Case Brief: *In re Triangle Capital Corporation Securities Litigation*[*]

INTRODUCTION

Although Rule 10b-5, a regulation promulgated by the U.S. Securities and Exchange Commission, provides an implied private remedy for securities fraud claims, this remedy does not follow explicitly from any legislative enactment.[1] Instead, private 10b-5 claims are a judge-made innovation. As the Supreme Court noted in *Blue Chip Stamps v. Manor Drug Stores*,[2] "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."[3] Judges have taken the liberty to mold this judicially implied private right of action, imposing various requirements throughout its jurisprudence. One such requirement is scienter,[4] the "intent to deceive, manipulate, or defraud."[5] In response to the growing volume of securities fraud claims, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA").[6] Among other things, the Act imposed heightened scienter requirements for bringing 10b-5 claims.[7]

In a recent Fourth Circuit case, *In re Triangle Capital Corp. Securities Litigation*,[8] the court analyzed the updated requirements for scienter in 10b-5 actions, adopting—and adapting—much of the doctrine formulated by the Supreme Court and the PSLRA.[9] Though the court purports to apply the same

1. *See* 17 C.F.R. § 240.10b-5(b) (2014). The rule was promulgated pursuant to statutory authority granted under the Securities and Exchange Act of 1934. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2010)).

2. 421 U.S. 723 (1975).

3. *Id.* at 737.

4. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–97 (1976) (requiring scienter for private 10b-5 actions, pursuant to the language of Section 10(b) of the Securities and Exchange Act of 1934, which "makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance'" (quoting 15 U.S.C. § 78j)); Aaron v. SEC, 446 U.S. 680, 691 (1980) (extending the scienter requirement to SEC enforcement actions); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977) (including reckless conduct in the scienter requirement); Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (defining "reckless behavior" narrowly and noting that the word "'reckless' . . . comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence'").

5. *Ernst & Ernst*, 425 U.S. at 193.

6. Private Securities Litigation Reform Act of 1995, Pub. L. No. 105-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); *see infra* text accompanying notes 46–47.

7. Private Securities Litigation Reform Act of 1995 sec. 201, § 78u-7, 109 Stat. at 758–62 (codified as amended at 15 U.S.C. § 78u-4(b)(2) (1995)).

8. 988 F.3d 743 (4th Cir. 2021).

9. *Id.* at 751.

test as the Supreme Court, the Fourth Circuit's application of the scienter standard seems to require a greater quantity of evidence than the standard contemplated by the Supreme Court.[10] Moreover, the Fourth Circuit's analysis reveals several factors of interest in determining the presence of fraudulent intent.[11]

FACTS OF THE CASE

Triangle Capital Corporation is a publicly traded business development company that provides customized lower-middle market financing to various U.S. companies.[12] Triangle's business model focuses on providing mezzanine financing, which is a riskier form of investing than traditional senior loans.[13] Mezzanine financing provides a lender with the ability to convert debt into equity interest in the event of default, meaning the lender receives a lower priority security interest.[14] Nevertheless, this investment form provides higher interest rates and higher yields.[15] Triangle disclosed its relatively risky investment practices in its 10-K,[16] noting some of the companies it had invested in might be referred to as "'high yield' or 'junk.'"[17]

Triangle's investment practices were largely determined by shareholders Garland S. Tucker, E. Ashton Poole, Steven C. Lilly, and Brent P.W. Burgess.[18] Starting in late 2013, lower-middle market mezzanine financing lenders allegedly began to experience rising competition from unitranche lenders.[19] Unitranche lending is inherently less risky than mezzanine financing, since it combines senior and subordinated debt into one package with a blended—and lowered—interest rate.[20] Accordingly, Triangle's financial advisors recommended that Triangle move away from risky mezzanine financing and into safer unitranche structures.[21] Nevertheless, Triangle did not

10. *Compare id.* (requiring a greater quantity of evidence of scienter), *with* Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 324 (2007) (requiring less evidence of scienter).

11. *See In re Triangle*, 988 F.3d at 751–56.

12. *Id.* at 746.

13. *Id.*

14. *Id.*

15. *Id.*

16. *See generally* Form 10-K, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/glossary/form-10-k [https://perma.cc/G6S5-4XKP] (defining a 10-K report as a publicly disclosed annual report that provides a "comprehensive overview of the company's business and financial condition," and explaining that the disclosure is required for publicly reporting companies under the federal securities laws).

17. *In re Triangle*, 988 F.3d at 746.

