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Supreme Court's Bright Line Test Narrowly Limits Primary Securities Fraud Liability: Janus Capital Group, Inc. v. First Derivative Traders

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The federal securities laws prohibit individuals and entities from making material misrepresentations or omissions in connection with the purchase or sale of securities. In *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. ___ (2011), the United States Supreme Court, reversing a decision of the United States Court of Appeals for the Fourth Circuit, largely resolved a disagreement among the lower federal courts regarding the level of involvement required to expose defendants to primary liability for a securities fraud violation. The Court held that primary liability can attach to a statement or omission only if the defendant had "ultimate authority" over its making or, perhaps, if it was publicly attributed to him. As a result, primary liability is no longer a risk for professionals who only prepare or contribute information to the public statement of another, absent explicit public attribution. This will insulate most professionals from primary liability.

The Supreme Court had previously held in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), that there is no aiding and abetting liability in private lawsuits under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The Court, in Central Bank, left open whether a secondary actor - like a lawyer, accountant, or bank - who employs a manipulative device or makes a material misstatement or omission on which a purchaser or seller of a security relies may be liable as a primary violator.

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Court held that there is no secondary liability under Section 10(b) for aiding and abetting a securities fraud and that primary liability requires that the defendant have performed a public role in the making of a misstatement such that investors can establish that they relied on that defendant's conduct in making their investment decisions. After *Stoneridge*, the circuit courts of appeal differed on the appropriate test for primary liability, *i.e.*, what an actor must do to "make" a misstatement or engage in a manipulative act under *Stoneridge*.

Attribution Requirement of the Second, Third, and Fifth Circuits

The Second, Third, and Fifth Circuits have held that securities fraud liability exists only if the alleged misstatement is attributable on its face to the defendant, what has become known as the bright-line attribution rule. *In re DVI, Inc. Securities Litigation*, 639 F.3d 623 (3d Cir. 2011); *Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.*, 625 F.3d 185 (5th Cir. 2010); *Pacific Investment Management Co. v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010).

In *Affco Investments*, the Fifth Circuit concluded that without "direct attribution" of a law firm's role in a fraudulent scheme, the plaintiffs "failed to show reliance" and the law firm, which had provided tax opinions, was not a primary violator. 625 F.3d 185, 192 (5th Cir. 2010). In *Pacific Investment Management v. Mayer Brown*, the Second Circuit also declined to find primary liability where a law firm acted behind the scenes in negotiating transactions and drafting loan and offering documents but where no specific information was attributed to counsel. The Second Circuit held: "[A] secondary actor can be held liable in a private damages action brought pursuant to Rule 10b 5(b) only for false statements attributed to the secondary actor defendant at the time of dissemination." 603 F.3d 144, 148 (2d Cir. 2010). The Court also touted the benefits of its bright-line rule stating:

An attribution requirement is relatively easy for district courts to apply and avoids protracted litigation and discovery aimed at learning the identity of each person or entity that had some connection, however tenuous, to the creation of an allegedly false statement. Furthermore, as the Supreme Court has explained, securities law is an area that demands certainty and predictability.... Uncertainty can lead to many undesirable consequences, for example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others.... Uncertainty also increases the costs of doing business and raising capital.

Id. at 157.

In the decision perhaps closest to the Supreme Court's decision in *Janus*, *In re DVI Securities Litigation*, the Third Circuit declined to find a law firm primarily liable for allegedly participating in the drafting of fraudulent public filings, in particular, the defendant's 10 Q disclosure, conspiring with other defendants to hide material information about the company's financial condition, and deflecting inquiries from the SEC. The Third Circuit rejected a "remoteness test," reasoning that *Stoneridge* was decided on the basis "that the vendors' conduct was not disclosed to the investing public," rather than the degree of remoteness of the conduct from the public disclosure. 639 F.3d 623, 646-47 (3d Cir. 2011). The Third Circuit also found it insufficient that the law firm's statements were eventually communicated to the investing public. Instead, in a presaging of the Janus decision, the Court noted that no action of the law firm "made it necessary" for the company to file a misleading quarterly report. *Id*. at 647. Nevertheless, the court stopped short of requiring that a defendant possess ultimate authority over the means by which a statement is communicated in order for primary liability to attach, holding only that the actionable statement must have been publicly attributed to the defendant. *Id*. at 648.

