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Sixth Circuit Adopts New Corporate Scienter Test in Securities Cases

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The Sixth U.S. Circuit Court of Appeals recently issued a significant decision clarifying the pleading standards in securities litigation, clarifying what must be alleged to impute a corporation with knowledge of alleged misconduct by its agents and employees.

In an effort to bridge a decade-old divide among appellate courts on the issue of corporate scienter (state of mind), the Court created a new test in *In re Omnicare, Inc. Securities Litigation*, holding that the state of mind of any of the following persons are probative for purposes of determining whether misrepresentations or were made by the corporation as a whole with the requisite scienter:

1. The individual agent who uttered or issued the misrepresentation;
2. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance; or
3. Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.

In Omnicare, a class of plaintiffs made up of the shareholders of the defendant healthcare provider accused it of misleading them about the company's compliance with Medicare and Medicaid billing regulations.

The Court recognized a divide on the corporate scienter issue among appellate courts, from a very narrow standard that the Fifth and Eleventh circuits have established, to a much broader interpretation that can be read from an earlier Sixth Circuit opinion, with a third approach by the Second, Seventh, and Ninth circuits. The Court called its approach a middle ground between other pleading standards for corporate scienter.

In 2004, the Fifth and Eleventh circuits adopted a narrow view allowing scienter to be imputed to the corporation only under the theory of *respondeat superior*, the court noted. These circuits "look to the state of mind of the individual corporate official or officials who make or issue the statement…rather than generally to the collective knowledge of all of the corporation's and officers employees acquired in the court of their employment."

A year later, in *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, the Sixth Circuit took a very different approach, allowing the knowledge of a corporate officer to be imputed directly to the corporation, even though the officer did not issue the false or misleading statement. This approach was also adopted by the Tenth Circuit.

Several years later, the Second, Seventh, and Ninth circuits weighed in as well. These circuits took a "middle position," agreeing that plaintiffs could plead collective corporate scienter, but only in certain circumstances when a company's public statements were so important or dramatically false to create a strong inference that at least some corporate officials knew of the falsity of statements.

Noting that a "middle ground" was necessary because neither approach was ideal, the panel in *Omnicare* criticized its own precedent, stating that past cases have "failed to recognize that" a different framework applies to "cases based on affirmative misrepresentations," as opposed to omissions, "and that different rules apply when the misrepresentation or

omission concerns hard [objective], as opposed to soft [speculative], information."

Ultimately, the Court adopted a new rule regarding the corporate scienter requirement of § 10(b), as stated above, rather than following either side of the circuit split. The panel insisted it was not contradicting the circuit's prior stance from *Bridgestone*, only qualifying some of its overly broad language.

Regarding "soft misrepresentations," the Court adopted the First Circuit's approach that pleading the defendant's knowledge of the falsity of the statements essentially "raises the bar" for pleading the scienter requirement of § 10(b). The Court noted that whether pleading "soft omissions" will meet the higher scienter bar ultimately depends on the facts of the case. In discussing the materiality element of § 10(b), the Court merely noted that the element involves a heavily fact-based inquiry into which the district courts and the Circuit must "tread lightly" and engage carefully.

This issue may come again up again in the future, as the Supreme Court could eventually weigh in on the pleading requirements for corporate scienter, given the disagreements between the different circuit courts of appeals on the proper standard. Our securities litigation team will be following the development of the law on this issue and issue subsequent "Alerts" as developments occur.

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