18. *Id.*

19. *Id.* at 746–47 (defining unitranche lending as the combination of senior and subordinated debt into one package, which results in a lower interest rate and a reduction in a borrower's costs).

20. *Id.* at 747.

21. *Id.*

follow this advice and instead focused primarily on mezzanine lending.[22] In early 2014, Tucker, the CEO, told investors that he—and others at Triangle—believed that "the lower middle market [was] poised to provide attractive investment opportunities during the balance of 2014."[23]

Several other facts indicated the limits of the mezzanine financing investment strategy. A December 2015 report issued by an investment bank and financial advisory firm noted that much of the mezzanine lending market had "continued to contract as unitranche and second lien [lending] have taken share."[24] However, the report also noted that, "[d]espite the growing popularity of the unitranche product," many clients "like[d] the patient capital that mezzanine offer[ed]," such that mezzanine financing "continue[d] to generate steady deal flow."[25] One year later, just before announcing the results for the final quarter of 2015, Triangle announced that Poole was replacing Tucker as the new CEO.[26] Tucker remained chairman of the board and received $2.5 million as a bonus for the restructuring of positions.[27] Shortly thereafter, Triangle reported a "strong finish" in the final quarter of 2015.[28] Several months later, Poole shifted Triangle's investment strategy into unitranche financing, moving "away from riskier, high-yield investments."[29]

After going public in July 2016, Triangle's messages to investors became somewhat alarming.[30] In February 2017, Poole noted that "Triangle was moving in a 'positive' direction, as opposed to its direction in previous periods, and implied that Triangle had weathered the storm that had gripped the entire [business development company] industry in 2015."[31] In May 2017, Lilly described Triangle's business activities in 2014 and 2015, which primarily consisted of mezzanine financing: "[I]f you look at that period . . . I think you would reasonably conclude that there was a period where Triangle was [chasing] yield more than it should have. . . . And that's not a long term strategy[] that is prudent for investors . . . ."[32] Shortly thereafter, seven loans were placed on nonaccrual status—these investments were no longer generating their stated interest rate.[33] Poole remarked that from 2013 to late 2015, "unitranche [was] becoming the security of choice by financial sponsors" and "[o]ur investment

22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.* at 747–48.
26. *Id.* at 748.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*

professionals were aware of these changes . . . and recommended to our former CEO to begin moving away from mezzanine."[34] Nevertheless, Triangle stuck with mezzanine financing, which, Poole noted, "was the wrong strategic call."[35] In November 2017, Triangle Capital Corporation's stock price dropped by twenty-one percent—a $262 million loss of market capitalization since the beginning of 2014.[36]

LifeWise, a shareholder, filed a class action securities fraud suit against Triangle under Rule 10b-5.[37] LifeWise alleged that, based on the preceding factual allegations, Triangle recklessly, knowingly, or purposefully defrauded its shareholders.[38] The district court dismissed the complaint for failure to state a claim, concluding that Lifewise failed to allege an essential element of its securities fraud claims—scienter.[39] The court reasoned that LifeWise's allegations were "not cogent and compelling [as] compared to the alternative explanation—that [D]efendants were aware that the . . . market was changing, but they continued to believe that high-quality investment opportunities remained in the marketplace."[40] LifeWise appealed.[41] On appeal, the Fourth Circuit affirmed, reasoning that an inference of innocence "drawn from the facts in their entirety" outweighed "any opposing [scienter] inference."[42]

HISTORY & CONTEXT

Scienter is a judicially implied requirement of a 10b-5 securities fraud action that Congress later codified in the PSLRA.[43] As noted by the Supreme Court in *Ernst & Ernst v. Hochfelder*[44] in 1976, the scienter requirement follows logically from the language in Section 10(b) of the Securities Exchange Act, which references a "manipulative or deceptive device."[45] In the years following *Hochfelder*, Congress confronted a flood of abusive practices in private securities litigation, including unmeritorious claims filed "with only [the] faint hope that

34. *Id.* at 749.

35. *Id.*

36. *Id.*

37. *Id.* Plaintiff also brought suit under section 20(a) of the Securities Exchange Act of 1934, Pub. L. No. 73-291, § 20(a), 48 Stat. 881, 899 (codified as amended at 15 U.S.C. § 78t(a) (2010)), enabling it to pursue claims against Tucker, Poole, and Lilly. *Id.*

38. *In re Triangle*, 988 F.3d. at 750–51.

39. *Id.* at 750.

