CLEARY GOTTLIEB

ALERT MEMORANDUM

Supreme Court Finds That Rule 10b-5's "Scheme Liability" Provisions Reach Someone Who Deceptively Uses—But Does Not Make—False Statements of Another

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On March 27, 2019, the Supreme Court issued a 6-to-2[1] decision in *Lorenzo v. SEC* focusing on the distinction between "making" a false statement under Exchange Act Rule 10b-5(b) and engaging in deceptive conduct—so-called "scheme liability"—under Rules 10b-5(a) and (c). The Court upheld a D.C. Circuit majority decision concluding that the SEC could hold an investment banker primarily liable for circulating false emails to investors even where he did not personally author the content of those messages. The decision is notable because it clarifies that the "scheme liability" provisions of Exchange Act Rule 10b-5(a) and (c) can impose liability even upon those defendants who could not otherwise be held primarily liable under the Supreme Court's 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, because they were not a "maker" of those statements under Exchange Act Rule 10b-5(b), but instead were involved in the preparation or dissemination of purportedly false statements "made" by others.[2]

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[1] Justice Thomas wrote the dissent with Justice Gorsuch joining. Justice Kavanaugh—who participated in the D.C. Circuit decision—did not take part in the decision.
[2] 564 U.S. 135 (2011). In *Janus*, the Court held that primary liability under Rule 10b-5(b) attached only to a false statement's "maker": "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* at 142.

The *Lorenzo* Court held that the three subsections of Rule 10b-5 serve, at least to some degree, to govern different and at times overlapping conduct. It concluded that cases involving false statements are not—assuming all other elements are satisfied—exclusively the province of Rule 10b-5(b). Some courts of appeals had rejected this approach, finding instead that scheme liability claims must be based on conduct that goes beyond misrepresentations.[3] Because the decision does not precisely define the reach of "scheme" liability with respect to false statements, the *Lorenzo* decision seems likely to lead to additional SEC enforcement actions or private litigation raising questions regarding the contexts in which defendants can be held primarily liable for statements that they did not themselves make.

Background

The case arose out of an SEC administrative action. In 2013, an SEC Administrative Law Judge found after hearing that Francis Lorenzo—the director of investment banking at a registered broker-dealer—violated all three subsections of Rule 10b-5 when he sent two emails to potential investors stating that debentures of a company called Waste2Energy Holdings, Inc. were "protect[ed]" by, among other things, "$10 million in 'confirmed assets'" when the issuer had written off substantially all of those assets just two weeks earlier. Lorenzo sent the email from his account as the head of investment banking, it was above his signature block, and it invited interested investors to call Lorenzo should they have questions.[4] At both the hearing and before the Commission on appeal, Lorenzo argued, among other things, that (1) he could not be held liable under Rule 10b-5(b) as the "maker" of the statements—as required by *Janus*—because the content of the emails had been written, and supplied to him, by his boss; and (2) to find him liable under Rule 10b-5(a) and (c)'s scheme liability provisions would be an end-run around *Janus*' requirement that only the "maker" of a false statement under Rule 10b-5(b) could be subject to liability.[5] The SEC agreed with the ALJ that Lorenzo both (1) "made" the statements at issue in violation of Rule 10b-5(b), and (2) "employ[ed] a deceptive 'device,' 'act,' or 'artifice to defraud'" in violation of subsections 10b-5(a) and (c), by "knowingly sen[ding] materially misleading language from his own email account to prospective investors."[6]

In a somewhat surprising decision, the D.C. Circuit disagreed with the SEC's conclusion that Lorenzo had made the statements in his emails within the meaning of *Janus*, but, with then-Judge Kavanaugh dissenting, upheld its conclusion that his use of those false statements created the basis for "scheme liability." There, the court found that Lorenzo was not the "maker" of the statements under *Janus* because his boss provided the content and directed him to send the messages. Thus, Lorenzo did not, as required by *Janus*, exercise "'ultimate authority' over the false statements," which resided with his boss.[7] Then-Judge

[3] *See, e.g., Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012) ("[A] scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b)."); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011) ("[A] defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rule 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions."); *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 177 (2d Cir. 2005) ("We hold that where the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b–5(a) and (c), and remain subject to the heightened pleading requirements of the PSLRA.").

[4] *In the Matter of Francis v. Lorenzo*, Exchange Act Rel. No. 74836, 2015 WL 1927763, at *5,11 (Apr. 29, 2015), vacated in part by *Lorenzo v. SEC*, 872 F.3d 578 (D.C. Cir. 2017).

