MARCH 29, 2019

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Justices clarify—and potentially expand—securities fraud liability for persons who participate in distributing false statements

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On Wednesday, in *Lorenzo v. Securities and Exchange Commission* (No. 10-1077), the Supreme Court clarified (or, according to the dissent, hopelessly blurred) the scope of securities fraud liability for persons who do not "make" false statements, but merely participate in disseminating them. Previously, in *Janus Capital Group, Inc. v. First Derivative Traders, Inc*., 564 U.S. 135 (2011), the Court held that liability under Rule 10b-5(b) for "making" an untrue statement of material fact may *only* lie against one who has "ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* at 142. Left undecided by *Janus* was whether a claim may be brought against someone who does not draft or create a false statement, but otherwise participates in disseminating that statement, under the remaining subsections of Rule 10b-5, which make it unlawful under Rule 10b-5(a) to "employ any device, scheme, or artifice to defraud," and under Rule 10b-5(c) to "engage it any act, practice or course of business" that "operates … as a fraud or deceit" (10b-5(c)). In *Lorenzo*, the Court, in a 6-2 decision, answered in the affirmative, potentially broadening the scope of liability theories available to both private litigants and the Securities and Exchange Commission ("SEC").

Overview

Lorenzo, an officer of a broker-dealer, sent out e-mails to solicit purchasers of debentures offered by his firm's only client, Waste2Energy, that misrepresented the client's financial condition. The content of the e-mails was entirely provided by his boss; Lorenzo merely copied and pasted the text into his own message and sent it out over his signature and title, "head of investment banking." The SEC instituted an enforcement action and found that Lorenzo had violated Rule 10b-5, §10(b) of the Securities Exchange Act of 1934, and §17(a)(1) of the Securities Act of 1933.

On appeal, the D. C. Circuit Court ruled that Lorenzo was not a "maker" of the false statements, because his boss controlled their content, and reversed the SEC's finding of liability under Rule 10b-5(b). But it upheld the Commission's finding that by knowingly disseminating false information, Lorenzo had violated the remaining subsections of Rule 10b-5, as well as §10(b) and §17(a)(1). The appeals court also rejected Lorenzo's contention that, in merely sending e-mails drafted by another, he did not have the requisite intent to establish a violation.

The Supreme Court granted certiorari to address only whether someone who is not a "maker" can be found to have violated the other subsections of Rule 10b-5 and related anti-fraud statutes for knowingly distributing false statements. Justice Kavanaugh, who had issued a dissent in the court of appeals below, recused himself.

The Supreme Court's decision

As the six-judge majority of the Supreme Court pointed out, most readers of those plain English words would have little trouble concluding that the criteria of subsections (a) and (c) of Rule 10b-5 are met when someone who calls himself the "head of investment banking" sends out an e-mail he knows is materially false to solicit an investment in the firm's client. Nonetheless, in prior decisions, the Court has circumscribed the scope of the securities anti-fraud provisions. For example, the Court has drawn careful distinctions between primary and secondary liability, a distinction that is important to the securities bar because only the SEC can pursue a claim of aiding and abetting a violation of Rule 10b-5. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

Then, in *Janus,* the Court carefully limited liability for "making" a false statement in violation of Rule 10b-5(b) to persons who have "ultimate control over that statement, including its content and whether and how to communicate it." 564 U.S. at 142. Lorenzo argued that holding him liable for "employing a device" or "engaging in an act or practice" would undermine the limitation on "maker" liability outlined in *Janus,* and the dissent agreed.

Justice Breyer and the majority defended against that argument by framing their decision as ruling that one who knowingly "disseminates" a false statement can be liable under Rule 10b-5(a) or (c), even if they were not a maker of the statement. Indeed, the majority emphasized that it was not disturbing or revisiting its holding in *Janus*, and examining only the question of liability under the alternate subsections of Rule 10b-5. By drawing that distinction, the majority appears to expressly intend to avoid upending the main purpose of the *Janus* opinion, which was to avoid imposing primary false statement liability on the host of accountants, advisors, lawyers, other professionals and staff people who may provide input into corporate statements but have no ability to control the ultimate contents of them or how they are used.

Notably, Lorenzo did not dispute the appellate panel's finding of fraudulent intent before the Court, and so Lorenzo's "scienter" was deemed established. The majority was clearly motivated by this admission, and the potential scenario that actors like Lorenzo might escape all liability, noting that "Congress intended to root out all manner of fraud in the securities industry." Slip op. at 13. Similarly, the Court admonished that "[its] conviction was strengthened by the fact that we confront here behavior that, though plainly fraudulent, might otherwise fall outside the scope of the Rule." *Id.* at 9. Plainly, the Court was disturbed by the prospect that its own precedent in *Janus* could be used to allow a bad actor such as Lorenzo to escape liability for knowing fraud.

In dissent, Justice Thomas (joined by Justice Gorsuch) complained that the majority had failed to grapple with the hard question presented in *Janus*: what level of conduct or involvement should render someone liable as a primary versus secondary violator? In their view, the limitation that liability was only being opened under subsections (a) and (c) for "disseminators" of false statements was inadequate, because it could apply to people whose involvement was clearly secondary, such as a secretary or staff person who mailed an envelope. The dissent even went so far as to describe Lorenzo's actions in this case as merely "ministerial," because his boss wrote the text and directed him to send it. Given Lorenzo's title of "head of investment banking," his intention to use the e-mails to solicit investors, and his admission of knowledge of the falsity of the e-mails, the majority did not share that view. Addressing Lorenzo's contention that "peripheral players" (such as himself) would be exposed to liability for merely participating in the dissemination of false information, the Court pushed right back, suggesting that "investors who received Lorenzo's e-mails would not view the deception so favorably." *Id.* at 11-12. Nonetheless, there will undoubtedly be future disputes in defining what counts as knowing "dissemination."

The dissent proposed what it considered a more principled test, arguing that the phrase "device, scheme or artifice to defraud" in (a) and "act, practice, or course of business" in (c) should both be read to require "some form of planning, designing, devising or strategizing." Dissent slip op. at 4. Under the dissent's test, even a high-level person might escape primary liability and private claims, but remain exposed to claims by the SEC for secondary liability if they, like Lorenzo, were "just following orders."

Conclusion

What is most striking about the two opinions is the difference in their tones. The majority engaged in a broader antifraud-type reading, motivated by an underlying concern that fraudsters could escape their just punishment. The majority avoided making technical distinctions between primary and secondary liability that would allow any true bad actors to slip through the cracks of private civil claims. Consistent with that approach, the Court disavowed concern that its reading of subsections (a), (b) and (c) might result in overlap such that more than one subsection could apply to the same conduct, which would conflict with the canon of construction that no language in a statute should be read to render another provision superfluous. The dissent had the exact opposite tone, expressing a strong desire for clear delineation of separate provisions and a fear that the SEC or private plaintiffs might sweep anyone within the scope of Rule 10b-5 by labeling conduct as an "'act,' 'device,' scheme,' or 'artifice.'" *Id.* at 6. It accused the majority of allowing the securities laws to be "stretched to their limits," which the dissenters clearly considered to be a bad thing.

The end result is that *Lorenzo* adds one new caveat to the securities laws: while a person who does not control the content of a false statement or the decision to release it is still not the "maker" of that statement under *Janus*, primary liability may nevertheless be imposed under Rule 10b-5 for knowingly participating in the transmittal of that false statement. Only the future will tell whether the *Lorenzo* decision is a minor gloss on the scope of Rule 10b-5, or whether it signals a willingness to expand the reach of the securities laws and the elimination of a clear distinction between primary and secondary liability, as the dissent warns.

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