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Lorenzo v. SEC: Supreme Court to Revisit Who Is a "Maker" of False Statements Under the Federal Securities Laws

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In *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), the U.S. Supreme Court held that only the "maker" of an alleged misstatement can be primarily liable under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5.[1] The "maker" of the statement is the person or legal entity with "ultimate authority" over that statement.[2] *Janus* pertained to subpart (b) of Rule 10b-5, which makes it unlawful to "make" a false or misleading statement in connection with the purchase or sale of a security.[3]

On December 3, 2018, the U.S. Supreme Court will hear argument on whether this rule in *Janus* applies to so-called "scheme liability" claims under subparts (a) and (c) of Rule 10b-5. Specifically, in *Lorenzo v. Securities and Exchange Commission*, No. 17-17077, the Supreme Court will decide whether a person who is not considered to be the "maker" of a false statement under *Janus* can, nevertheless, still be liable for that false statement under the "scheme liability" provisions of Rule 10b-5(a) and (c), as the SEC contends.[4]

The Circuit Courts are divided on this issue. The Second, Eighth, and Ninth Circuits have held that the SEC cannot repackage what is essentially a misstatement claim as a fraudulent scheme claim against a defendant who could not be directly liable for the statement at issue as its "maker."[5] The Eleventh and D.C. Circuits have ruled that the "maker" requirement in *Janus* is limited to Rule 10b-5(b) claims, thus allowing fraudulent scheme claims to proceed against "non-makers."[6]

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1 *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 144 (2011).

2 *Id.* at 143 n.6.

3 17 C.F.R. § 240.10b-5(b).

4 *Lorenzo v. Sec. & Exch. Comm'n*, 872 F.3d 578 (D.C. Cir. 2017), cert. granted sub nom. *Lorenzo v. S.E.C.*, 138 S. Ct. 2650 (2018).

5 *Pub. Pension Fund Grp. v. KV Pharma. Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-58 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005).

6 *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 795-96 (11th Cir. 2015); *SEC v. Familant*, 910 F. Supp. 2d 83, 93-95 (D.D.C. 2012).

The Supreme Court's ruling on this question impacts not only claims brought by the SEC, but also, potentially, claims for private liability under Rule 10b-5. The "maker" requirement in *Janus* applies with equal force to private claims brought by shareholders against a company or its officers and directors.

Background on *Janus* and the Supreme Court's Prior Foray into Scheme Liability

Pursuant to its authority under Section 10(b) of the Exchange Act, the SEC promulgated Rule 10b-5 which makes it unlawful for any person, directly or indirectly, to use any "manipulative or deceptive device" or to make a material untrue statement or omission in connection with the purchase or sale of a security.[7] Essentially, the rule prohibits two types of conduct. First, Rule 10b-5(b) prohibits any person from "mak[ing] any untrue statement of a material fact or … omit[ting] to state a material fact necessary … to make the statements made, in light of the circumstances under which they were made, not misleading…."[8] This is often referred to as the *misstatement* provision of Rule 10b-5. Second, Rule 10b-5(a) and (c) make it unlawful "[t]o employ any device, scheme, or artifice to defraud" or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person…."[9] These two subparts are often referred to as the *scheme liability* provisions of the rule.

In actions brought under the misstatement provision of Rule 10b-5(b), the Supreme Court held in *Janus* that, as noted above, only the person who "makes" the statement can be primarily liable.[10] The Court defined the "maker" as the person or entity with "ultimate authority over the statement, including its content and whether and how to communicate it."[11] The Court held that the maker rule "might be best exemplified by the relationship between a speechwriter and a speaker."[12] This is so because "[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it" and "it is the speaker who takes credit—or blame—for what is ultimately said."[13] In other words, a party who merely assists in the drafting or dissemination of a misleading statement cannot be primarily liable under Rule 10b-5(b) if he or she lacks "ultimate control" over the content of the statement.[14]

The last time the Supreme Court was asked to define the contours of scheme liability claims was in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc*.[15] In *Stoneridge*, the plaintiffs alleged that Charter Communications, a publicly traded cable television company, falsely reported inflated revenues that were made possible by "sham contracts" with certain of its vendors.[16] The plaintiffs sought to hold those vendors primarily liable under Rule 10b-5(a) and (c) for Charter's alleged misstatements because, according to the plaintiffs, the vendors had participated in a "scheme or artifice to

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7 17 C.F.R. § 240.10b-5.

8 17 C.F.R. § 240.10b-5(b).

9 17 C.F.R. § 240.10b-5(a) and (c).

10 *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 144 (2011).

11 *Id.* at 143 n.6.

12 *Id.* at 143.

13 *Id.*

14 *Id.* at 147-48.

15 *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta*, 552 U.S. 148 (2008). Alston & Bird was counsel of record in the *Stoneridge* case.