[5] *In the Matter of Gregg C. Lorenzo, Francis v. Lorenzo, & Charles Vista, LLC*, SEC Release No. 544, 2013 WL 6858820, at *7 (Dec. 31, 2013), aff'd by *In the Matter of Francis v. Lorenzo*, Exchange Act Rel. No. 74836, 2015 WL 1927763 (Apr. 29, 2015); *In the Matter of Francis v. Lorenzo*, Exchange Act Rel. No. 74836, 2015 WL 1927763, at *10.

[6] *In the Matter of Francis v. Lorenzo*, 2015 WL 1927763 at *11.

[7] *Lorenzo v. SEC*, 872 F.3d 578, 587 (D.C. Cir. 2017). Given that Lorenzo presented the email as his own, this view of *Janus* seems to heavily downplay (if not outright

Kavanaugh made clear in his dissent that he would have rejected the SEC's scheme liability theory too because in his view (1) Lorenzo lacked the necessary intent to have violated Rule 10b-5(a) or (c), and (2) misstatements, standing alone, may not constitute the basis for scheme liability claims.[8]

The Supreme Court granted *certiorari* in June 2018. Neither party disputed the D.C. Circuit's finding that Lorenzo did not "make" the statements at issue and thus could not have violated Rule 10b-5(b).

The Supreme Court's Decision

In its decision, the Supreme Court rejected the argument accepted by a number of Circuit courts that to find primary liability for the use of misstatements by someone other than their maker would erode the division between primary liability and secondary liability.[9] This distinction—which is significant because private litigants cannot bring actions for aiding and abetting another's fraud—has animated past Supreme Court decisions.[10]

The Court held instead that, even if the defendant is not a maker of a misleading statement under Rule 10b-5(b), "dissemination of false or misleading statements with intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b–5."[11] Looking at definitions of "device," "scheme," and "artifice to defraud," Justice Breyer, writing for the majority, concluded that "[i]t would seem obvious that the words in these provisions are, as ordinarily used, sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud."[12] As Justice Breyer noted:

> These provisions capture a wide range of conduct. Applying them may present difficult problems of scope in borderline cases. Purpose, precedent, and circumstance could lead to narrowing their reach in other contexts. But we see nothing borderline about this case, where the relevant conduct (as found by the Commission) consists of disseminating false or misleading information to prospective investors with the intent to defraud. And while one can readily imagine other actors tangentially involved in dissemination—say, a mailroom clerk—for whom liability would typically be inappropriate, the petitioner in this case sent false statements directly to investors, invited them to follow up with questions, and did so in his capacity as vice president of an investment banking company.[13]

In finding that Rule 10b-5(a) and (c) can reach the *use* (if not the *making*) of false statements, the Court addressed a question that has long vexed courts and litigants in federal securities fraud actions: whether each of the rule's subsections are mutually exclusive such that "the only way to be liable for false statements is through those provisions that refer *specifically* to false statements."[14] Answering that question firmly in the negative, the Court found that "this Court and the Commission have long recognized considerable overlap among the subsections of the

disregard) *Janus*' finding that "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed." *Janus*, 564 U.S. at 142-43.

[8] *Id.* at 600 (Kavanaugh, J. dissenting).

[9] *Id.* at 600 (Kavanaugh, J. dissenting) ("Otherwise, the SEC would be able to evade the important statutory distinction between primary liability and secondary (aiding and abetting) liability."); *see also, e.g., Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d at 987; *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d at 1057.

[10] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (2011) (finding that private plaintiffs may not maintain aiding-and-abetting suits brought under Section 10(b) and Rule 10b-5); *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008) (claims against a counterparty that did not interact with investors alleging that sham contracts allowed the issuer to make false statements constituted at most claims for secondary liability).

[11] *Lorenzo v. SEC*, -- S. Ct. --, 2019 WL 1369839 (U.S. Mar. 27, 2019), at *4.

[12] *Id.*

[13] *Id.* at *5.

[14] *Id.* (emphasis in original).

