ALERT MEMORANDUM

Second Circuit Reaffirms Stringent Standard For Pleading Corporate Scienter in Securities Fraud Class Actions

June 5, 2020

It is well-settled under the PSLRA's heightened pleading standards that a securities fraud plaintiff must allege particularized facts giving rise to a strong inference of scienter. However, courts have occasionally struggled to set forth clear standards for how this burden can be met with respect to a corporation (as opposed to an individual defendant). In a *per curiam* opinion issued last week, the Second Circuit provided important guidance on the standards for pleading corporate scienter, holding that—in all but "exceedingly rare instances"—the plaintiff must plead particularized facts connecting employees with knowledge of the underlying issues to the challenged misstatements.[1] Further, the Second Circuit also declined to adopt the so-called "core operations" doctrine, under which a plaintiff asks a court to assume that a company would be aware of all issues involving its key product, holding that "[s]uch a naked assertion, without more, is plainly insufficient to raise a strong inference of collective corporate scienter."[2] And, the Second Circuit also rejected the suggestion that a jury verdict finding that a company intentionally misled consumers in violation of consumer protection laws necessarily established scienter in the context of a securities fraud action.[3]

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Taken together, these holdings provide powerful tools for defendants to argue that a securities fraud plaintiff has not adequately pleaded corporate scienter in the absence of particularized factual allegations that the employees responsible for the challenged statements, or other senior officers or directors, possessed scienter.

[1] *Jackson v. Abernathy et al.*, No. 19-1300-cv, slip op. at 10 (2d Cir. 2020).
[2] *Id.* at 12.
[3] *Id.* at 8 n.2.

Background

Plaintiff Ronald Jackson was an investor in Avanos Medical, Inc. (previously Halyard Health, Inc.), a health product manufacturer that was a subsidiary of manufacturer Kimberly-Clark Corporation.[4] On June 28, 2016, Jackson filed a putative securities class action complaint against both Avanos and Kimberly-Clark, along with several individual employees of those corporations, alleging claims under of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder.[5] The complaint's principal allegation was that Avanos and Kimberly-Clark represented to their shareholders that their "MicroCool Breathable High Performance Surgical Gown," a protective gown designed for health care providers to guard against infectious diseases, had met certain standards of quality, when in reality the senior executives of the defendant corporations knew that there had been issues with the gown.

On March 30, 2018, the district court granted Defendants' motion to dismiss the operative complaint, holding that Plaintiff's allegations were insufficient to plead that the individual defendants possessed scienter, and, accordingly, that those allegations failed to plead scienter against Avanos and Kimberly-Clark as well.[6]

In April 2018, Plaintiff moved to set aside the judgment and for permission to file an amended complaint incorporating testimony and a jury verdict from a related consumer fraud class action in California.[7] In that consumer fraud action, three employees of Kimberly-Clark testified that "the MicroCool gown's compliance problems were well known at the companies."[8] Those employees included the president of Kimberly-Clark's healthcare division, who reported directly to the company's CEO, as well as the director of global strategic marketing and the global director of surgical and infection prevention.[9] Likely based in part on the testimony from these employees, the jury in the consumer fraud action found that the companies had intentionally misled consumers about the gown's protective qualities, in violation of California's consumer protection laws.[10] In the securities class action, Plaintiff argued that this testimony and the jury verdict tended to support a strong inference of scienter against each of the individual defendants.[11]

On March 31, 2019, the district court denied Plaintiff's motion, reasoning that his proposed second amended complaint would be futile because even the new testimony could not support an inference of scienter, including because they did not adequately establish "that the Individual Defendants had been personally informed or would reasonably have been informed about any alleged issues with the MicroCool gowns."[12]

Plaintiff subsequently appealed that decision to the Second Circuit. Notably, on appeal, he dropped his claims against the individual defendants, and instead argued only that the testimony from the individuals in the consumer fraud class action was sufficient to impute scienter to the corporate defendants.[13] Plaintiff also invoked the core operations doctrine by arguing that because the protective gown was a "key product" to the manufacturers' operations, senior corporate executives would have been aware that their statements were inaccurate.[14] And, Plaintiff also suggested that the corporate defendants should be precluded from contesting scienter in the securities class action because the jury in the consumer fraud class action found that they had intentionally defrauded consumers.[15]

[4] *Jackson v. Avanos Med., Inc. et al.*, 2019 WL 1437517, at *1 (S.D.N.Y. Mar. 31, 2019), *aff'd sub nom. Jackson v. Abernathy et al.*, No. 19-1300-cv (2d Cir. 2020).