16 *Id.* at 153–54.

defraud" and by "engaging in a course of business which operates … as a fraud or deceit."[17] The plaintiffs contended that it was the vendors' willingness to participate in the "sham contracts" that allowed Charter to mislead its auditors and, thus, without the cooperation and assistance of the vendors, the alleged fraud would not have been possible.[18]

The Supreme Court in *Stoneridge* drew a distinction between the person who actually made the alleged misstatement on which the supposedly injured investors relied (i.e., Charter) and the vendors who made no direct statements to investors, but instead were accused only of playing a role behind the scenes in structuring transactions in such a way that they assisted with or facilitated their customer's ability to report supposedly inflated revenue.[19] The Supreme Court held that the vendors' actions were too remote to satisfy the requirement of reliance for private liability under Section 10(b).[20] Reliance is one of the mandatory elements of a Section 10(b) claim, if brought by a private investor, and it was undisputed that the investors at issue in *Stoneridge* had not relied on anything the vendors said or did.[21] They were, in fact, unaware of the vendors' role in the alleged misstatements at the time they purchased Charter stock.[22]

Lorenzo v. SEC

Francis V. Lorenzo worked as the director of investment banking at Charles Vista, LLC, a registered broker-dealer. During the relevant period, his only client was Waste2Energy Holdings, Inc., a startup seeking to develop "gasification" technology.[23] The company's technology "never materialized," and it sought to "escape financial ruin" by offering $15 million in convertible debentures.[24] Charles Vista's owner allegedly drafted two emails containing material misrepresentations about Waste2Energy's financial condition and instructed Lorenzo to send the emails to potential investors.[25] Lorenzo sent the emails from his account, included his email signature on the emails, and asked potential investors to call him with any questions.[26] The SEC instituted enforcement actions against Lorenzo, Charles Vista, and its owner. Charles Vista and its owner settled, but Lorenzo refused to settle and asked for a hearing before an SEC administrative law judge. At the hearing, Lorenzo testified that he had merely copied and pasted the content of the emails and that the language at issue had been drafted by the owner of Charles Vista. The ALJ found that Lorenzo violated all three subparts of Rule 10b-5.[27] The SEC upheld the ALJ's decision, and Lorenzo appealed to the D.C. Circuit.[28]

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17 *Id.* at 156–57.

18 *Id.* at 159–60.

19 *Id.* at 161.

20 *Id.*

21 *Id.* at 159.

22 *Id.*

23 *Lorenzo v. SEC*, 872 F.3d 578, 581 (D.C. Cir. 2017), *cert. granted* (U.S. Jun. 18, 2018) (No. 17-1077).

24 *Id.*

25 *Id.* at 581–82.

26 *Id.* at 582.

27 *Id.*

28 *Id.*

The D.C. Circuit found that Lorenzo was not the "maker" of the statements at issue as defined by *Janus* since he sent the email "at the behest of his boss" who "supplied the content" and, thus, he could not be personally liable for the alleged misstatements in the emails under Rule 10b-5(b).[29] The court, however, held that Lorenzo violated the scheme liability rule of subparts (a) and (c) of Rule 10b-5 through "his own active 'role in producing and sending the emails [which] constituted employing a deceptive 'device, act,' or 'artifice to defraud'[.]"[30] The D.C. Circuit sided with the Eleventh Circuit that had previously held Rule 10b-5(a) and (c) can be used to establish primary liability for the dissemination of false statements, even if the defendant was not the maker of the statements under Rule 10b-5(b). Judge Kavanaugh, now of the Supreme Court, dissented and accused the SEC of trying to circumvent *Janus*.[31]

Analysis and Potential Outcome of *Lorenzo* Appeal

The *Lorenzo* appeal has been fully briefed and oral argument is set for December 3, 2018. In his briefs before the Court, Lorenzo argues that the majority opinion from the D.C. Circuit "renders *Janus*'s standards for misstatement claims meaningless"[32] and "virtually eliminates the distinction between primary and secondary liability[.]"[33] Lorenzo explains that the D.C. Circuit's ruling was inconsistent with past Supreme Court cases, such as *Stoneridge*, where the Supreme Court had "rejected a broad test for primary liability" and "drew a sharp distinction between the person who made the misstatements and the vendors who played some role in facilitating the false statements."[34] Lorenzo asks the Court to follow *Stoneridge* by drawing "a [similarly] sharp distinction between the person who made the misstatements (here, [Lorenzo's] boss) and the person who had a secondary role in disseminating the statements by email ([Lorenzo]) and hold that [Lorenzo] cannot be held liable as a primary violator of the securities laws."[35]

In contrast, the SEC argues on appeal that Lorenzo's actions are covered under the plain meaning of Rule 10b-5(a) and (c).[36] The SEC further argues that both *Janus* and *Stoneridge* are distinguishable. The SEC explains that, even under the *Janus* "maker" definition, Lorenzo would be liable because he "delivered the speech" so to speak when he sent the email, regardless of the fact that he did not write it.[37] According to the SEC, the fact that *Janus* involved an adviser *drafting* misstatements in a prospectus that was *issued* by a different entity creates a significant distinction from the facts present in *Lorenzo*. The SEC also argues that *Janus* did not address the scope of Rule 10b-5(a) or (c) and, thus, Lorenzo is attempting to "bootstrap" the *Janus* opinion by extending it to provisions of Rule 10b-5 that the ruling did not address. The SEC distinguished *Stoneridge* by arguing that Lorenzo, unlike the defendants in *Stoneridge*, interacted directly with the investors by sending the false email and "placing his imprimatur on their contents."[38]

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29 *Id.* at 586–87.

