long ago warned that the purpose of a scienter requirement was to prevent the ''frightening'' prospect for corporations that a ''*failure properly to amass* or weigh *the facts*—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.''[56] ''[S]uch a test, as applied to the corporation issuing a false or misleading proxy statement, would result in *virtually absolute liability* because of the agency doctrine that a corporation is charged with the knowledge of all its agents.''[57] This would make the scienter requirement a practical nullity.

IV. Pleading Scienter

Most of the cases adopting or at least applying the Restatement rule have been decided on motions to dismiss. Yet, those Circuits that adopt the rule explicitly as to proof of a Section 10(b) violation have stopped short of excluding the possibility of stating a claim without explicitly identifying, in the complaint, the responsible corporate officer. But the *dicta* setting forth the exception to this rule are best understood as, at most, a narrow exception preserved to deal with extreme cases.

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[50] *See Sci. Application*, 626 F.3d at 1274-76 (False Claims Act); *United States v. Philip Morris USA Inc.*, 566 F.3d 1095, 1122 (D.C. Cir. 2009) (RICO); *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 670 n.6 (D.C. Cir. 1996) (Warsaw Convention). At least one District Court in the D.C. Circuit has applied the Restatement rule in the securities context, but with the ambiguous suggestion that ''a corporation could be found to possess its own scienter absent a finding of scienter in the individuals who spoke to the market . . . in rare situations where the underlying evidence of corporate-wide knowledge is so dramatic that collective knowledge may be inferred.'' *Plumbers Local #200 Pension Fund v. Washington Post Co.*, 930 F. Supp. 2d 222, 231 n.4 (D.D.C. 2013) (citing *Makor*, 513 F.3d at 710).

[51] 399 F.3d 651, 686-90 (6th Cir. 2005) (''Ono's awareness of the claims as gleaned from these meetings is directly attributable to Bridgestone because 'knowledge of a corporate officer or agent acting within the scope of [his] authority is attributable to the corporation.' '' (footnote omitted) (alteration in original) (quoting 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 12.8[4], at 444 (4th ed. 2002))).

[52] *See Konkol v. Diebold, Inc.*, 590 F.3d 390, 397-98 (6th Cir. 2010) (scienter of corporation not alleged without more detailed allegations of how that management was made aware of, among other things, false-invoice scheme by lower-level employees; ''The standard from *Tellabs* requires *specific* facts that those reports were known to Defendants and reflected the revenue-recognition scheme in such a way that it would have been obvious that Diebold was improperly inflating its revenue.'' (emphasis in original)).

[53] *See Frank v. Dana Corp.*, 646 F.3d 954, 963 (6th Cir. 2011). *Frank* overruled *Konkol* and other Sixth Circuit scienter cases on grounds not relevant here.

[54] *Lilley v. Charren*, 17 Fed. Appx. 603, 607 (9th Cir. 2001).

[55] *See In re IBM Corp. Sec. Litig.*, 163 F.3d 102, 107-09 (2d Cir. 1998); *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 812 (2d Cir. 1996). *See also Cerner*, 425 F.2d at 1085-86 (sales forecasts not fraudulent because a regional sales manager found them ''unattainable''); *Nolte*, 390 F.3d at 315-16 (complaint did not plead that management disbelieved in the adequacy of financial reserves because of one non-speaking executive's opinion).

[56] *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring) (emphasis added).

[57] *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301 n.20 (2d Cir. 1973) (Friendly, J.) (emphasis added) (''However, it seems to us that in this type of case the scienter issue would revolve around the intent with which the proxy statement is prepared, and whether it was willfully misleading or merely negligently drafted.'').