Rule and related provisions of the securities laws" and that:

> It is understandable . . . that in declaring certain practices unlawful, it was thought prudent to include 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.[15]

Here, the Court found that such overlap would not render *Janus* a "dead letter," but rather that some conduct may fall within none, one, or even multiple of Rule 10b-5's prohibitions.[16] The Court likewise rejected the argument—made both by Lorenzo and Justice Thomas in dissent—that its decision eviscerates the distinction between primary and secondary liability, noting that conduct amounting to merely aiding and abetting another's false statement may, if the relevant elements are satisfied, also constitute a primary violation of the "scheme liability" provisions.[17]

In contrast, and possibly presaging future litigation, Justices Thomas and Gorsuch expressed concern that this decision will place no limit on plaintiffs' ability to recast claims that should properly be brought as aiding-and-abetting under the broad rubric of "scheme liability." Noting that *Lorenzo* would transform "administrative acts," such as disseminating an email, into "other form[s] of fraud," the dissent argued that "the majority does precisely what we declined to do in *Janus*: impose broad liability for fraudulent misstatements in a way that makes the category of aiders and abettors in these cases almost nonexistent . . . . If Lorenzo's conduct here qualifies for primary liability under § 10(b) and Rule 10b–5(a) or (c), *then virtually any person who assists with the making of a fraudulent misstatement will be primarily liable and thereby subject not only to SEC enforcement, but private lawsuits*."[18]

The majority seemed troubled with a conclusion that a defendant, such as Lorenzo, could with the requisite state of mind use plainly false statements to dupe investors with impunity.[19] However, the decision seems sure to lead to additional litigation as to the precise demarcation between primary "scheme" and secondary liability. Indeed, the Court itself seemed to acknowledge the difficulties of such line drawing, writing that—while 10b-5's constituent subsections "capture a wide range of conduct"—"[a]pplying them may present difficult problems of scope in borderline cases."[20] The opinion itself offers little in the way of a roadmap for making that determination. On the one hand, the Court noted "even a bit participant in the securities markets 'may be liable as a primary violator under [Rule] 10b-5' so long as 'all of the requirements for primary liability . . . are met.'"[21] On the other, as noted above, the majority made much of the fact that Lorenzo was significantly more than such a "bit participant"—he "disseminat[ed] false or misleading information to prospective investors with the intent to defraud."[22] Indeed, the majority noted that while—in other cases "[p]urpose, precedent, and circumstance could lead to narrowing [10b-5 (a) and (c)'s] reach in other contexts . . . we see nothing borderline about this case."[23] Of course, the devil will be in determining

[15] *Id.* (internal citations and quotation marks omitted).
[16] *See id.* at *6 ("And we can assume 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.").
[17] *Id.* at *7 ("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.").
[18] *Id.* at *12 (Thomas, J. dissenting) (internal quotation marks omitted) (emphasis added).
[19] *Id.* at *7 ("And if, as Lorenzo claims, the disseminator has not primarily violated other parts of Rule 10b–5, then such a fraud, whatever its intent or consequences, might escape liability altogether").
[20] *Id.* at *5.
[21] *Id.* at *7 (quoting *Central Bank of Denver, N.A.*., 511 U.S. at 191 (discussing the liability of "secondary actors" such as lawyers, accountants, or banks for securities fraud)).
[22] *Lorenzo v. SEC*, 2019 WL 1369839 at *5.
[23] *Id.*

where the “borderline” falls between 10b-5(b) and “scheme liability.”

One possible answer could be to consider whether the defendant *interacted* directly with investors. Thus, while Lorenzo did not “make” the statements at issue, he sent them to investors—and, thus, in the Court’s view, misled them. By contrast, the *Stoneridge* defendants, who the Court found were at best merely secondary actors, had no interaction at all with investors, but rather were alleged to have entered into sham contracts with the issuer (which was then alleged to have prepared false books on the basis on those contracts).[24] There, the Court noted that lack of investor contact: “Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. [The issuer] was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements.”[25]

Because the Supreme Court pointedly did not set out a bright line rule to demarcate the border between 10b-5’s various provisions, this issue is certain to be hotly litigated in the future. However—given the majority’s efforts to make clear that Lorenzo’s conduct was not a close call—it may be reasonable to assume that the Court would not seek to stretch Lorenzo’s holding much beyond these facts: requiring a defendant to have direct interaction with investors and a meaningful role in the underlying deceptive conduct.

Nevertheless, for now a degree of uncertainty persists. One beneficiary of this may be the SEC’s own enforcement program. Erosions of the lines between 10b-5(a) and (c), on the one hand, and 10b-5(b), on the other, may make it easier for the agency to bring actions—either on a settled or litigated basis—where post-*Janus* jurisprudence otherwise presented obstacles. Thus, we could begin to see SEC actions pleading misstatement cases as well as settled cases more broadly under 10b-5(a) and (c), which the SEC may not previously have been able to bring under 10b-5(b).

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[24] *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta*, 552 U.S. 148, 153–55 (2008).
[25] *Id.* at 166.

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