

Tenth Circuit: Affirms the Dismissal of a Securities Fraud Action for Failure to Allege That Any Individual Defendant or the Corporation Itself Acted with Scienter

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On February 25, 2020, the Tenth Circuit affirmed the dismissal of a securities fraud action alleging misstatements concerning a money transfer company's anti-money laundering ("AML") and anti-fraud compliance systems. *Smallen v. The Western Union Co.*, 2020 WL 893826 (10th Cir. 2020) (Baldock, C.J.). The Tenth Circuit recognized that "the complaint may give rise to some plausible inference of culpability on the part of [d]efendants," but determined that plaintiff did not plead particularized facts raising a strong inference of scienter as to any of the individual defendants. The court further found that that plaintiff did not plead that the corporation itself acted with scienter. Addressing a question of first impression, the court held that for purposes of pleading a corporation's scienter with respect to alleged misstatements, the knowledge of non-defendant corporate agents who played no role in those statements cannot be imputed to the corporation.

Plaintiffs Failed to Plead Scienter as to Any of the Individual Defendants

The Tenth Circuit rejected plaintiff's contention that the individual defendants "must have known the company's compliance programs were ineffective" because the company received complaints regarding hundreds of millions of dollars in fraudulent transactions. The court explained that the transactions at issue represented less than 1% of the total dollars transferred by the company and therefore did not impact "an overwhelming percentage of the company's business."

The Tenth Circuit also declined to infer the individual defendants' scienter based on "materials from [the company's] board and committee meetings, which the individual defendants allegedly attended." The court explained that "mere attendance at meetings does not contribute to an inference of scienter." The Tenth Circuit further determined that it could not infer the individual defendants' scienter based on reports and records concerning compliance issues that were produced to government investigators. The court explained that there were no "particularized allegations showing the [i]ndividual [d]efendants themselves dealt with the government regulators, reviewed the underlying documents submitted as part of the investigations, or were otherwise informed legal noncompliance existed within the company during the [c]lass [p]eriod." While the court found plaintiffs' theory of scienter "strongest against" the company's CEO, who was allegedly "regularly briefed" on compliance issues, the court concluded that it could not "infer scienter based only a defendant's position in a company or involvement with a

particular project.”

The Tenth Circuit also held that findings in a joint settlement agreement with federal regulators and admissions in a deferred prosecution agreement did not demonstrate that the individual defendants knew of compliance violations. The court found plaintiff’s reliance on these documents was “simply another variation of fraud by hindsight” because “neither document provide[d] particularized facts tying the [i]ndividual [d]efendants to these violations or otherwise showing they were aware of ongoing illegality and widespread disciplinary failures during the [c]lass [p]eriod.” The Tenth Circuit also found that plaintiffs could not demonstrate a motive to defraud based on the individual defendants’ stock sales, as two of the defendants “increased their aggregate holdings” while one of the defendants sold no company stock during the class period.

The Scienter of Non-Defendant Corporate Agents Who Played No Role in the Alleged Misstatements Cannot Be Attributed to the Corporation

The Tenth Circuit acknowledged that “[a]lthough [p]laintiff fail[ed] to adequately plead scienter for any of the [i]ndividual [d]efendants, the complaint could, in theory, still give rise to a strong inference [that the company] acted with the requisite state of mind.” The court explained that “[c]orporations, of course, do not have the their own state of mind. Rather, the scienter of a corporation’s agents must be imputed to it.”

The court noted that “[t]he appropriate standard for evaluating whether a non-defendant corporate agent’s state of mind can be imputed to a corporate defendant under the [Private Securities Litigation Reform Act (“PSLRA”)] appears to be an open question” in the Tenth Circuit. The court held that “[b]ecause the allegations here concern allegedly fraudulent public statements,” it would “look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like).”

The court expressly rejected plaintiffs’ argument that “the scienter of *any* [company] agent, including lower-level corporate officers who played no role in the misstatement, can be imputed to the company for purposes of liability under the PSLRA.” The court explained that “[i]f the scienter of any agent is imputable to a corporation, ‘then it is possible that a company could be liable for a statement made [] so long as a low-level employee, perhaps in another country, knew something to the contrary.’” The court found that “[s]uch a result runs afoul of the PSLRA’s heightened standard for pleading scienter.”

The court determined that plaintiff’s allegations did not “give rise to a strong inference of scienter as to any identifiable [corporate] officer,” and further held that the company was not “subject to § 10(b) liability under the doctrine of ‘corporate scienter,’” which “allows a plaintiff to plead scienter against a corporate defendant without doing so for a particular individual.” The court noted that the Tenth Circuit has “neither accepted nor rejected this theory of corporate scienter,” but found that it need not resolve the question as “the facts pleaded are a far cry” from the frequently-cited hypothetical situation “as to when the doctrine would apply”: the example of a car company that claimed to have sold millions of vehicles but in fact sold none.

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