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Client Alert
Commentary

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Supreme Court Ruling Extends Reach of Primary Liability for Securities Fraud

Highly anticipated opinion extends primary liability for securities fraud beyond the "maker" of false statements.

Key Points:

- The Court held that a defendant's act of sending emails drafted by another, that the defendant understood to contain material untruths, was sufficient to establish that the defendant employed a "device," "scheme," or "artifice to defraud" or an "act, practice or course of business" that "operates ... as a fraud or deceit" under Rule 10b-5(a) and (c), § 10(b) of the Securities Exchange Act, and § 17(a)(1) of the Securities Act.
- The Court's decision has implications for any party involved in the "dissemination" of information to investors, regardless of whether he or she "made" the statement. This is of particular significance to bankers and other investment professionals who may "cut and paste" the statements of others. However, the decision does not affect the requirement that to be liable for securities fraud, the person disseminating the information must have intent to defraud.
- The Court noted that its 2011 *Janus*[1] ruling may remain relevant (and preclude liability) if "an individual neither *makes nor disseminates* false information — provided, of course, that the individual is not involved in some other form of fraud."[2]
- The Court recognized that applying Rule 10b-5(a) and (c) may "present problems of scope in borderline cases," creating the likelihood of intense factual inquiry in lower courts.

Background

On March 27, 2019, the US Supreme Court issued its much anticipated decision in *Lorenzo v. Securities and Exchange Commission*.[3] In a 6-2 decision,[4] the Court held that an individual who has not violated Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5(b) (the Rule) by virtue of not being in a position of "ultimate authority" over fraudulent statements, may nonetheless have violated Rule 10b-5(a) or (c) in issuing those statements.

The decision comes nearly eight years after the Court decided *Janus Capital Group, Inc. v. First Derivative Traders*.[5] In *Janus*, the Court addressed the circumstances in which an individual can be held primarily liable under Section 10b-5(b) of the Exchange Act, which makes it illegal "to make any untrue statement of a material fact" in connection with the purchase or sale of any security.[6] The Court held that Section 10b-5(b) primary liability extends only to the "maker" of a false statement, and not to others who executed the trades about which false statements were later made.[7] *Janus* defined a "maker" of a statement as one who held "ultimate authority" over the statement, and concluded that if a person does not have "ultimate authority" over a statement, that person may only be held secondarily liable for securities fraud under an aiding-and-abetting theory. As there is no private right of action for aiding and abetting securities fraud,[8] the *Janus* ruling placed a significant limitation on potential private civil litigation under Rule 10b-5(b). Because there cannot be secondary liability without primary liability, under *Janus*, if the "maker" of the statement did not act with scienter, or intent to defraud, and could therefore not be primarily liable for violating the Rule, then no person who had helped disseminate the false statement could be liable as an aider or abettor.[9]

In response to *Janus*, both private plaintiffs and the Securities and Exchange Commission (the SEC, or the Commission) sought to bypass the "ultimate authority" requirement by invoking Rule 10b-5(a) and (c), which make it unlawful "to employ any device, scheme, or artifice to defraud," and "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit."[10] These efforts eventually gave rise to a circuit split. For example, the Second Circuit rejected these efforts, holding that scheme liability under subsections (a) and (c) requires a deceptive act that is distinct from alleged misstatements covered by subsection (b).[11] In *Lorenzo*, the D.C. Circuit took the opposite approach, holding that each of the subsections of Rule 10b-5 should read independently, and that alleged violations based on misstatements are not limited to claims under Rule 10b-5(b).[12] The Supreme Court granted review and agreed with the D.C. Circuit's analysis.

Brief Case History

The defendant in this case is Francis Lorenzo, who was the vice president of investment banking at Charles Vista, LLC, a registered broker-dealer in New York. Lorenzo's only client at the time was a company called Waste2Energy, which was developing technology to convert "solid waste" into "clean renewable energy." In a June 2009 filing, the company had stated that its total assets were worth US$14 million, a figure that included intangible assets in the form of intellectual property valued at US$10 million. In October 2009, the company publicly disclosed that it had written off the value of that intellectual property and that its total assets amounted to less than US$400,000.