[5] *Id.*

[6] *Jackson v. Abernathy*, No. 19-1300-cv, slip op. at 5.

[7] *Id.* at 5.

[8] *Id*. at 6.

[9] *Id.*

[10] *Id.* at 6-7.

[11] *Id.* at 7.

[12] *Jackson v. Avanos Med.*, 2019 WL 1437517, at *2 (internal citations and quotations omitted).

[13] *Jackson v. Abernathy*, No. 19-1300-cv, slip op. at 7.

[14] *Id.* at 8.

[15] *Id.* at 8 n.2.

The Second Circuit's Ruling

In a *per curium* decision released on May 27, 2020, the Second Circuit affirmed the district court's rulings and rejected Plaintiff's arguments for assuming that the corporate defendants possessed scienter.

The *Jackson* court began by noting that "[w]here a defendant is a corporation" the applicable heightened pleading standards "require[] pleading facts that give rise to a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter."[16] The Second Circuit conceded that "[a]scribing a state of mind to a corporate entity is a difficult and sometimes confusing task" because "the hierarchical and differentiated corporate structure often muddies the distinction between a deliberate fraud and an unfortunate (yet unintentional) error caused by mere mismanagement."[17] Citing prior Second Circuit authority, the court said that the "most straightforward" way to plead corporate scienter is to "impute it from an individual defendant who made the challenged statement."[18] The court further noted that "[t]he scienter of the other officers or directors who were involved in the dissemination of the fraud may also be imputed to the corporation, even if they themselves were not the actual speaker."[19] And, the court acknowledged that prior Second Circuit cases have held that "a statement may be so dramatic that collective corporate scienter may be inferred" even without alleging scienter with respect to any individual.[20] Significantly, however, the *Jackson* court cabined this exception to "exceedingly rare instances."[21]

For several reasons the Second Circuit concluded that Plaintiff's proposed amended complaint "set[] forth no such allegations" satisfying these standards.[22]

First, it found that Plaintiff's "general" allegations about the three employees who testified in the consumer class action—in particular, that they warned "unidentified senior executives" about the protective gown's defects—were not sufficiently particularized to impute scienter to the corporate defendants.[23] The court noted that "[t]hose employees did not themselves possess scienter, as the steps they took to raise concern about the MicroCool gown's testing failures belie any inference of fraudulent intent."[24] Moreover, although the complaint set forth "allegations that three employees knew of problems with the MicroCool gown," it provided "no connective tissue between those employees and the alleged misstatements."[25] Thus, the court could "only guess what role those employees played in crafting or reviewing the challenged statements and whether it would otherwise be fair to charge the Corporate Defendants with their knowledge."[26]

Second, the Second Circuit also rejected Plaintiff's invocation of the "core operations" doctrine—arguing that "the MicroCool gown was of such core importance to the Corporate Defendants that their senior officers must have known that the challenged statements were false."[27] In short, the *Jackson* court concluded that the "naked assertion, without more," that "the MicroCool gown was a 'key product' for the Corporate Defendants" was "plainly insufficient to raise a strong inference of collective corporate scienter."[28]

Third, the court gave no credence to the Plaintiff's suggestion that the corporate defendants should be precluded from contesting scienter because the jury in the consumer fraud class action found that the companies had intentionally defrauded consumers. Addressing that argument in a footnote, the Second Circuit stated Plaintiff "ha[d] not demonstrated that the

[16] *Id.* at 9 (internal citation and quotations omitted).

[17] *Id.* (internal citation and quotations omitted).

[18] *Id.* at 10 (internal citation omitted).

[19] *Id.* (internal citation omitted).

[20] *Id.* (internal citation and quotations omitted).