40. *Id.*

41. *Id.*

42. *Id.* at 751, 756 (internal quotation marks omitted) (quoting Yates v. Mun. Mortg. & Equity, LLC, 744 F.3d 874, 885 (4th Cir. 2014)).

43. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101(b)(2), 109 Stat. 737, 746–47 (codified at 15 U.S.C. § 78u-4(b)(2) (1995)).

44. 425 U.S. 185 (1976).

45. *Id.*; Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b); the current statute still contains this language).

the discovery process might lead eventually to some plausible cause of action" and "the targeting of deep pocket defendants . . . without regard to their actual culpability."[46] This "significant evidence of abuse"[47] prompted the passing of the PSLRA in 1995, which, among other things, heightened the scienter requirement for 10b-5 claims.[48] Under the PSLRA, the standard for scienter rose to that of "particular[]" facts giving rise to a "strong inference" of scienter.[49] In *Tellabs Inc. v. Makor Issues & Rights, Ltd.*,[50] the Supreme Court defined "strong inference" as a "cogent" inference of scienter that a "reasonable person" would deem "at least as compelling as any opposing inference one could draw from the facts alleged."[51] Several of the justices argued that this standard was too relaxed because it deemed a perfect fifty-fifty balance of opposing inferences a "strong inference."[52] In his concurrence, Justice Scalia provided an illustrative hypothetical:

> If a jade falcon were stolen from a room to which only A and B had access, could it *possibly* be said there was a "strong inference" that B was the thief? I think not, and I therefore think that the Court's test must fail. In my view, the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence.[53]

Justice Scalia's concern was shared by Justice Alito.[54] The fear was that the pleading standards were too lenient and contravened the intent of the PSLRA.[55]

LEGAL ISSUES AND OUTCOME

In reaching its decision, the Fourth Circuit presented a thorough outline of its interpretation of the scienter requirement for securities fraud claims. The court noted that, under 10b-5, "scienter" is a mental state encompassing purpose, knowledge, and severe recklessness.[56] Further, a defendant that acts with a conscious object to deceive, manipulate, or defraud acts with the requisite intent.[57] "Severe recklessness" requires an "act so highly unreasonable and such

46. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730.

47. *Id.*

48. 15 U.S.C. § 78u-4(b)(2)(A) ("[T]he complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

49. *In re* Triangle Cap. Corp. Sec. Litig., 988 F.3d 743, 751 (4th Cir. 2021) (emphasis omitted).

50. 551 U.S. 308 (2007).

51. *Id.* at 324.

52. *Id.* at 324 n.5.

53. *Id.* at 329 (Scalia, J., concurring).

54. *Id.* at 335 (Alito, J., concurring).

55. *See id.* at 330–31 (Scalia, J., concurring); *id.* at 335 (Alito, J., concurring); *id.* at 335–37 (Stevens, J., dissenting).

56. *In re* Triangle Cap. Corp. Sec. Litig., 988 F.3d 743, 751 (4th Cir. 2021).

57. *Id.*

an extreme departure from the standard of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[58] The PSRLA heightens the standard; under the Act, circumstantial evidence can support a finding of scienter only if the scienter inference is "strong."[59] Moreover, "[a] scienter inference is 'strong' if, when 'weighed against the opposing inferences that may be drawn from the facts in their entirety,' it 'is at least as compelling as any opposing innocent inference.'"[60]

Viewing the foregoing facts in their entirety, the Fourth Circuit concluded that the inference of innocence outweighed any scienter inference.[61] First, the court dismissed the allegation that Triangle's investment advisors' advice that Triangle should adopt a unitranche-investment strategy supported an inference of scienter.[62] The court reasoned that this evidence was unduly vague and lacked a showing of "some particular motive to defraud investors."[63] Next, the court refuted the proposition that Poole's and Lilly's 2017 statements noting the shortcomings of the 2014–2015 mezzanine lending practices amounted to admissions that they knew—or recklessly disregarded—that the market "had no viable prospects."[64] Instead, the court noted that these statements were backward-looking and did not necessarily support that Poole and Lilly had actual, contemporaneous knowledge or reckless disregard of the state of the market.[65] If anything, the court notes, these backward-looking statements hint at mere "buyer's remorse" following a legitimate exercise of business judgment.[66]

Moreover, the court concluded that allegations of the defendant's generalized motive to keep share prices high from 2016–2017 did not give rise to an inference of scienter: "[W]e 'reject[] these types of generalized motives—which are shared by *all* companies . . . .'"[67] In a similar vein, the court concluded that Poole's subsequent shift in business strategy toward unitranche lending following his appointment as CEO merely reflected strategic business judgment, not an intent to defraud.[68] The court also summarily rejected the argument that the 2015 Report supported any inference of scienter; the report

58. *Id.* (internal quotation marks omitted) (quoting Ottmann v. Hanger Orthopedic Grp., Inc., 353 F.3d 338, 343 (4th Cir. 2003)).

