

1 UNITED STATES COURT OF APPEALS

2 FOR THE SECOND CIRCUIT

3
4 August Term 2007

5 (Argued: January 30, 2008 Decided: June 26, 2008)

6 Docket No. 06-2902-cv

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8 TEAMSTERS LOCAL 445 FREIGHT DIVISION PENSION FUND,

9
10 Plaintiff-Appellee,

11 -- v. --

12
13 DYNEX CAPITAL INC. and MERIT SECURITIES CORPORATION,

14
15 Defendants-Appellants,

16
17 STEPHEN J. BENEDETTI, THOMAS H. POTTS, LEHMAN
18 BROTHERS, INC. and GREENWICH CAPITAL MARKETS, INC.,

19
20 Defendants.

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25 B e f o r e : WALKER, CALABRESI, and POOLER, Circuit Judges.

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27 Interlocutory appeal from a partial denial of a motion to
28 dismiss in a securities fraud action in the United States
29 District Court for the Southern District of New York (Harold
30 Baer, Jr., Judge). Defendants-Appellants Dynex Capital and Merit
31 Securities argue that the district court erred in finding that

1 plaintiff adequately pleaded scienter as to the corporate
2 defendants even though it did not successfully plead scienter as
3 to any specific individual defendant.
4

5 VACATED and REMANDED.

6 JOEL P. LAITMAN (Kurt Hunciker and
7 Frank R. Schirripa, on the brief),
8 Schoengold Sporn Laitman & Lometti,
9 P.C., New York, N. Y., for
10 Plaintiff-Appellee.

11
12 EDWARD J. FUHR (Terence J.
13 Rasmussen and Joseph J. Saltarelli,
14 on the brief), Hunton & Williams
15 LLP, New York, N.Y., for
16 Defendants-Appellees.

17
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19 LLP, Washington, D.C., for Amici
20 Curiae Business Roundtable, Chamber
21 of Commerce of the United States of
22 America, Financial Markets
23 Association, and Securities
24 Industry Association.

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34 Consumer Attorneys.

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38 Diego, Cal., for Amicus Curiae
39 Amalgamated Bank.

40
41 Stanley D. Bernstein, Bernstein
42 Liebhard & Lifshitz, LLP, New York,
43 N.Y., for Amici Curia States of

1 Mississippi, New Jersey, New
2 Mexico, and Rhode Island; Iowa
3 Public Employees' Retirement
4 System; Pennsylvania Public School
5 Employees' Retirement System;
6 Pennsylvania State Employees'
7 Retirement System.
8

9 JOHN M. WALKER, JR., Circuit Judge:

10 In this putative securities fraud class action, defendants-
11 appellants Dynex Capital Inc. ("Dynex") and Merit Securities
12 Corp. ("Merit") appeal an order entered on February 10, 2006 in
13 the District Court for the Southern District of New York (Harold
14 Baer, Jr., Judge) denying a motion by Dynex and Merit to dismiss
15 the action as to them. On appeal, defendants argue that the
16 district court erred when it found that plaintiff had
17 successfully pleaded scienter against Dynex and Merit despite
18 failing to find scienter pleaded as to any specific officer or
19 employee of either company. They also assert that certain
20 aspects of this action are barred by standing rules and the
21 applicable statute of limitations.

22 Although there are circumstances in which a plaintiff may
23 plead the requisite scienter against a corporate defendant
24 without successfully pleading scienter against a specifically
25 named individual defendant, the plaintiff here has failed to do
26 so. As a result, we vacate the district court's order and remand
27 with instructions to dismiss Teamsters' complaint but allow them
28 an opportunity to replead. It is not necessary, on this

1 interlocutory appeal, to reach defendants' arguments concerning
2 standing and the statute of limitations.

3 **BACKGROUND**

4 Dynex, a Virginia-based financial services company, invests
5 in bonds secured by mortgages on manufactured housing. Merit is
6 one of its subsidiaries. Stephen Benedetti served as president
7 and CEO of Merit at all relevant times, and also held various
8 officer and director positions at Dynex. Thomas Potts served as
9 Dynex's president and principal executive officer from 1997 to
10 June 2002.

11 Between 1996 and 1999, Merit made thousands of loans to
12 people seeking to buy manufactured homes. In March and August of
13 1999, Merit pooled these loans and issued two sets of asset-
14 backed securities secured by the loans, the Series 12 Bonds and
15 the Series 13 Bonds, with the income generated by the loans as
16 collateral. Each series was backed by a separate pool of loans,
17 and each was divided into several classes.