In the meantime, Waste2Energy had hired Lorenzo's firm to sell US$15 million worth of debentures, which would be secured not by the company's assets but by its future earning potential. To effect this securities sale, Lorenzo's boss instructed him to email two prospective investors information about Waste2Energy. Lorenzo's boss drafted the emails, which touted the securities' "3 layers of protection" and claimed that the company had "$10 million in confirmed assets."[13] While Lorenzo noted that both emails were sent "[a]t the request of" his boss, he sent the emails under his own name, using his own title of Vice President — Investment Banking, and invited investors to follow up with questions.[14]

In 2013, the SEC commenced proceedings against Lorenzo, his boss, and his firm, claiming among other breaches that Lorenzo had violated Rule 10b-5 of the Exchange Act. The Commission ultimately found that Lorenzo had violated this provision and others by "sending false and misleading statements to investors with the intent to defraud."[15] The Commission fined Lorenzo US$15,000, ordered him to cease and desist from violating the securities laws, and banned him from working in the securities industry for life.

Lorenzo appealed the Commission's decision on two grounds. First, he argued that he lacked the intent required to establish liability under the securities laws because he did not send the emails with intent to deceive, manipulate, or defraud. According to his testimony, he had "cut and pasted" the content of the emails from a draft composed and approved by his boss and had subsequently come to believe the statements to be true.[16] A panel of the Court of Appeals for the D.C. Circuit disagreed (with then-Judge Kavanaugh in dissent) because it found that Lorenzo had actual knowledge that the company had written off the value of its intellectual property and had less than US$400,000 in total assets at the time he sent the emails.[17] Taken together, the court found Lorenzo's knowledge that the statements contained false information and the act of sending the emails in his own name satisfied the scienter requirement of Rule 10b-5.

Lorenzo's second argument was that even if he had sent the email with the requisite mental state, he could not have violated Rule 10b-5(b) because he did not "make" the relevant statements under *Janus*, and an alleged misstatement could not be the basis for a violation of Rule 10b-5(a) or (c). The D.C. Circuit rejected that argument as well, with then-Judge Kavanaugh again dissenting. The court sustained the Commission's finding that, by knowingly disseminating false information to prospective investors, Lorenzo had violated subsections (a) and (c) of Rule 10b-5.[18] Lorenzo petitioned for a writ of certiorari addressing this question, and the Supreme Court agreed to hear the case. (Notably, Lorenzo did not seek to appeal the D.C. Circuit's holding that he sent the email with the requisite fraudulent intent.)

The Supreme Court held oral argument on December 3, 2018. The argument focused on whether accepting the SEC's position that Lorenzo had violated subsections (a) and (c) based on his dissemination of a false statement would undermine *Janus*' distinction between primary and secondary liability. The parties agreed that under *Janus*, Lorenzo did not violate Rule 10b-5(b) because he did not "make" the relevant statements. Lorenzo argued that an alleged misstatement could not be the basis for a finding that he had violated Rule 10b-5(a) and (c), as that would render Rule 10b-5(b) — and the limits imposed by *Janus* — largely superfluous. Lorenzo further argued that because the conduct at issue was a statement, the only way he could be liable for that conduct was through Rule 10b-5(b), the provision that refers specifically to statements.

In response, the SEC (represented by the Department of Justice) emphasized the textual differences between Rule 10b-5(a) and (c), on the one hand, and Rule 10b-5(b), on the other. The SEC noted that while Rule 10b-5(b) specifically penalizes those who "make" false statements, other parts of the Rule do not include that word and therefore should not be read to preclude primary liability for those (like Lorenzo) who do something other than "make" those statements.

The Supreme Court's Decision

The Supreme Court agreed with the SEC, affirming the D.C. Circuit's decision by a 6-2 margin (with Justice Kavanaugh recused).

Writing for the majority, Justice Breyer began by rejecting the premise of Lorenzo's argument that each of the three provisions of Rule 10b-5 "should be read as governing different, mutually exclusive, spheres of conduct."[19] The Court relied on the Rule's language, its own precedent interpreting the Rule and "related provisions of securities laws," and the SEC's interpretation of the Rule to support its conclusions that the three provisions of Rule 10b-5 overlapped considerably and that "[e]ach succeeding prohibition was … meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections."[20]

Having disposed of Lorenzo's primary contention, the Court next addressed whether its decision would render its holding in *Janus* a "dead letter." In a brief discussion, the Court brushed aside such concerns, emphasizing that *Janus* had said nothing about Rule 10b-5's application to "the dissemination of false or misleading information" and that *Janus* would remain relevant and preclude liability "where an individual neither *makes* nor *disseminates* false information—provided, of course, that the individual is not involved in some other form of fraud."[21] The Court recognized that applying Rule 10b-5(a) and (c) may "present problems of scope in borderline cases," and that "one can readily imagine other actors tangentially involved in dissemination—say, a mailroom clerk—for whom liability would typically be inappropriate."[22] But the Court did not view Lorenzo's case as borderline, emphasizing that its "conviction is strengthened by the fact that we here confront behavior that, though plainly fraudulent, might otherwise fall outside the scope of the Rule."[23]