30 *Id.* at 589–90.

31 *Id.* at 596–02.

32 Brief of Petitioner at 16, *Lorenzo v. SEC*, No. 17-1077, 2018 WL 4035397 (U.S. August 20, 2018).

33 *Id.* at 17.

34 *Id.* at 39.

35 *Id.* at 40–41.

36 Brief of Respondent at 15, *Lorenzo v. SEC*, No. 17-1077, 2018 WL 4859376 (U.S. October 5, 2018).

37 *Id.* at 23.

38 *Id.* at 34.

Thus, Lorenzo is liable for his own "course of conduct" that is fully consistent with *Stoneridge*.[39] In addition, the SEC disputes the notion that the D.C. Circuit's holding eliminates the distinction between primary and secondary liability. Instead, primary liability would be limited to those who play an "active role in producing and sending" material misstatements with deceptive intent and thereby could be said to have "employed" a deceptive device, act, or artifice to defraud.[40]

If the Supreme Court should rule in Lorenzo's favor, *Janus* would become a gating item that limits the SEC's ability to bring claims for primary liability under Rule 10b-5 based on alleged misstatements regardless of the particular provision of the rule that is invoked. The SEC (but not private plaintiffs) could still pursue these non-makers as aiders and abettors.[41]

Recent changes in the Court's composition and how the Court previously ruled in *Stoneridge* may provide some indication of how *Lorenzo* will be decided. In many ways, this case is analogous to *Stoneridge*. In *Stoneridge*, the plaintiffs tried to expand the scope of private liability for alleged misstatements by arguing that, even though a claim could not be brought under the provision of the rule that specifically addresses misstatements or omissions, those claims can nevertheless exist under the scheme liability provisions of Rule 10b-5. In *Stoneridge*, like in *Lorenzo*, claims under subpart (b) could not exist because a mandatory requirement for subpart (b) liability could not be satisfied as a matter of law with respect to the defendant at issue. In *Stoneridge*, it was the reliance requirement (which does not apply to the SEC) while in *Lorenzo* the separate "maker" requirement is what doomed subpart (b) liability.

The Court in *Stoneridge* refused to allow an end-run around the requirements of subpart (b) by allowing claims deficient under that subpart to proceed because the parties had purportedly engaged in a "scheme" to make a misstatement. The result should be the same in *Lorenzo*. *Stoneridge* was decided before *Janus* and, thus, the vendors in *Stoneridge* did not argue that they would not qualify as "makers" of the statements at issue, but they very well could have. The vendors had made no public statements themselves and had no authority or ultimate control over the timing, distribution, or contents of the statements on which the claims in *Stoneridge* were made. The Court's conclusion in *Stoneridge* should foreclose the liability proposed in *Lorenzo* because in both instances a necessary requirement for liability based on an alleged false and misleading statement is lacking.

The decision in *Stoneridge* was decided 5–3 in an opinion written by Justice Kennedy. The three dissenting votes were cast by Justices Stevens, Ginsberg, and Souter. Justice Breyer was recused from the case. Three of the Justices who voted with the majority in *Stoneridge* are on the Court today along with one of the dissenters. Assuming that Justices Roberts, Thomas, and Alito (majority) and Ginsberg (dissent) remain consistent with their positions in *Stoneridge*, the decision will come down to Justices Gorsuch, Sotomayor, Kagan, and Breyer. Most court watchers believe that Justice Gorsuch will vote with the conservative majority from *Stoneridge*, whereas it seems unlikely that Justices Kagan, Sotomayor, and Breyer will do the same as all three Justices dissented in *Janus*. Justice Kavanaugh, who issued a dissenting opinion in the case on the D.C. Circuit, has recused himself, which sets the stage for a 4–4 split. If the Court splits evenly, the ruling of the lower court regarding the scope of liability under Rule 10b-5(a) and (c) will stand.[42]

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39 *Id*.

40 *Id.* at 33.

41 *See* 15 U.S.C. § 78t(e). Private litigants cannot bring claims for aiding and abetting liability. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

42 When the Supreme Court is split, it issues a *per curiam* ("by the court") opinion that does not contain the names of the Justices issuing the opinion. *Per curiam* opinions are typically short opinions that uphold the ruling of the lower court but do not contain the same precedential value as a decision that is signed by a majority or plurality of Justices.

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