

Fourth Circuit: Inference of Scienter “Exceptionally Weak” Where BDC’s Investment Strategy Appeared Bad Only in Hindsight and BDC Disclosed That Investments Would Be Classified as Junk

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On February 22, 2021, the Fourth Circuit affirmed the dismissal with prejudice of a securities fraud class action against a business development company (“BDC”) as well as director liability claims against three directors/executives alleging that defendants failed to disclose the risks of the BDC’s investment strategy, which involved offering mezzanine financing to lower middle market companies. *In re Triangle Capital Corp. Sec. Litig.*, 988 F.3d 743 (4th Cir. 2021) (Agee, J.). The court held that the heightened burden for pleading scienter under the Private Securities Litigation Reform Act (“PSLRA”) was not satisfied. The court found that the inference of scienter rested on “statements and omissions of facts arising from the execution of legitimate, subjective business judgments that, only when viewed in hindsight, allegedly become misleading.”

Background

Plaintiff argued that defendants “knew in 2014 and 2015 that the mezzanine lending market was contracting, and that the mezzanine deals that remained were of inferior quality than what was available before the rise of unitranche lending.” Plaintiffs asserted that “this knowledge, coupled with the ‘false’ representations about the quality of those deals and the state of the mezzanine market, give rise to a strong inference of scienter.”

Specifically, plaintiff argued that certain statements to investors equated to admissions that defendants knew in 2014 and 2015 that they were investing in low-quality deals. In a May 2017 investor call, one of the defendant executives said, in reference to the BDC’s 2014 and 2015 business activity, that “there was a period where [the BDC] was chasing yield more than it should have.” In a November 2017 investor call, another defendant executive explained how the investment decisions from 2013 to 2015 contributed to some investments later going on full non-accrual status. This executive stated that the adherence to a mezzanine investment strategy during a period of massive change in the market “was the wrong strategic call” when “other investment strategies were available which provided a better risk-reward equation.”

Inference of Scienter Is Weak in Part Due to Ambiguities and Lack of Motive

Focusing only on the element of scienter, the court determined that “to the extent that we can make any inference of scienter from [plaintiff’s] allegations, it is exceptionally weak.” With respect to plaintiff’s allegation that the defendant executives (who largely controlled the investment committee’s decisions) were advised that the mezzanine lending market was contracting and that it should focus on unitranche lending, the court stated that “two factors diminish the strength of any scienter inference that could be drawn.” First, plaintiff “never specifies when this advice was given, how firm in their conviction these investment advisors were in recommending that [the BDC] should avoid mezzanine deals moving forward, or what a mix of mezzanine and unitranche investments should look like.” Second, plaintiff failed to allege that defendants had some particular motive to defraud investors. The court concluded that these “ambiguities, and the lack of a motive to defraud, thus diminish the strength of any scienter inference that can be drawn from the allegation.”

Retrospective Statements Do Not Support a Strong Inference of Scienter

Plaintiff also alleged that an investment bank’s report that compiled survey results and commentary about lending market trends concluded that the mezzanine market was “rapidly shrinking.” However, the court found that “the Report contains 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.” The court concluded that “[w]ithout more, we cannot reasonably infer from [the executive’s] retrospective statement in [the] May 2017 [investor call] that in 2014 and 2015, [] [d]efendants knew that the quantity of investments was incompatible with quality.”

The court continued that “[f]or similar reasons, we cannot reasonably draw that same inference from [the] November 2017 conversation with investors.” The court noted that “[o]f course, many bad investments will, in retrospect, look like the wrong strategic call.” However, the court cautioned that nothing said in the November 2017 investor call “plausibly suggests that [the BDC] or its C-level executives *knew* or recklessly disregarded the fact that each of their portfolio companies bore inherently more risk than the typical ‘high yield’ or ‘junk’ securities that constituted [the BDC’s] investment portfolio.” The court stated that “[i]n fact, [the BDC] regularly disclosed to its investors that ‘junk’ was how their investments would be classified.” The court observed that pleading fraud by hindsight is precisely what Congress intended the PSLRA to eliminate. The court concluded that “[c]onsidering these allegations holistically and in their proper context, we hold that [plaintiff] has failed to allege a strong inference of scienter.” The court then stated that “the much stronger inference is that [d]efendants had an honest debate about the merits of a subjective business judgment, and in hindsight, simply made the wrong choice with some investments.”

Authors and
Contacts

Paul Gluckow

Partner and General Counsel

pgluckow@stblaw.com

+1-212-455-2653

Jonathan Youngwood

Partner

jyoungwood@stblaw.com

1-212-455-3539

Lynn Neuner

Partner

lneuner@stblaw.com

+1-212-455-2696