18 After the bond issue, the value of the collateral began a
19 sharp decline. Increasing numbers of borrowers defaulted on
20 their loans: in August 1999, 1.35% of Merit's borrowers were
21 delinquent, but, by November 2001, that figure had risen to
22 5.01%. During the same period, Merit's "loss severities,"
23 namely, the difference between amounts loaned to finance home
24 purchases and the lesser amounts realized from the sale of those

1 properties after foreclosure, also increased. In other words,
2 not only were more people defaulting on their loans, but each
3 default was becoming more financially damaging to Merit.

4 In October 2003, Dynex disclosed that it had understated
5 the repossession rates on the Series 13 Bond collateral by
6 approximately 34%. At the same time, Moody's Investor Service
7 began a review of the bonds, with an eye toward downgrading their
8 credit ratings. On February 24, 2004, Moody's downgraded the
9 Series 13 Bonds' rating from "high quality" to "speculative,"
10 based partly on the collateral's rising repossession rates. In
11 March, Fitch Ratings issued a similar downgrade for the Series 12
12 Bonds. In April 2004, Merit disclosed that it had identified "an
13 internal control deficiency" related to the recording of loan
14 losses, and would therefore restate its earnings for two periods
15 in 2003. In the aftermath of these events, the prices of the
16 various classes of Series 12 and 13 Bonds decreased by varying
17 amounts, up to 85%.

18 In February 2005, plaintiff-appellee Teamsters Local 445
19 Freight Division Pension Fund ("Teamsters"), which had purchased
20 approximately \$450,000 worth of Dynex's Series 13 Bonds in early
21 2002, filed an action in the Southern District of New York
22 alleging violations of sections 10(b) and 20(a) of the Securities
23 Exchange Act of 1934 ("Exchange Act"). Teamsters named Dynex and
24 Merit as corporate defendants, and Benedetti and Potts as

1 individual defendants. Teamsters brought the putative class
2 action "on behalf of all open market purchasers of Series 12 and
3 13 bonds between February 7, 2000 and May 13, 2004." (the "class
4 period"). In re Dynex Capital, Inc. Sec. Litig. (Dynex I), No.
5 05-civ-1897, 2006 WL 314524, at *1 (S.D.N.Y. Feb. 10, 2006).
6 There is no allegation, however, that Teamsters purchased the
7 Series 12 bonds.

8 The complaint alleged that Dynex, a late entrant to the
9 manufactured homes financing market looking to increase its
10 market share, had to purchase loans made to "uncreditworthy
11 borrowers." Id. In order to do so, they "overtly" told dealers
12 that they were willing to buy "bad paper" (i.e., very risky
13 loans) and failed to disclose these practices in the offering
14 materials that accompanied the 1999 bond issues. Id. After the
15 initial offering and throughout the class period, Teamsters
16 alleges, the defendants "misrepresented the cause of the bond
17 collateral's poor performance; misrepresented the reasons for
18 restating its loan loss reserves; and concealed the loans' faulty
19 underwriting." Id. The defendants moved to dismiss the
20 complaint, claiming, inter alia, that Teamsters had failed to
21 adequately plead scienter.

22 The district court agreed with defendants that Teamsters
23 "ha[d] failed to adequately plead scienter with respect to Potts
24 and Benedetti," the individual defendants. Id. at *9. Although

1 Teamsters "aptly described a pattern of reckless corporate
2 behavior," they did not "allege[] that Potts or Benedetti saw or
3 had access to specific reports or statements that indicated
4 malfeasance," nor "directly supervised or knew of any identified
5 individual(s) who were engaged in specific wrongdoing," and
6 therefore "failed to link that [reckless] behavior to any
7 culpable individuals." Id. Because plaintiff's complaint did
8 not show that Potts or Benedetti's "culpability [was] based upon
9 more than [each man's] mere position in the corporate hierarchy,"
10 id. at *8, the district court determined that it did not satisfy
11 the heightened scienter pleading requirement of the Public
12 Securities Litigation Reform Act (the "PSLRA").

