To Our Clients and Friends

Memorandum

Supreme Court Creates Uncertainty About the Reach of "Scheme" Liability Under Rule 10b-5

Earlier this week, the Supreme Court issued its decision in *Lorenzo v. SEC*, holding that those who disseminate false or misleading statements to potential investors with the intent to defraud — even if they are not the author or "maker" of the statement — can be found to have violated subsections (a) and (c) of Rule 10b-5 and related provisions of the federal securities laws. *Lorenzo v. SEC*, 587 U.S. __, 2019 WL 1369839 (Mar. 27, 2019). *Lorenzo* is noteworthy because it could be seen as expanding potential liability under Rule 10b-5 and may be used by civil plaintiffs to try to resuscitate exposure for third-party actors who were thought to be outside the ambit of Rule 10b-5 after earlier decisions in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011) and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

In *Central Bank*, the Court held that there is no private right of action for aiding and abetting a Rule 10b-5 violation by someone else. In *Janus*, the Court held that only the "maker" of a statement — one who has "ultimate authority" over the statement's content and whether to communicate it — can be liable for violations of subsection (b) of Rule 10b-5. These decisions had helped limit the scope of 10b-5 cases in recent years. In a ruling that goes further than what many hoped *Janus* suggested, the Court in *Lorenzo* held that "dissemination of false or misleading statements with intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5…even if the disseminator did not 'make' the statements and consequently falls outside subsection (b) of the Rule."

Background

The facts of the case were not sympathetic. Francis Lorenzo, an investment banker at Charles Vista, LLC, sent an email to two potential investors concerning one of Charles Vista's clients, Waste2Energy Holdings, Inc. ("W2E"). Lorenzo's email touted certain claimed protections for the potential investment, including W2E having $10 million in assets, which Lorenzo knew to be inaccurate. The emails were written by and sent at the request of Lorenzo's boss, but in the email, Lorenzo told the potential investors to call him with any questions, listing his name and title as "Vice President—Investment Banking."

On appeal from administrative proceedings before the SEC, the D.C. Circuit held that, although Lorenzo's statements were false or misleading and had been made with the requisite mental state, Lorenzo could not be liable for violating subsection (b) of Rule 10b-5 because, under *Janus*, Lorenzo was not the "maker" of the statements. *Lorenzo v. SEC*, 872 F.3d 578 (D.C. Cir. 2017). Rather, Lorenzo's boss retained "ultimate authority" over the statements' content. But the D.C. Circuit concluded that Lorenzo nonetheless could be liable for violating subsections (a) and (c) of Rule 10b-5, which do not require that a defendant "make" a statement to impose liability.

The Supreme Court granted certiorari "to resolve disagreement about whether someone who is not a 'maker' of a misstatement under *Janus* can nevertheless be found to have violated the other subsections of Rule 10b-5 and related provisions of the securities laws, when the only conduct involved concerns a misstatement."

The Decision

In the Court's March 27, 2019 decision, Justice Breyer (writing for a 6-2 majority) reasoned that the language of subsections (a) and (c) of Rule 10b-5 are sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud. The Court held that, by sending emails he knew to contain materially false statements, Lorenzo "employ[ed]" a "device," "scheme," and "artifice to defraud" within the meaning of subsection (a) of the Rule. By the same conduct, he "engage[d] in a[n] act, practice, or course of business" that "operate[d]…as a fraud or deceit" under subsection (c) of the Rule. For purposes of the appeal, it was undisputed that the statements were false and sent with the requisite scienter.

Lorenzo had urged that these sections should not reach his conduct:

> This is so, he says, because the only way to be liable for false statements is through those provisions that refer *specifically* to false statements. Other provisions, he says, concern "scheme liability claims" and are violated only when conduct other than misstatements is involved. Thus, only those who "make" untrue statements under subsection (b) can violate Rule 10b-5 in connection with statements.

The Court disagreed, describing the relevant securities laws as "includ[ing] both a general proscription against fraudulent and deceptive practices and, out of an abundance of caution, a specific proscription against nondisclosure even though a specific proscription against nondisclosure might in other circumstances be deemed surplusage." The Court's "conviction [wa]s strengthened by the fact that we here confront behavior that, though plainly fraudulent, might otherwise fall outside the scope of the Rule." In other words, the Court was not comfortable giving a pass to an obvious fraudster by finding that Rule 10b-5 could not reach him.

The Court recognized that applying subsections (a) and (c) of Rule 10b-5 to the dissemination of alleged misstatements "may present difficult problems of scope in borderline cases," such as where the individual is only "tangentially involved in dissemination." But because "Lorenzo d[id] not challenge the appeals court's scienter finding," — that is, because it was settled that Lorenzo actively intended to deceive investors — the Court found it "difficult to see how his actions could escape the reach of those provisions."

The dissent expressed concern that the Court's *Lorenzo* decision would render its *Janus* decision "a dead letter." *Janus* involved a mutual fund advisor that was legally distinct from the fund that issued the challenged prospectus, and thus was not the "maker" of the challenged statements, despite having participated in the preparation of those statements. But the *Lorenzo* ruling reads *Janus* as saying "nothing about the Rule's application to the dissemination of false or misleading information" and, accordingly, the Court reasoned that "*Janus* would remain relevant (and preclude liability) where an individual neither *makes* nor *disseminates* false information."

The Court also was not persuaded by Lorenzo's argument that finding him liable under subsections (a) and (c) of Rule 10b-5 would "erase or at least weaken what is otherwise a clear distinction between

primary and secondary (*i.e.*, aiding and abetting) liability." The Court observed that it is "hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another." The Court characterized its decision in *Central Bank* as recognizing "the need for a clean line between conduct that constitutes a primary violation of Rule 10b-5 and conduct that amounts to a secondary violation." But the Court concluded that its latest guidance — that "[t]hose who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c)…even if they are secondarily liable under Rule 10b-5(b)" — does not blur this clean line.

It remains to be seen whether the Court's *Lorenzo* decision in fact opens the door to broader claims against non-"makers" that some thought dead after *Central Bank* and *Janus*. Certainly we expect industrious plaintiffs to try to assert claims against non-"makers" of a statement on the grounds that they nonetheless were part of a "scheme or artifice to defraud" under Rule 10b-5(a) or "engaged in a[n] act or practice…[that] would operate as a fraud" under Rule 10b-5(c).

Of course, any claim under Rule 10b-5(a) and (c) must still include factual allegations that provide a "strong inference" that the defendant acted with an intent to defraud. And the Court made clear that the prohibition of aiding and abetting liability delineated in *Central Bank* remains in effect. But if and when the market turns down and shareholders look for problems and deep-pocketed participants to blame, we would not be surprised to see an attempted resurgence of 10b-5 claims against collateral participants on the grounds that *Lorenzo* endorsed primary liability alternatives under subsections (a) and (c) of the Rule and limited the "maker" requirement only to claims under subsection (b).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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