Lorenzo v. SEC: the supreme court rules on scheme liability under the federal securities laws

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Abstract

Purpose – *To analyze the impact of the Supreme Court's decision in Lorenzo v. SEC.*

Design/methodology/approach – *Discusses the lead up to the decision, the arguments made by both sides, and the opinion of the Court, and makes predictions about the likely impact of the decision.*

Findings – *The holding is unlikely to have a significant impact on private securities litigation as shareholders, unlike the SEC, are required to prove reliance and, under the Lorenzo fact pattern, reliance cannot be shown.*

Originality/value – *Expert analysis and guidance from experienced securities litigation counsel.*

Keywords *US Securities and Exchange Commission (SEC), Lorenzo v. SEC, Misstatement liability, Scheme liability, SEC Rule 10b-5, Securities fraud*

Paper type *Technical paper*

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In what has come to be known as the "Copy-Paste Fraud," the US Supreme Court held on March 27, 2019 that an individual who knowingly disseminates false and misleading information to prospective investors with the intent to defraud may be held liable under subsections (a) and (c) of SEC Rule 10b-5, even if the disseminator would not qualify as the "maker" of the statements at issue and consequently could not be held personally liable for the statements under subsection (b) of the Rule.

The conduct at issue in *Lorenzo* and procedural history

In 2009, Francis Lorenzo, then the director of investment banking at Charles Vista LLC, sent two emails to prospective investors describing an upcoming debenture offering by Waste2Energy Inc. Though the emails were drafted by Lorenzo's boss and sent at his direction, Lorenzo conceded that he knew the emails contained misleading information about Waste2Energy. Lorenzo signed the emails with his own name and title and invited the recipients to "call with any questions."

In 2013, the US Securities and Exchange Commission (SEC) charged that Lorenzo had violated SEC Rule 10b-5, Section 10(b) of the Exchange Act, and Section 17(a)(1) of the Securities Act. When the SEC found him liable as both a "maker" of misleading statements under Rule 10b-5(b) and for employing a deceptive "device," an "artifice to defraud," and/or a deceptive "act" under Rule 10b-5(a) and (c), Lorenzo appealed to the D.C. Circuit. Although the D.C. Circuit agreed that Lorenzo could not be held liable as a "maker" under Rule 10b-5(b), it nonetheless found him liable under Rule 10b-5(a) and (c), which are often referred to collectively as the "scheme liability" provisions of the Rule. The Supreme Court granted certiorari to address the question of whether someone who is not a "maker" of a

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misstatement under the Court's prior decision in *Janus Capital Group, Inc. v. First Derivative Traders*[1] can nevertheless be found to have violated the other subsections of Rule 10b-5 when the only allegedly fraudulent conduct that occurred was a misstatement this particular defendant did not make.

The supreme court holds Lorenzo liable for distribution of misstatements under rule 10b-5(a) and (c)

In a 6–2 opinion in which Justice Kavanaugh was recused, the Supreme Court found that someone who disseminates false or misleading statements with the intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5. Justice Breyer delivered the opinion of the Court, in which Chief Justice Roberts and Justices Ginsburg, Alito, Sotomayor, and Kagan joined. Justice Thomas filed a dissenting opinion that was joined by Justice Gorsuch.

The Court found it "obvious" that Lorenzo's conduct fit into the plain language of the scheme liability provisions of Rule 10b-5. The Court rejected as "difficult to reconcile with the Rule's language" the notion offered by Lorenzo that subsection (b) – the only part of the Rule that expressly mentions speech – was supposed to be the exclusive vehicle by which speech-based claims could be pursued. The Court explained that "Congress intended to root out all manner of fraud in the securities industry" and Lorenzo's conduct was "plainly fraudulent".

The decision largely turned on the unique facts of Lorenzo's situation because he had conceded on appeal that he acted with fraudulent intent. In light of that unusual admission, it was easy for the Justices to find that his conduct – the knowing dissemination of false information to investors for purposes of soliciting an investment – was actionable under subsections (a) and (c) of Rule 10b-5, which speak in terms of a "scheme to defraud" and engaging in "deceptive" acts. This was the viewpoint expressed by Justice Alito during the oral argument.

In *Janus*, the Court found that only the person with "ultimate authority" over a statement could be primarily liable under Rule 10b-5(b). The majority dismissed the dissent's claim that finding Lorenzo liable under Rule 10b-5(a) and (c) would render Rule 10b-5(b) superfluous. The majority explained that the Supreme Court and the SEC had "long recognized considerable overlap among the subsections of the Rule and related provisions of the securities laws" and that the provisions of Rule 10b-5 are not "mutually exclusive." As evidence of this, the Court noted that if this were not the case, Lorenzo "might escape liability under the Rule altogether" and there is no reason that "Congress or the Commission would have wanted to disarm enforcement in this way".

The Court also quickly disposed of the contentions that its decision departed from the Court's precedent in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.*[2], and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc*[3]. As to *Central Bank*, which held that Rule 10b-5's private right of action does not permit suits against aiders and abettors, the Court found that those who disseminate false statements with an intent to defraud can be primarily liable under Rule 10b-5(a) and (c), even if they can only be held secondarily liable under Rule 10b-5(b). The Court found Lorenzo's reliance on *Stoneridge* even less compelling. In *Stoneridge*, the Court held that private plaintiffs could not bring suit against certain defendants whose allegedly deceptive acts were not known to investors. The Court found the *Lorenzo* facts distinguishable because Lorenzo emailed potential investors directly and, thus, he did not engage in a "concealed fraud".

Takeaway and impact

Notably, the majority opinion acknowledges that the case did not present a close call on the facts, and future courts will have to address "difficult problems of scope in borderline cases." More importantly, the claims in *Lorenzo* were brought by the SEC, not private shareholders, and the ruling will likely have limited impact on the scope of liability that companies and their executives face in private lawsuits brought by investors under Section 10(b).

As the Court acknowledges in *Lorenzo*, private litigants have to plead and prove other elements that the SEC does not, such as reliance on the alleged misstatements. The Supreme Court's discussion of how Lorenzo "intended" for investors to rely on the false and misleading information he disseminated confuses what are separate elements in private claims. Reliance is a separate element from fraudulent intent (which Lorenzo conceded) and reliance in private litigation is looked at not from the defendant's perspective, but from the perspective of the investor. Thus, in private actions, it does not matter for reliance purposes whether the defendant "intended" for shareholders to rely – the issue is whether they in fact did rely.

Private litigants will still have to plead and prove reliance, which will continue to serve as a barrier to expanded liability in private actions under the facts of *Lorenzo*. Indeed, the two potential investors who received Lorenzo's email would not have been able to sue him privately based on the record before the Court. There was no evidence that either individual even read his email, let alone relied on it in making the decision to pursue the investment opportunity at issue. Thus, the *Lorenzo* facts would preclude private liability in an individual action in the absence of pleading and proof of individual reliance.

Moreover, even if Lorenzo had distributed his email more broadly, the traditional presumption of reliance available in securities class actions would not apply because he made no statements to the market and, thus, the "fraud on the market" presumption would be unavailable. Absent the benefit of a presumption of reliance, a "class" of persons who received Lorenzo's email would still need to prove individual reliance on his statements, and the claims would be unable to proceed on a class basis for that reason.

For additional information about the appeal, go to www.alston.com/en/insights/publications/2018/11/supreme-court-to-revisit

Notes

1. 564 U. S. 135 (2011).
2. 511 U. S. 164 (1994).
3. 552 U. S. 148 (2008).