59. *Id.* (quoting 15 U.S.C. § 78u-4(b)(2)).

60. *Id.* (quoting Yates v. Mun. Mortg. & Equity, LLC, 744 F.3d 874, 885 (4th Cir. 2014)).

61. *Id.* at 756.

62. *Id.* at 751–52.

63. *See id.* at 752.

64. *Id.*

65. *Id.*

66. *Id.* at 753.

67. *Id.* at 754 (emphasis in original) (quoting Ottmann v. Hanger Orthopedic Grp., Inc., 353 F.3d 338, 352 (4th Cir. 2003)).

68. *Id.* at 753–54.

contained "just as many optimistic statements about the state of the mezzanine lending market as it does those expressing concern with the potential changes in that market."[69] In sum, the court engaged in a balancing inquiry, concluding that the scales tipped towards innocence rather than fraudulent intent.[70]

POTENTIAL IMPACT

This Fourth Circuit decision alleviates some of Justice Scalia's and Justice Alito's fears in *Tellabs*. As previously mentioned, the *Tellabs* test holds that a "strong inference" of scienter, which is an inference that a "reasonable person" would deem "at least as compelling as any opposing inference one could draw from the facts alleged," is sufficient to fulfill the scienter requirement.[71] The Fourth Circuit certainly applies the *Tellabs* test,[72] but the court's application seems to deviate from a pure fifty-fifty weighing inquiry. *In re Triangle Capital Corp.* seems analogous to the case of the stolen jade falcon. The evidence in *In re Triangle Capital Corp.* seems to yield a fifty-fifty balance of opposing inferences, which should satisfy the scienter requirement under *Tellabs*. Provided that the scienter requirement encompasses a threshold as low as severe recklessness, it seems at least as likely that Triangle consciously disregarded the danger of misleading the plaintiff.

More specifically, the evidence of Poole and Tucker's unfavorable backward-looking statements, coupled with the contemporaneous representations that mezzanine financing proved to be a solid business plan despite abundant forward-looking evidence to the contrary, does seem to support an inference of conscious disregard. This inference of scienter seems roughly equal to an inference of innocence.[73] In other words, it seems likely that a reasonable person would conclude that the defendant's statements to shareholders misleadingly downplayed (or outright omitted) the hampered performance of Triangle's mezzanine investment strategy, despite the defendant's demonstrated knowledge of the inherent risks of mezzanine lending and the current status of its investments.

For those unconvinced, it is worth noting that, as stated in *In re Triangle Capital Corp.*, the Fourth Circuit's standard for severe recklessness need not require subjective, *conscious* disregard of the danger, but only a danger "so

69. *Id.* at 753.

70. *See id.* at 756.

71. Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 324 (2007).

72. *In re Triangle*, 988 F.3d at 751.

73. *See id.* at 751–54. It is worth noting that the Fourth Circuit never denies that the plaintiff's allegations give rise to an inference of scienter; the court's focus is on the precise degree of the inference. *See id.* at 752 ("[T]o the extent that we can make any inference of scienter from these allegations, it is exceptionally weak.").

obvious that the defendant *must have* been aware of it."[74] Accordingly, that Triangle had "actual" contemporaneous knowledge of its deviation from its standard of care is not necessary to satisfy the scienter requirement.[75]

Yet, the court holds that evidence of scienter is lacking[76]—or "less often than not." Returning to the jade falcon hypothetical, the court does not find a "strong inference" that B was the thief despite his access to the room. Instead, the court seems to implicitly require a threshold of "more likely than not," which comports more closely with Justice Scalia's proposed formulation of the standard.[77] Thus, *In re Triangle Capital Corp.* seems to interpret the standard more strictly than the *Tellabs* Court might have expected. In sum, the Fourth Circuit's analysis suggests that the flexibility afforded by the *Tellabs* standard does respect the broad mandate of the PSLRA to discourage "abusive practices committed in private securities litigation."[78]

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74. *Id.* at 751 (emphasis added).

75. *Id.* In this way, the Fourth Circuit's formulation more closely resembles gross negligence than recklessness.

76. *Id.* at 756.

77. Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 329 (2007) (Scalia, J., concurring) (emphasis omitted).

78. *See* H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730.

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