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Second Circuit Update

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Second Circuit Clarifies Pleading Requirements for Scienter in Securities Fraud Class Actions

Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc., 2008 WL 2521676 (2d Cir. June 26, 2008)

The Second Circuit recently remanded a putative securities fraud class action with instructions to dismiss the complaint with leave to replead because the plaintiff had failed to adequately plead scienter on the part of the named individual defendants as well as the corporate defendants.

In *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, Inc.*, 2008 WL 2521676 (2d Cir. June 26, 2008), the Court held that while under certain circumstances, a plaintiff may plead the requisite scienter against a corporate defendant without successfully pleading scienter against a named individual defendant, the plaintiff had failed to do so.

The PSLRA's Pleading Requirements

To survive a motion to dismiss under the Public Securities Litigation Reform Act (the "PSLRA"), a plaintiff must state facts "giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). When one or more defendants are corporate entities, as in *Teamsters*, the allegations "must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter." *Teamsters*, 2008 WL 2521676, at *4. The most straightforward way to raise such an inference for a corporate defendant is to plead it for an individual defendant by pleading particularized allegations demonstrating that the defendant acted consciously or recklessly or that the defendant had both the motive and opportunity to commit fraud. However, this is not the only way.

In the wake of the U.S. Supreme Court's remand in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Seventh Circuit noted that a complaint's allegations could raise a strong inference of corporate scienter without naming the individuals responsible for the fraud, providing the following example:

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.

Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008).

However, the fraud alleged in *Teamsters* was not so dramatic.

The Allegations

Plaintiff held \$450,000 in defendant Merit Securities Corporation's ("Merit") Series 13 Bonds. Merit issued these securities in connection with thousands of mobile-home loans it had made. The income generated by

the loans acted as collateral for the bonds. After the value of the collateral declined sharply due to a substantial increase in the default rate on the loans, Moody's downgraded the bonds from "high quality" to "speculative." Dynex Capital, Inc. ("Dynex") announced that it would restate earnings for certain periods due to an internal recording deficiency at Merit, the subsidiary that originated the loans. Plaintiff then filed suit in the Southern District of New York, alleging violations of sections 10(b) and 20(a) of the Securities Exchange Act. Named in the lawsuit were Dynex, Merit and their respective chief executive officers.

The complaint alleged that, because Dynex was a late entrant to the home-financing market, it had to purchase loans from uncreditworthy borrowers. Dynex told dealers that it was willing to buy very risky loans -- a fact it failed to disclose in the offering materials of its bond issue. Plaintiff further alleged that after the initial offering, the defendants concealed the loans' problematic underwriting and misrepresented the cause of the bond collateral's poor performance and the reasons for restating loan loss reserves.

The District Court's Opinion

Defendants moved to dismiss the complaint, arguing that plaintiff had failed to adequately plead scienter. The District Court agreed that the plaintiff had not adequately pled scienter with respect to the individual defendants, noting that while plaintiff "described a pattern of reckless corporate behavior," it did not allege that those individuals "saw or had access to specific reports or statements that indicated malfeasance." Plaintiff also failed to allege that the individual defendants "directly supervised or knew of any identified individual(s) who were engaged in specific wrongdoing." *Teamsters*, 2008 WL 2521676, at *2.

Nevertheless, the District Court found that scienter had been properly pled against the corporate defendants. A plaintiff may plead scienter against a corporate defendant without pleading scienter against an individual employee of that corporation, the court noted. The allegation that defendant systematically originated defective loans despite the clear uncreditworthiness of borrowers "allowed the inference that officers and employees of the corporate defendants had the motive and opportunity to commit fraud." *Id.* Even if, as defendants argued, such a scheme made no economic sense, the district court held that the allegation "constituted strong circumstantial evidence of recklessness." *Id.*

The Second Circuit's Opinion

The Second Circuit reviewed the District Court's ruling de novo. The Court rejected defendants' contention that because the plaintiff failed to plead scienter on the part of the individual defendants it could not as a matter of law plead scienter against the corporate defendants. Nonetheless, the Court held that plaintiff had failed to raise a strong inference of scienter against the corporate defendants.

