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COURT REJECTS NOVEL THEORY OF CORPORATE LIABILITY IN SECURITIES CASE

(In re: Dynex Capital Inc. Securities Litigation)

The Washington Legal Foundation (WLF) scored a victory last week when the U.S. Court of Appeals for the Second Circuit reversed a lower court ruling that found that a corporation can be held liable in a securities class action case based on the collective knowledge of corporate employees, even though there was no finding that any employee possessed the requisite knowledge to commit fraud. If the lower court opinion had been upheld, it would have exposed many businesses to abusive class action lawsuits and would be contrary to the strict pleading requirements that Congress intended to apply in securities litigation. The case was remanded to the district court where the plaintiffs will be allowed to refile their complaint, but only if they can allege specific acts of fraud.

In the *Dynex* case, a securities class action was filed against Dynex and several individual officers claiming that the company misrepresented the quality of the bonds that it issued to investors. The district court dismissed the case against the individual officers, finding that the plaintiffs did not sufficiently plead knowledge or scienter on the part of the individuals. Nevertheless, the court held that the company itself can be held liable based on the collective knowledge or "scienter" of any and all employees of the company. In effect, the court imposed strict liability on the corporation, even though no employee was identified as having the intent to make any false statement.

In its brief, WLF argued that this "collective scienter" theory is contrary to the common law and decisions of other courts which require specific allegations of intent or scienter in a complaint against individuals because a corporation, by definition, is a fictional entity and cannot be personified. In addition, WLF argued that this broad theory of corporate liability conflicts with the rigorous pleading requirements of the Private Securities Litigation Reform Act (PLSRA) enacted by Congress in 1995.

WLF's brief was drafted with the *pro bono* assistance of Lyle Roberts, partner in the Washington, D.C. office of LeBoeuf, Lamb, Greene & MacRae, LLP; John Letteri, counsel to the firm; and associates Lisa Keenan, Ilona Coleman-Lange, and Rachel Wolkinson.

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