13 As to the corporate defendants Dynex and Merit, however, the
14 district court found scienter adequately pleaded. "A plaintiff
15 may, and in this case has, alleged scienter on the part of a
16 corporate defendant without pleading scienter against any
17 particular employees of the corporation." Id. at *9. The
18 district court noted plaintiff's allegation that "Dynex
19 systematically originated defective loans, despite clear signs
20 that borrowers were not creditworthy." Id. at *10. In its view,
21 these allegations allowed the inference that "officers and
22 employees of the corporate defendants had the motive and
23 opportunity to commit fraud." Id. The district court found
24 that, because plaintiff's allegations constituted strong

1 circumstantial evidence of recklessness, a sufficiently culpable
2 mental state, Teamsters had successfully alleged scienter as to
3 Dynex and Merit. Id. The district court denied defendants'
4 motion for reconsideration, but certified the issue for an
5 interlocutory appeal. In re Dynex Capital, Inc. Sec. Litig., No.
6 05-civ-1897, 2006 WL 1517580 (S.D.N.Y. June 2, 2006).

8 DISCUSSION

9 We review the denial of a motion to dismiss the complaint de
10 novo, accepting the truth of each factual allegation it contains.
11 United States v. Baylor Univ. Med. Ctr., 469 F.3d 263, 267 (2d
12 Cir. 2006). While we normally draw reasonable inferences in the
13 non-movant's favor on a motion to dismiss, see id., section
14 21D(b) (2) of the PSLRA, which governs scienter pleading in
15 securities fraud actions, establishes a more stringent rule for
16 inferences involving scienter, and requires that a plaintiff's
17 complaint "state with particularity facts giving rise to a strong
18 inference that the defendant acted with the required state of
19 mind." 15 U.S.C. § 78u-4(b) (2).

20 Congress did not define "strong inference," but the Supreme
21 Court has recently held that, to qualify as "strong," an
22 "inference of scienter must be more than merely plausible or
23 reasonable-it must be cogent and at least as compelling as any
24 opposing inference of nonfraudulent intent." Tellabs, Inc. v.

1 Makor Issues & Rights, Ltd., 127 S.Ct. 2499, 2504-05 (2007). The
2 Court has also defined the required state of mind as “a mental
3 state embracing intent to deceive, manipulate, or defraud.” Id.
4 at 2507 (internal quotation marks and citation omitted). In
5 addition to actual intent, the Second Circuit has also concluded
6 that recklessness is a sufficiently culpable mental state in the
7 securities fraud context. See Novak v. Kasaks, 216 F.3d 300,
8 308-09 (2d Cir. 2000). In Novak, we also summarized our case law
9 in this area as suggesting that the required strong inference

10
11 may arise where the complaint sufficiently alleges that the
12 defendants: (1) benefitted in a concrete and personal way
13 from the purported fraud; (2) engaged in deliberately
14 illegal behavior; (3) knew facts or had access to
15 information suggesting that their public statements were not
16 accurate; or (4) failed to check information they had a duty
17 to monitor.

18
19 Id. at 311 (internal citations omitted).

20 Appellants Dynex and Merit contend that the district court’s
21 finding that the Teamsters’ complaint did not raise a strong
22 inference of scienter with regard to the individual defendants,
23 Potts and Benedetti, precludes as a matter of law the finding of
24 such an inference with regard to the corporate defendants. Thus,
25 they argue that the refusal to dismiss as against Dynex and Merit
26 rests on a legal error; namely, the district court’s belief that
27 “[a] plaintiff may, and in this case has, alleged scienter on the
28 part of a corporate defendant without pleading scienter against

1 any particular employees of the corporation." Dynex I at *10. To
2 accept this view, defendants contend, would be tantamount to
3 endorsing a doctrine of "collective scienter," which posits,
4 contrary to "settled principles of corporate liability," that a
5 corporate entity can act with an intent that is not derivative of
6 the intent of one of its agents. Appellants' Br. at 17.

7 In support of their position, defendants point to State
8 Teachers Retirement Board v. Fluor Corp., 654 F.2d 843 (2d Cir.
9 1981). In that case, we affirmed a grant of summary judgment for
10 a securities-fraud defendant because "there [wa]s no evidence on
11 the record...that [Fluor director of investor relations] Russler
12 or any other Fluor officer acted with scienter." Id. at 853
13 (emphasis added). To the defendants, this demonstrates this
14 court's view that "[t]he lack of scienter on the part of the
15 corporation's agents precluded any finding of scienter on the
16 part of the corporation." Appellants' Br. at 18.