Plaintiff argued that it satisfied the PSLRA's pleading requirements by alleging that: (1) one of the corporate defendants "knew facts or had access to information suggesting that their public statements were not accurate" because the individual defendants had access to certain "collection data" that would have revealed "that the true reason for the underperforming bond collateral was the manner in which the collateral was originated;" (2) defendants failed to check information they had a duty to monitor; and (3) certain unspecified employees or officers of the corporate defendants and, by imputation, the corporate entities, benefited "in a concrete and personal way, from the alleged fraud" and their motive was to avoid full disclosure of the impaired quality of the collateral. *Id.* at *5.

The Second Circuit found plaintiff's arguments unpersuasive and dismissed the complaint with leave to replead. In so doing, the Court noted that plaintiff had failed to: (1) allege that any of the "collection data" was incorporated into any written reports available to the defendants; (2) specifically identify any reports or statements available to defendants indicating that their statements were false; or (3) allege that anyone at the corporate defendants had a compelling motive to mislead investors other than the insufficient general motive to maintain the appearance of profitability.

Conclusion

Teamsters confirmed that while a plaintiff need not plead scienter against a specifically named individual defendant to plead the requisite scienter against a corporate defendant, the Second Circuit will require pleading consistent with recent Supreme Court precedent.

No Forum Shopping in Insurance Dispute, Second Circuit Says

Employers Ins. of Wausau v. Fox Entm't Group, Inc., 522 F.3d 271 (2d Cir. 2008)

The Second Circuit recently held that a New York federal district judge should not have dismissed a declaratory judgment action on the grounds that it was filed to get the jump on a competing insurance coverage action later filed in California. In *Employers Insurance of Wausau v. Fox Entertainment Group, Inc.*, 522 F.3d 271 (2d Cir. 2008), the Court reasoned that there was no indication that the plaintiffs were engaging in forum shopping by filing in New York. Thus, the "special circumstances" exception to the general rule that the first filed of two law suits takes precedence did not apply.

Background

On February 28, 2006, two insurance carriers (the "Insurers") filed suit in the Southern District of New York seeking a declaratory judgment that they had no obligations to provide insurance coverage to the defendants in a class action suit filed in the Central District of California. The class action, *East v. Twentieth Century Fox Corp.*, 2008 WL 907947 (C.D. Calif. Jan. 9, 2008), was brought on behalf of the owners of copyrighted musical compositions and sound recordings used in the television show "Santa Barbara" (the "East Action").

Nearly one month later, the East Action defendants filed their own complaint in the Superior Court of California seeking a declaratory judgment obligating the Insurers to provide coverage for the claims in the East Action, as well as damages for breach of contract and tortious breach of the implied duty of good faith and fair dealing. The California action was removed to the Central District of California.

Dismissal of the New York Action

On July 27, 2006, a Southern District of New York judge dismissed the Insurers' complaint. The district court held that although the first-filed rule presumes that the complaint filed earliest takes precedence, a subsequent filing will be given priority when either balancing the conveniences or special circumstances favor the second action.

The court did not balance the conveniences, but did find that two special circumstances existed warranting departure from the first-filed rule. First, the court determined that the Insurers filed suit before coverage had been requested by the defendants. Second, the court determined that the Insurers were forum shopping, purposefully excluding certain California-based defendants in the originally filed action in an attempt to avail themselves of advantages provided under New York law. The court held that these special circumstances warranted dismissal of the first-filed New York action.

The Second Circuit Reverses and Remands

The Second Circuit noted at the outset that a plaintiff's choice of forum is generally honored and when competing lawsuits have been filed, the suit filed first generally takes priority. The second-filed action will be given precedence only if it is favored by the "balance of convenience" or when "special circumstances" warrant its priority. *Employers Ins. of Wausau*, 522 F.3d at 274-75. Thus, "the first-filed rule is only a 'presumption that may be rebutted by proof'" that the second-filed action is in a more appropriate forum. *Id.* at 275.

The factors to be balanced are essentially identical to those considered on a motion to transfer venue: the plaintiff's choice of forum, the convenience of the parties and their witnesses, the ability to compel those witnesses to testify, the location of the relevant evidence and the financial means of the parties. These factors should be evaluated as of the time of balancing rather than as of the date the complaint was filed.

