March 28, 2019

U.S. Supreme Court Holds that Primary Liability under the Federal Securities Laws May Be Based on Misstatements that the Defendant Did Not Make

On March 27, 2019, the Supreme Court held in *Lorenzo* v. *Securities & Exchange Commission*, No. 17-1077 (U.S.) that under certain circumstances a person who does not "make" a misstatement may nonetheless be held primarily liable under the antifraud provisions of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and related SEC Rules for intentionally "disseminating" a misstatement.[1]

In *Janus Capital Group, Inc*. v. *First Derivative Traders*, the Supreme Court held that only the "maker" of a material misstatement may be held primarily liable under Rule 10b-5(b), and that the "maker" is the person with "ultimate authority over the statement, including its content and whether and how to communicate it"—not anyone else who merely prepares or publishes a statement on behalf of others.[2]

The question in *Lorenzo* was whether a person who disseminated a material misstatement to investors under his own name and with the intent to deceive can be primarily liable not under Rule 10b-5(b), but under Rules 10b-5(a) or (c). The SEC argued that such a person could be liable under Rule 10b-5(a) for employing "any device, scheme, or artifice to defraud," or under Rule 10b-5(c) for engaging in "any act, practice, or course of business" which would "operate as a fraud or deceit."[3] Prior to the Supreme Court's decision, the appellate courts were split on this question. The Second, Eighth, and Ninth Circuits held that liability under Rules 10b-5(a) and (c) requires deceptive conduct that is separate and apart from a misstatement.[4] However, the D.C. Circuit in *Lorenzo* did not require deceptive conduct beyond a

1 Section 17(a)(1) of the Securities Act makes it unlawful "in the offer or sale of any securities . . . directly or indirectly . . . to employ any device, scheme, or artifice to defraud." 15 U.S.C. § 77q(a)(1). Section 10(b) of the Exchange Act makes it unlawful to "directly or indirectly . . . use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78(j)(b).

2 564 U.S. 135, 142–44 (2011) (fund adviser that drafted materially misleading statements in a prospectus issued by the fund could not be primarily liable under Rule 10b-5(b) because the fund, not the adviser, "made" the misstatements).

3 *See* 17 C.F.R. § 240.10b-5.

4 *See Pub. Pension Fund Grp*. v. *KV Pharm. Co*., 679 F.3d 972, 987 (8th Cir. 2012) ("We join the Second and Ninth Circuits in recognizing 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

misstatement to establish liability under Rules 10b-5(a) or (c). In a 6-2 ruling, the Supreme Court affirmed the D.C. Circuit's decision.

This issue has particular import for private securities litigation, where plaintiffs are foreclosed from bringing "aiding and abetting" claims.[5] Private plaintiffs may now attempt to invoke *Lorenzo* to pursue misrepresentation claims against defendants who do not "make" any statement to investors but are nonetheless actively involved in disseminating statements. The Supreme Court was careful to re-affirm *Janus*'s construction of Rule 10b-5(b) and cabin its decision to the unique facts presented in *Lorenzo*. But private plaintiffs will undoubtedly try to use *Lorenzo* to plead around *Janus* and expand the scope of those who may be liable for securities fraud. Whether or not plaintiffs succeed will be up to the lower courts that must grapple with more difficult "borderline" cases.

Factual and Procedural Background

In 2013, the SEC found that Francis Lorenzo, a vice president of investment banking for a registered broker-dealer, had violated the antifraud provisions of the federal securities laws.[6] Specifically, Lorenzo sent two emails to prospective investors advertising a debenture offering for a start-up company (Waste2Energy Holdings, Inc.) that materially misrepresented the value of its assets.[7] Lorenzo transmitted the emails under his own name and signature block, and invited investors to call him personally with any questions. However, Lorenzo's boss had supplied the content of the emails, and the emails expressly said they were being sent at the request of Lorenzo's boss.[8]

An SEC administrative law judge ("ALJ") held that Lorenzo had willfully, or at a minimum recklessly, violated: (i) Section 17(a)(1) of the Securities Act, 15 U.S.C. § 77q(a)(1); (ii) Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b); and (iii) Securities Exchange Act Rules 10b-5(a)-(c), 17 C.F.R. § 240.10b-5(a)-(c).[9]

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only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 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).").

5 *See Central Bank of Denver NA* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) (private civil liability under Rule 10b-5 does not extend to those who merely aid and abet a 10(b) violation).