17 The language emphasized above clearly distinguishes Fluor
18 from the instant case. In Fluor, there was "no evidence" of
19 scienter as to "Russler or any other Fluor officer." 654 F.2d at
20 853. In this case, by contrast, while the district court
21 similarly found no evidence of scienter on the part of the
22 specifically named officers, it did find sufficient allegations
23 of scienter as to other unnamed "officers" of the company. See
24 Dynex I at *10. Specifically, the district court found

1 Teamsters' allegations "sufficient to infer that officers and
2 employees of the corporate defendants had the motive and
3 opportunity to commit fraud." Id. And under Novak, properly
4 alleging an individual's motive and opportunity to commit fraud
5 is one way of raising a strong inference of scienter as to that
6 individual. See 216 F.3d at 307.

7 Furthermore, defendants' reliance on Fluor, a case decided
8 over a decade before the enactment of PSLRA, and one involving a
9 motion for summary judgment, rather than a motion to dismiss (as
10 here), demonstrates the fundamental flaw in their argument: they
11 improperly conflate pleading rules and liability rules. To prove
12 liability against a corporation, of course, a plaintiff must
13 prove that an agent of the corporation committed a culpable act
14 with the requisite scienter, and that the act (and accompanying
15 mental state) are attributable to the corporation. See, e.g.,
16 Fluor, 654 F.2d at 853; Makor Issues & Rights, Ltd. v. Tellabs,
17 Inc., 513 F.3d 702, 708 (7th Cir. 2008).

18 To survive a Rule 12(b)(6) motion under the PSLRA, a
19 plaintiff must only state facts "giving rise to a strong
20 inference that the defendant acted with the required state of
21 mind." 15 U.S.C. § 78u-4(b)(2). When the defendant is a
22 corporate entity, this means that the pleaded facts must create a
23 strong inference that someone whose intent could be imputed to
24 the corporation acted with the requisite scienter. In most

1 cases, the most straightforward way to raise such an inference
2 for a corporate defendant will be to plead it for an individual
3 defendant. But it is possible to raise the required inference
4 with regard to a corporate defendant without doing so with regard
5 to a specific individual defendant. As the Seventh Circuit
6 recently observed in the wake of the Supreme Court's remand in
7 Tellabs,

8 [I]t is possible to draw a strong inference of corporate
9 scienter without being able to name the individuals who
10 concocted and disseminated the fraud. Suppose General
11 Motors announced that it had sold one million SUVs in 2006,
12 and the actual number was zero. There would be a strong
13 inference of corporate scienter, since so dramatic an
14 announcement would have been approved by corporate officials
15 sufficiently knowledgeable about the company to know that
16 the announcement was false.

17
18 Makor Issues & Rights, 513 F.3d at 710. Accordingly, we reject
19 appellants' contention that Teamsters failed as a matter of law
20 to plead scienter against Dynex and Merit when it failed to plead
21 scienter against Potts and Benedetti. Congress has imposed
22 strict requirements on securities fraud pleading, but we do not
23 believe they have imposed the rule urged by defendants, that in
24 no case can corporate scienter be pleaded in the absence of
25 successfully pleading scienter as to an expressly named officer.

26 Nevertheless, because we review the denial of a motion to
27 dismiss de novo, we must still determine whether Teamsters has
28 raised a "strong inference" of scienter against Dynex and Merit.

29 Teamsters argues that their complaint satisfies the pleading

1 requirements of the PSLRA, as explained in Novak, in three ways.
2 First, they claim that they have sufficiently pleaded that Dynex
3 “knew facts or had access to information suggesting that their
4 public statements were not accurate,” Novak, 216 F.3d at 311,
5 because senior executives such as Potts and Benedetti had access
6 to “collection data” which “reflected the high percentage of Buy
7 Fair [sic] Loans, First Payment Default delinquencies and failed
8 or impaired repossessions.” Complaint at 14-15, ¶¶ 27-28. These
9 data, Teamsters claims, would reveal “that the true reason” for
10 the underperforming bond collateral was “the manner in which the
11 collateral was originated.” Id. But, as we observed in Novak,
12 “[w]here plaintiffs contend defendants had access to contrary
13 facts, they must specifically identify the reports or statements
14 containing this information.” 216 F.3d at 309. Teamsters’ broad
15 reference to raw data lacks even an allegation that these data
16 had been collected into reports that demonstrated that loan
17 origination practices were undermining the collateral’s
18 performance. Accordingly, they have not raised an inference of
19 scienter based on knowledge of or access to information
20 demonstrating the inaccuracy of Dynex’s public statements.