Fourth Circuit Approach to Materials Prepared by Investment Advisers

The Fourth Circuit, in a case that the Supreme Court has now reversed, applied a more relaxed approach, but only in the context of a securities fraud claim against an investment adviser. In *Janus Capital Group Inc. v. First Derivative Traders*, 564 U.S. ___ (2011), the plaintiffs alleged that an investment adviser to a group of mutual funds was primarily liable under Section 10(b) and Rule 10b 5 because it helped in the preparation of a misleading prospectus for the funds. The Fourth Circuit held that the plaintiffs stated a valid claim of primary liability against the adviser, reasoning that by helping to create the misleading prospectus the adviser was effectively a maker of the misrepresentations. *In re Mutual Funds Investments Litigation*, 566 F.3d 111 (4th Cir. 2009). Specifically, the Fourth Circuit declared that in light of the customarily close connection between a mutual fund adviser and the funds, investors could infer that if the adviser did not actually write the misstatements it must have at least approved them. The court stated that given "the publicly disclosed responsibilities of [Janus]," as the fund adviser, "interested investors would infer that [Janus] played a role in preparing or approving the content of the...fund prospectus." *Id*. at 121. Accordingly, the court concluded that investors could have attributed the misleading statements to the adviser even if attribution was not explicit.

Supreme Court Decision in *Janus*

In Janus, a narrowly divided Supreme Court rejected the Fourth Circuit's special approach for investment advisers and held that, in general, a defendant does not "make" a statement or omission unless the defendant possesses "ultimate authority over the statement, including its content and whether and how to communicate it." *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U. S. ___ (2011). "One who prepares or publishes a statement on behalf of another," in contrast, "is not its maker." *Id*.

The Court grounded its "ultimate authority" rule on its observation in *Stoneridge* that it was not "necessary and inevitable" that the misstatement at issue in that case would make its way into the company's publicly disclosed financial statement. Only the conduct of the party with "ultimate authority" over a public statement can determine what the content of that statement will be, and so only that party is able to "make" the statement. Others can only suggest, and, were that enough basis for primary liability, "aiders and abettors would be almost nonexistent," the Court observed. *Id*.

Approaching the issue from the perspective of reliance, the Court reiterated its observation in *Stoneridge* that the investors could not have relied on deceptive acts of which they were not aware, implying that the *Janus* investors likewise could not have relied on the nonpublic statements of the defendant adviser. Even if the adviser's statements were later incorporated into public statements of the fund, it was the statements of the fund on which investors relied. The Court was not entirely unmoved by the lower court's reasoning but concluded that "[a]ny reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the Court." *Id*. The fund, the Court emphasized, was an independent legal entity that had observed all corporate formalities and was the entity required to file the prospectuses. As such, its actions and statements were its own and not those of the defendant, its adviser.

Beyond rejecting the Fourth Circuit's ruling, the Supreme Court gave little encouragement to the mere "attribution" approach of the lower courts. While acknowledging that the text of Rule 10b-5 leaves room for the possibility that a misstatement may be made "indirectly," the Court expressed the view that such a statement would fail to satisfy the requirement of being "made" by a defendant unless it was expressly attributed to that defendant. "More may be required to find that a person or entity made a statement indirectly," the Court stated, "but attribution is necessary." *Id*. at __ n.11.

The Supreme Court's ruling in *Janus* significantly increases the level of certainty surrounding the law of primary securities fraud, effectively foreclosing the possibility of liability for such professionals as bankers, accountants, and lawyers who merely assist in the creation of a public statement, at least if statements are not expressly attributed to them.