6 *See Gregg C. Lorenzo, Francis* V. *Lorenzo & Charles Vista, LLC*, SEC Rel. No. 544, 2013 WL 6858820, at *5–7 (Dec. 31, 2013).

7 *See id.* at *4–5.

8 *See id.*

9 *See id.* at *5–7.

The ALJ issued a cease-and-desist order, imposed a $15,000 civil money penalty, and barred Lorenzo from the securities industry for life.[10] The SEC sustained the ALJ's order.[11]

On appeal, the D.C. Circuit found substantial evidence to support the SEC's findings that (i) the statements in Lorenzo's emails were materially false, and (ii) Lorenzo acted with fraudulent intent when disseminating the material misstatements.[12] However, the D.C. Circuit reversed the SEC's determination that Lorenzo had violated Rule 10b-5(b), which renders it unlawful in connection with a securities transaction to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading."[13] Specifically, the D.C. Circuit held that Lorenzo could not have violated Rule 10b-5(b) because Lorenzo did not "make" the statements under the Supreme Court's decision in *Janus*. Instead, Lorenzo's boss maintained "ultimate authority" over the messages by supplying their content and directing Lorenzo to distribute the emails to investors.[14] Nonetheless, since Lorenzo knowingly sent material misrepresentations from his own email account to investors and encouraged them to contact him directly with questions, the D.C. Circuit majority concluded that Lorenzo had violated the "scheme liability" provisions of SEC Rules 10b-5(a) and (c), along with Section 10(b) of the Exchange Act and Section 17(a)(1) of the Securities Act.[15] Unlike Rule 10b-5(b), those provisions do not speak in terms of "making" a false statement.

Justice Kavanaugh, then a judge on the D.C. Circuit, dissented.[16] He reasoned that the majority opinion created a circuit split by holding that "mere misstatements, standing alone, may constitute the basis for so-called scheme liability under the securities laws—that is, willful participation in a scheme to defraud—even if the defendant did not make the misstatements."[17] Then-Judge Kavanaugh observed that the SEC could have charged Lorenzo with aiding-and-abetting violations, but should not have been able to "expand the scope of primarily liability under the securities laws."[18]

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10 *See id.* at *10.

11 *See In the Matter of Francis Lorenzo*, SEC Rel. No. 9762, 2015 WL 1927763, at *17 (Apr. 29, 2015), vacated in part, *Lorenzo* v. *SEC*, 872 F.3d 578 (D.C. Cir. 2017).

12 *See Lorenzo* v. *SEC*, 872 F.3d 578, 583 (D.C. Cir. 2017).

13 *See id.* at 587–88; 17 C.F.R. § 240.10b-5(b).

14 *Lorenzo*, 872 F.3d at 587–88.

15 *See id.* at 588–89.

16 *See id.* at 596–97 (Kavanaugh, J., dissenting).

17 *Id.* at 600.

18 *Id.* at 601.

The Supreme Court granted *certiorari* to resolve the circuit split. Presumably due to his role in the D.C. Circuit decision, Justice Kavanaugh recused himself from the case in the Supreme Court.

The Supreme Court's Opinions

The Majority Opinion

In a 6-2 opinion authored by Justice Breyer, the Supreme Court held that a person who disseminates materially misleading statements with the intent to defraud investors can be held primarily liable under Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and SEC Rules 10b-5(a) and (c) thereunder, even if that person does not "make" any statement to investors.[19] Thus, although Rule 10b-5(b) specifically governs the making of false statements, it is not the exclusive mechanism for regulating fraudulent conduct that involves disseminating misstatements.

First, the Supreme Court examined the plain language of Rules 10b-5(a) and (c). The majority understood the dissemination of materially false emails with fraudulent intent to constitute a "device," "scheme," or "artifice to defraud" under the plain language of subsection (a), as well as an "act, practice, or course of business" that operated "as a fraud or deceit" under subsection (c).[20] The Court found support for this reading in the dictionary definitions of: a "device" as something formed by design; a "scheme" as a project, plan or program of something to be done; and an "artifice" as an artful stratagem or trick.[21]

Second, the Court concluded that the history and purpose of the securities laws do not establish that subsection (b), the "making-false-statements provision," is the only provision that applies when fraud occurs by means of a misstatement. The Court observed that it has "long recognized considerable overlap among the subsections of the Rule" such that each provision covers additional illegal acts without narrowing the reach of other subsections to mutually exclusive spheres.[22] For example, the same conduct could constitute a "device, scheme, or artifice to defraud" under subsection (a), as well as an "act . . . which operates . . . as a fraud" under subsection (c).[23] According to the majority, accepting the view that subsection (b) alone regulates conduct involving misstatements would mean that those who disseminate (but do not "make") materially false statements with fraudulent intent may escape liability altogether.[24]

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19 *Lorenzo* v. *SEC*, No. 17-1077, slip op. at 2.