Justice Thomas authored the dissent. In his view, the majority's interpretation of the statute impermissibly blurred the boundaries between the subsections of Rule 10b-5, contrary to "the cardinal rule that, if possible, effect shall be given to every clause and part of a statute."[24] Because Rule 10b-5(b) specifically addresses false statements, Thomas argued that subsections (a) and (c) should be read to impose liability on conduct other than false statements.

Future Implications

The Court's decision will likely significantly boost efforts by the SEC and private litigants to bring securities fraud cases under Rule 10b-5(a) and (c). Although the Court briefly acknowledged concerns that its *Lorenzo* decision would eradicate distinctions between primary and secondary actors created in *Janus*, the SEC and private litigants likely will continue to seek to erode any boundary between liability under Rule 10b-5(b) and liability under subsections (a) and (c). The Court's vague assertion that an individual can be held liable under those subsections for "some other form of fraud" in connection with a misstatement — even if he or she neither made nor disseminated the misstatement — may embolden securities plaintiffs to shrink the practical impact of the *Janus* decision still further. That line likely also will be the subject of significant litigation as lower courts grapple with what constitutes "some other form of fraud" referenced in the majority opinion. Such cases could increasingly limit any practical application of *Janus.*

Notably, the Supreme Court's decision does not affect the requirement that every Section 10b and Rule 10b-5 plaintiff prove that the defendant acted with scienter. In this case, Lorenzo did not challenge at the Supreme Court the finding that he sent out emails with intent to defraud. A person who truly "cuts and pastes" information and disseminates it at the request of a supervisor often would not have the requisite state of mind for liability. Because participation in the dissemination of information with knowledge that the information is false will now constitute a primary Rule 10b-5 violation, scienter will become an even bigger focus at the pleading stage. It will be especially important for those accused of disseminating alleged misstatements to focus on the absence of scienter in their efforts to dismiss meritless suits.

Conclusion

Read simply, the Court's decision to affirm liability in *Lorenzo* is not surprising based on its facts — *i.e.*, a senior person at a broker-dealer sending potential investors an email containing information he knew was false. However, in holding Lorenzo liable under subsections (a) and (c) of Rule 10b-5 — while assuming that he was not in "ultimate control" of a false statement he disseminated — the Court has invited private plaintiffs and the SEC to expand the boundaries of what actions may be the basis for liability under the broader scheme liability and deceptive practices sections of the Rule. Though the Court preserved *Janus* as a formal matter, it gave the SEC and private plaintiffs a clear roadmap for avoiding *Janus*' restrictions in cases involving the dissemination of false information by a knowing accomplice.

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Endnotes

[1] *Janus Capital Grp., Inc. v. First Derivative Traders,* 564 U.S. 135 (2011).

[2] *Lorenzo v. Sec. & Exchange Comm'n*, 587 U.S. ___, No. 17-1077, slip op. at 3 (U.S. Mar. 27, 2019) (emphasis added).

[3] *See slip op*.

[4] Justice Breyer delivered the opinion of the Court, with Justices Roberts, Ginsberg, Alito, Sotomayor, and Kagan joining. Justice Thomas filed a dissenting opinion, in which Justice Gorsuch joined. Justice Kavanaugh took no part in the consideration or decision of the case.

[5] *Janus*, 564 U.S. 135.

[6] 17 CFR § 240.10b-5 (b).

[7] *Janus*, 564 U.S. at 142.

[8] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164, 191 (1994).

[9] Slip op. at 15.

[10] 17 CFR § 240.10b-5 (a), (c).

[11] *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) (rejecting scheme liability under 10b-5(a) because the only alleged violations were misrepresentations and omissions).

[12] *Lorenzo v. Sec. & Exchange Comm'n*, 872 F.3d 578, 589 (D.C. Cir. 2017).

[13] Slip op. at 3.

[14] *Id.* at 20.

[15] *Id.* at 3.

[16] *Id.* at 26.

[17] *Id.* at 10.

[18] *Lorenzo*, 872 F.3d at 583.

[19] Slip op. at 7.

[20] *Id.* at 8.

[21] *Id.* at 10.

[22] *Id.* at 7.

[23] *Id.* at 9.

[24] *Id.* at 24.