Special circumstances warranting priority for the second-filed suit are rare, the Court noted. For example, when a declaratory judgment is anticipatory and filed after a direct threat of litigation, or when it is clear that a first-filing plaintiff is forum shopping, the balance-of-convenience analysis is unnecessary and the second-filed action will be favored. However, clouded assertions of forum shopping will not suffice. The ties between the litigation and the forum must be tenuous, or the litigant must have chosen the forum with manipulative or deceptive intent to gain some advantage for a court to give the second-filed suit priority.

In remanding the case, the Second Circuit found that special circumstances did not exist in *Employers Insurance of Wausau* and that the district court should not have departed from the first-filed rule without conducting a balance-of-convenience analysis. The Court concluded that the suit was not improperly anticipatory because defendants had made numerous coverage requests before the Insurers' filed their

complaint, that the ties to the New York forum were not tenuous and that forum shopping was not the sole motivation for the Insurers' choice of forum.

Conclusion

Forum is always a consideration to some degree. However, the Wausau decision cautions both careful consideration of the ties to the forum and the elements of the balancing analysis in every case.

New York Court Sets Aside Verdict Imposing Alter Ego Liability

Fantazia Int'l v. CPL Furs N.Y., Inc., 2008 WL 2610599 (Sup. Ct. N.Y. Co. June 19, 2008)

A New York trial court recently set aside a verdict imposing alter ego liability because the weight of the evidence did not demonstrate the complete domination and control of one company over another. In *Fantazia Int'l v. CPL Furs New York, Inc.*, 2008 WL 2610599 (Sup. Ct. N.Y. Co. June 19, 2008), the Court held that maintenance of separate bank accounts and financial records tended to show that there was no absence of corporate formalities to warrant piercing the corporate veil.

Background

Plaintiff sued defendants for unpaid commissions pursuant to a contract between plaintiff and defendant CPL Furs New York, Inc. ("CPL"). One of the central issues in dispute was whether CPL was the alter ego of defendant Centropel Pelzhandel GmbH ("Centropel") and whether, as such, Centropel also was liable for the alleged breach of contract.

Relationship Between CPL and Centropel

CPL is a New York corporation formed by its president, George Papageorgiou ("George") in 1985. Centropel is a German company formed five years later and owned solely by Marko Papageorgiou ("Marko"), George's brother. Both companies are involved in the fur industry and are part of a network of five businesses known as the CPL Group. Within the group, CPL and Centropel often work together. Trial testimony established that at the time the agreement between plaintiff and CPL was executed, George was not only the president of CPL, but simultaneously served as a director and consultant for Centropel. Marko at all times remained the sole owner of Centropel and was never associated with CPL.

Legal Analysis

The Court noted that a fact-sensitive inquiry into the testimony and evidence adduced at trial is required to pierce the corporate veil and uphold the jury's determination that CPL was the alter ego of Centropel. That evidence must ultimately establish the "complete domination" of CPL by Centropel. A bare assertion that CPL was Centropel's alter ego is insufficient. Plaintiff bears the heavy burden of establishing the complete domination of CPL by Centropel that resulted in CPL's alleged breach of its contract with the plaintiff.

In evaluating whether Centropel completely dominated CPL, the Court considered such factors as whether there was a disregard for corporate formalities; inadequate funding or personal use of corporate funding; an overlap of corporate assets or utilities or a shared group of employees, owners or directors; and the extent of CPL's financial independence and business discretion. The ultimate issue to be determined from the trial evidence was whether CPL was merely a fragment of Centropel.

The judge concluded from the trial evidence that defendants adhered to corporate formalities and were financially separate and distinct entities. They each maintained separate bank accounts and filed separate tax returns. The companies were located in different countries and did not share officers, directors or owners, other than George Papageorgiou, which alone was insufficient evidence to support piercing the corporate veil.

The trial evidence further established that CPL had a business function distinct from that of Centropel, and any work relationship the companies shared stemmed solely from the fact that their businesses were related and dependent on each other, a factor that does not necessarily prevent them from being separate and distinct entities. The Court also found that there was no proof that CPL was inadequately capitalized, that personal use was made of corporate funds or that Centropel was responsible for CPL's debts.

New Trial Warranted

Although the Court found that the jury's decision was not so utterly irrational to warrant a directed verdict, the jury had incorrectly interpreted the trial evidence. The Court ordered a retrial of plaintiff's alter ego claim because the weight of the evidence did not support a finding that CPL was completely dominated by Centropel.

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