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Supreme Court Limits Liability For False Statements Under Rule 10b-5 To Those With "Ultimate Authority" For Them

Janus Capital Group, Inc. v. First Derivative Trader held that the investment adviser to a mutual fund could not be liable in a private action under Section 10(b) of the Securities Exchange Act for allegedly false statements contained in prospectuses issued by the mutual fund, even though the investment adviser wrote the allegedly misleading prospectuses.

Facts. Janus Capital Management LLC ("JCM") is the investment adviser to Janus Investment Fund (the "Fund"), a business trust created by JCM's parent, Janus Capital Group, Inc. ("Group"). Group, JCM and the Fund are distinct legal entities, and the Fund has an independent board of trustees. However, all of the Fund's officers are employees of JCM, and JCM provides all necessary management and administrative services needed by the Fund, including the drafting and review of the Fund's prospectuses. The prospectuses were challenged under Section 10(b) because they purportedly stated that the Fund would not permit market timing trading, and yet allegedly did so. *Janus Capital* did not address whether the Fund, which issued the challenged prospectuses, was liable under Section 10(b). Instead, the focus was on whether JCM could be primarily liable – under a fraud on the market theory based upon secondary market trading of Group securities – because JCM was the author of the Fund's prospectuses.

The Court's Analysis. Rule 10b-5 prohibits "mak[ing] any untrue statement of a material fact" in connection with the purchase or sale of securities. The majority described the issue as what it means to "make" a statement, and held that the "maker" of a statement is "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Applying this test, the Court held that the Fund, not JCM, was the "maker" of the challenged statements, because the Fund was the entity with "ultimate authority" over the prospectuses, bore the statutory obligation to (and did) file the prospectuses with the SEC, and the prospectuses are attributed to the Fund and not to JCM. In so defining "make" under Section 10(b), the Court rejected a competing definition urged by the Government, under which "make" would mean "create." Under that definition, JCM would have been responsible under Section 10(b) for fraudulent statements in Fund prospectuses, because JCM "created" them.

The Court found support for the definition of "make" it adopted in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). *Central Bank* held that Section 10b-5's private right of action did not permit suits against "aiders and abettors," and *Janus Capital* reasoned that a definition of "make" that included persons or entities without "ultimate control" over the content of a statement would substantially undermine the bright line distinction between aiders and abettors and primary violators *Central Bank* sought to draw. *Stoneridge* held that customers and suppliers to a company were not primary violators for transactions they engaged in that allowed a "company to mislead its auditor and issue a misleading financial statement" where the suppliers had no control over how the issuer chose to report the subject transactions in its public filings. *Stoneridge* reasoned that "nothing [the defendants] did made it necessary or inevitable for [the company] to record the transactions as it did."

Implications. First, in *Janus Capital* the Court continues to narrowly confine Section 10(b), and by implication any other right of action judicially implied from Congressional legislation. In *Alexander v. Sandoval*, 532 U.S. 275 (2001), the Court reformulated, by significantly narrowing, the test for the judicial creation of a private right of action. Under *Alexander*, the courts will imply a cause of action only when, at a minimum, there is a discernable congressional intent to create a cause of action. *Central Bank* saw the Court forcefully applying this new approach, by rejecting private rights of action under Section 10(b) for aiding and abetting – even though the existence of such a right was widely accepted in the lower courts. *Stoneridge* was animated by similar concerns. As in *Central Bank* and *Stoneridge*, the *Janus Capital* Court noted the "narrow scope that we must give the implied private right of action," saying "[c]oncerns with the judicial creation of a private cause of action caution against its expansion," and emphasized that it is "mindful that we must give 'narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law." Particularly in the securities area, these opinions will likely provide at least a basis for resisting any efforts to expand further the scope of implied rights of action, and perhaps justify questioning their use in areas lower courts now accept.

Second, *Janus Capital* adds powerful support for the argument that, to be a primary violator under Section 10(b), a statement must be attributed to the defendant. "[I]n 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 publicly attributed." Thus, "[o]ne who prepares or publishes a statement on behalf of another is not its maker." This should put to rest, therefore, whether counsel who prepares disclosure documents can be liable under Section 10(b). Even where a defendant is named in a selling document, it will have no Section 10(b) liability absent proof that it had "ultimate authority" over the content of the document, including "whether and how to communicate" the information in it. As the Court stated, "[m]ore may be required to find that a person or entity made a statement indirectly, but attribution is necessary."

Third, application of the Court's new "ultimate authority" test will pose difficult challenges in the lower courts. For example, courts are grappling with the concept of "corporate scienter" – when has a corporation made a statement with scienter. The issue is complex because a corporation can only act through its agents, and it may well be that no one person within the organization is aware that a public statement is false. In *Janus Capital*, the Court seemed to accept that the Fund's trustees rather than the Fund's agents (JCM) had ultimate authority for the prospectuses that the Fund issued. If so, could even the Fund be liable under Section 10(b) for false statements in the prospectuses if, for example, the Fund's trustees were not aware of their falsity? The *Janus Capital* dissent argued that this result was essentially compelled by the majority's holding, and that as a result primary liability for corporate actors under Section 10(b) would be dramatically curtailed: as the dissent rhetorically stated, "[w]hat is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both the board and public into believing they are true?"

Fourth, the *Janus Capital* test will likely impact the SEC's ability to bring aiding and abetting Section 10(b) claims. While the SEC (unlike private litigants) clearly has authority to pursue those who aid and abet Section 10(b) violations, the SEC often pursues individuals both as primary violators and aiders and abettors. Until now, the SEC has routinely pursued corporate officials as primary violators in corporate disclosure cases. But that may prove impossible since in the usual case false statements are made by and in the name of the corporation. Depending on the responsibilities of the corporate official, it is not at all clear that any individual's scienter will be able to be attributed to the corporation. Absent clear evidence of a corporate violation, it may be impossible for the SEC to pursue successfully an aiding and abetting claim against any individual – even where the individual may have intentionally prepared a false statement used to mislead investors.

Fifth, *Janus Capital* may lead to new focus on the contours of control person liability. As the dissent noted, there is a "dearth of authority construing Section 20(b)." The majority explicitly declined to address whether, in Section 20(b), "Congress created liability for entities that act through innocent intermediaries." The lower courts, however, accept that Section 20(b) liability does not attach unless there was an underlying primary violation in the first place. As such, unless the Court intends to give the express language of Section 20(b) meaning that the lower courts have not, the question the majority left open will be likely answered "no."

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