Judge Richard A. Posner posed the following hypothetical in *Makor*, subsequently cited as well by the Second Circuit in *Dynex*:

> Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.[58]

Neither the Seventh nor Second Circuits found any basis to apply this hypothetical, and both accepted that it was available, at most, only at the pleading stage – under those facts, it would almost certainly be the case that the evidence would show that the company's officers knew that its core business was a complete sham. If management actually had some valid reason for being unaware of that fact, liability could not be proven under the Restatement rule as adopted by the Seventh and Second Circuits. While Judge Posner's hypothetical is in tension with the PSLRA's particularity requirement, it has been fairly common for courts to distinguish situations in which the corporate defendant was alleged to be aware that its core business simply did not exist.[59]

The other significant rule of pleading that presents some tension with the Restatement rule is the line of cases permitting a securities fraud claim to be pleaded by showing ''motive and opportunity'' to commit fraud. ''Motive and opportunity'' has remained controversial; the Ninth Circuit, for example, held that the PSLRA eliminated it as a basis for pleading scienter.[60] Other Circuits consider ''motive and opportunity'' as at least a factor at the pleading stage, generally while cautioning against using it as an exclusive avenue to satisfying the PSLRA's pleading standard.[61]

In any event, the motive and opportunity cases are flatly inconsistent with collective scienter. Individual directors and officers must have a ''concrete and personal'' motive, beyond mere general interest in maintaining appearance of corporate profitability.[62] ''[U]nusual'' insider stock sales are generally considered only when carried out under suspicious circumstances by multiple officers and directors responsible for corporate disclosures or by the officer primarily responsible for a particular disclosure.[63] This is because the test is not just motive but motive *and opportunity*: only those individuals with knowledge of the undisclosed facts *and* involvement in the alleged misrepresentations can be said to have an opportunity to commit the alleged fraud.[64] But the connection between motive and opportunity would be severed if the agent having a motive could be aggregated with the agent having the opportunity.

V. Conclusion

The Restatement rule has deep roots in the same common law doctrines that permit corporations to be sued under Section 10(b) and Rule 10b-5 in the first place. It has been explicitly or implicitly adopted by nearly every Circuit to consider the question. The competing collective scienter approach, by contrast, has gained little traction in the courts, is in tension with many settled aspects of Section 10(b) law, and would present significant problems in practice. Accordingly, the better practice is for courts addressing Section 10(b) claims against corporate defendants to explicitly adopt the Restatement rule. Defendants in such cases are well-advised to insist on its application.

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[58] 513 F.3d 702, 710 (7th Cir. 2008); *see also Dynex*, 531 F.3d at 195-96 (''Congress has imposed strict requirements on securities fraud pleading, but we do not believe 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.'').

[59] *See, e.g., Detroit Gen.*, 621 F.3d at 808 (''This is not a situation where the falsity was so obvious that anyone familiar with the business of the company would have known the statements to be false at the time they were made.''); *Mizzaro*, 551 F.3d at 1251 (''This is not a case where allegedly fraudulent transactions amounted to an overwhelming percentage of the corporation's business.''); *S. Ferry LP, #2 v. Killinger*, 542 F.3d 776, 784-85 & n. 3 (9th Cir. 2008) (limiting to ''some unusual circumstances'' the situations in which scienter could be inferred solely from the fact that the statements at issue mischaracterized the company's ''core operations'').

[60] *See, e.g., In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999).

[61] *See, e.g., Ottmann*, 353 F.3d at 344-46 (collecting cases from First, Second, Third, Sixth, and Eighth Circuits).

[62] *See, e.g., Kalnit*, 264 F.3d at 139-42; *Rothman v. Gregor*, 220 F.3d 81, 92-93 (2d Cir. 2000).

[63] *See, e.g., In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74-76 (2d Cir. 2001); *Stevelman v. Alias Corp.*, 174 F.3d 79, 85-86 (2d Cir. 1999).

[64] *See, e.g., Scholastic*, 252 F.3d at 75-76 (vice president for finance and investor relations had opportunity because of access to information, ability ''to control the extent to which it was released to the public,'' and involvement in the misrepresentations); *Suez Equity Investment, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001) (corporate affiliates did not have opportunity to commit fraud); *San Leandro*, 75 F.3d at 814 n.14 (complaint failed to allege that single director ''acting alone had the opportunity to manipulate Philip Morris' plans'').

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