21 Teamsters’ second contention fails for much the same reason.
22 They argue that they have raised an inference of scienter by
23 alleging that “the defendants failed to review or check
24 information that they had a duty to monitor.” Id. at 308. But

1 again, they have not specifically identified any reports or
2 statements that would have come to light in a reasonable
3 investigation and that would have demonstrated the falsity of the
4 allegedly misleading statements.

5 Finally, Teamsters argues it satisfied Novak's "motive and
6 opportunity prong" by demonstrating that unspecified employees or
7 officers of Dynex and Merit, and, by imputation, the corporate
8 entities themselves, benefitted "in a concrete and personal way"
9 from the alleged fraud. Appellee's Br. at 30 (citing Novak, 216
10 F.3d at 311). Their motive, according to Teamsters, was to avoid
11 "fully disclos[ing] the impaired quality of the collateral." Id.
12 This alleged motive is insufficient. In Novak, we observed that
13 "[p]laintiffs could not proceed based on motives possessed by
14 virtually all corporate insiders, including . . . the desire to .
15 . . . sustain the appearance of corporate profitability, or of the
16 success of an investment." 216 F.3d at 307 (internal quotation
17 and citation omitted). Teamsters' proffered motive is the same
18 desire to maintain the appearance of profitability that we have
19 consistently rejected as insufficient in securities fraud
20 pleading. See Chill v. Gen. Elec. Co., 101 F.3d 263, 268 (2d
21 Cir. 1996) ("[I]f scienter could be pleaded on that basis alone,
22 virtually every company in the United States that experiences a
23 downturn in stock price could be forced to defend securities
24 fraud actions." (internal quotation marks and citation omitted)).

1 In sum, Teamsters fails to allege the existence of
2 information that would demonstrate that the statements made to
3 investors were misleading, e.g., information showing that the
4 primary cause of the bonds' poor performance was not the general
5 weakness in the mobile homes market. They have also failed to
6 allege that anyone at Dynex or Merit had a compelling motive to
7 mislead investors regarding the bonds. As a result, a number of
8 competing inferences regarding scienter arise. One might infer
9 that no one at Dynex or Merit found the statements misleading
10 because they identified the cause of the bonds' performance as
11 accurately as possible, or that no one responsible for the
12 statements made to investors had reason to believe that Dynex
13 employees were systematically flouting its underwriting
14 guidelines or giving them false information about the cause of
15 the bonds' poor performance. Teamsters would have us infer that
16 someone whose scienter is imputable to the corporate defendants
17 and who was responsible for the statements made was at least
18 reckless toward the alleged falsity of those statements. We
19 cannot say, based on the allegations in the complaint, that this
20 inference is "at least as compelling" as the competing inference,
21 Tellabs, 127 S.Ct. at 2505; i.e., that the statements either were
22 not misleading or "were the result of merely careless mistakes at
23 the management level based on false information fed it from
24 below." Makor Issues & Rights, 513 F.3d at 709. Accordingly, the

1 PSLRA requires dismissal of the complaint. We note, however,
2 that before it authorized the interlocutory appeal at bar, the
3 district court granted plaintiff leave to replead within 30 days.
4 We believe this course to be proper on remand, with respect to
5 both the individual and corporate defendants.

6 Finally, defendants argue that the plaintiff lacks standing
7 to represent the Series 12 bondholders, and that the statute of
8 limitations has run as to some of the statements plaintiff
9 alleges to be fraudulent. While we have discretion to address
10 these issues on an interlocutory appeal, see Yamaha Motor Corp.
11 v. Calhoun, 516 U.S. 199, 205 (1996), we decline to do so at this
12 stage, as the resolution of these issues will not "materially
13 advance the ultimate termination of the litigation." 28 U.S.C. §
14 1292(b).

16 CONCLUSION

17 For the foregoing reasons, the judgment of the district
18 court is VACATED insofar as it denied the motion to dismiss
19 defendants Dynex and Merit. The case is REMANDED with
20 instructions to dismiss as to these two defendants with leave to
21 replead.