[21] *Id.*

[22] *Id.*

[23] *Id.* at 11.

[24] *Id.* at 10.

[25] *Id.* at 11-12.

[26] *Id.* at 12.

[27] *Id.*

[28] *Id.*

issues in the two proceedings are identical" and, "[i]ndeed, it is not at all apparent that the individuals whose states of mind are relevant to prove corporate scienter in the context of a consumer fraud action are the same individuals whose states of mind are relevant in the context of a securities fraud action."[29]

Implications of Jackson

The *Jackson* decision provides significant guidance to courts resolving whether a plaintiff has adequately pleaded corporate scienter, a task that the Second Circuit referred to as "difficult and sometimes confusing."[30]

Perhaps most significantly, the decision confirms that in almost all cases a plaintiff must plead particularized facts giving rise to a strong inference of scienter with respect to an individual who made the challenged statements, or some other senior officer or director. Under *Jackson*, it is not sufficient to allege that someone—or even multiple people—at the company knew about underlying issue, without providing any "connective tissue between those employees and the alleged misstatements."[31] Indeed, the Second Circuit cited favorably to a prior district court decision holding that it is insufficient to "separately allege misstatements by some individuals and knowledge belonging to some others where there is no strong inference that, in fact, there was a connection between the two."[32]

The *Jackson* decision is also important in that it casts further doubt on the continued vitality of the core operations doctrine in the Second Circuit. Since the enactment of the PSLRA, district courts in the Second Circuit have increasingly expressed doubts concerning whether the core operations doctrine—which requires nothing more than the conclusory identification of the relevant issue as a "core operation" of the company in order to plead scienter—is sufficient to satisfy the applicable heightened pleading standards.[33] *Jackson*'s rejection of the "naked assertion, without more," that the MicroCool gown was a "key product" for the corporate defendants, explicitly affirms the holdings of these lower courts that the core operations doctrine is not an independently sufficient basis to plead scienter.[34]

Finally, the Second Circuit's rejection of the suggestion that scienter could be established in the securities class action based solely on the related consumer class action, which resulted in a jury verdict that the companies had defrauded consumers, serves as an important reminder that the scienter inquiry in securities class actions is narrowly focused on whether the defendants intentionally or recklessly misled investors. Increasingly, securities class actions are filed as follow-on actions after a company has been found liable for some underlying misconduct. The *Jackson* decision confirms that, in such cases, merely alleging that the company was found liable for engaging in such misconduct is not sufficient to plead a strong inference of scienter, even where the underlying misconduct itself involved a culpable state of mind. Instead, a plaintiff must separately allege that the company possessed scienter in failing to disclose that underlying misconduct to investors.

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[29] *Id.* at 8 n.2.

[30] *Id.* at 9.

[31] *Id.* at 12.

[32] *Id.* at 8 n.2.

[33] *See, e.g.*, *Reilly v. U.S. Physical Therapy, Inc.*, No. 17 Civ. 2347, 2018 WL 3559089, at *18 (S.D.N.Y. July 23, 2018); *Shemian v. Research In Motion Ltd.*, No. 11 Civ. 4068, 2013 WL 1285779, at *18 (S.D.N.Y. 2013); *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 353 (S.D.N.Y. 2011); *In re Rockwell Med., Inc. Sec. Litig.*, No. 16 Civ. 1691, 2018 WL 1725553, at *14 (S.D.N.Y. Mar. 30, 2018).

[34] *See In re Rockwell Med.*, 2018 WL 1725553, at *15 ("[T]he core operations inference may be considered as part of a court's holistic assessment of the scienter allegations, but it is not independently sufficient to raise a strong inference of scienter.") (internal citations and quotations omitted); *In re Express Scripts Holding Co. Sec. Litig.*, No. 16 Civ. 3338, 2017 WL 3278930, at *18 (S.D.N.Y. Aug. 1, 2017) ("that an allegedly fraudulent statement concerned "core operations," standing alone, is insufficient to support strong circumstantial evidence of scienter.") (quoting *Glaser v. The9, Ltd.*, 772 F. Supp.2d 573, 595 (S.D.N.Y. 2011).