20 *Id.* at 5–6.

21 *Id.* at 6 (internal citations omitted).

22 *Id.* at 7–8.

23 *Id.* at 8.

24 *Id.* at 9.

Finally, the Court rejected the suggestion that its ruling renders *Janus a* "dead-letter" or meaningfully undermines the distinction between primary and secondary liability. The Court explained that *Janus* considered subsection (b) of Rule 10b-5 in a case where an investment adviser drafted misstatements issued by another entity that had ultimate authority. After *Lorenzo*, the Court maintained, *Janus* still precludes primary liability where an individual does not make or disseminate false information or engage in other fraudulent conduct.[25] According to the majority, the line between primary and secondary liability remains equally clear: those who disseminate (but do not "make") materially false statements with the intent to defraud can be primarily liable under subsections (a) and (c), even if they could be held only secondarily liable in an SEC enforcement action for aiding and abetting under subsection (b).[26]

The Dissenting Opinion

Justice Thomas, joined by Justice Gorsuch, dissented on the ground that a person who does not "make" a misstatement under Rule 10b-5(b) cannot be held primarily liable under the general conduct-based provisions for disseminating that same misstatement.[27]

First, the dissent disagreed that transmitting a misstatement on behalf of its maker constitutes a "device, scheme, or artifice to defraud" under Rule 10b-5(a). Citing the same dictionary definitions as the majority, the dissent interpreted primary liability to require "planning, designing, devising, or strategizing."[28] According to the dissent, Lorenzo may have knowingly "assisted" a scheme, but he did not himself plan, design, devise, or strategize that scheme.[29]

Second, the dissent argued that allowing a person who has not made a misstatement to be held primarily liable for an "artifice to defraud" under Rule 10b-5(c) would violate the canon of interpretation that "the specific governs the general," and render superfluous the "maker" provision in Rule 10b-5(b).[30] Under this reading, the provisions specifically addressing false statements should effectively occupy the field in misstatement cases.[31]

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25 *Id*. at 10.

26 *Id*. at 10–12.

27 *Lorenzo* v. *SEC*, No. 17-1077, slip op. at 1 (Thomas, J., dissenting).

28 *Id*. at 4 (Thomas, J., dissenting).

29 *Id*. at 5 (Thomas, J., dissenting).

30 *Id*. at 6 (Thomas, J., dissenting).

31 *Id*. at 7 (Thomas, J., dissenting).

Third, the dissent understood the Court's opinion to undermine *Janus* given that Lorenzo did not "make" the fraudulent statements at issue and undertook only "administrative acts."[32] Viewing Lorenzo's role as indistinguishable from a secretary who sends an email for his boss, the dissent faulted the Court for ignoring the "on-point requirements of a narrower provision" under Rule 10b-5(b) that specifically addresses fraudulent statements, and for blurring the line between fraud and aiding-and-abetting liability.[33]

Implications

The Supreme Court's ruling in *Lorenzo* will be seized upon by plaintiffs to argue that defendants can be liable for statements that they themselves did not "make." Any such expansion of liability would be of particular import in private securities litigation where private plaintiffs cannot bring aiding-and-abetting claims under the federal securities laws.[34]

There is, however, a strong argument that *Lorenzo* should be confined to its particular fact pattern involving direct dissemination of materially false information with fraudulent intent and attribution. Under *Janus*, attribution of a misstatement to a particular person is "strong evidence" that such person made the misstatement under Rule 10b-5(b).[35] In *Lorenzo*, although the defendant disseminated fraudulent statements under his own name and invited investors to call him directly, the D.C. Circuit ruled that Lorenzo did *not* "make" those statements because he lacked ultimate authority over their content. Thus, *Lorenzo* was a unique case in which the misstatement was attributed to a defendant who was not its "maker" but who disseminated the misstatement to investors with fraudulent intent. In scenarios where a non-speaker may play a more remote role in drafting or disseminating statements, it may well be argued that *Lorenzo* does not support primary liability for securities fraud. Indeed, there are strong arguments that underwriters, investment bankers, lawyers, and others who do not have ultimate authority over statements should not be subject to any additional liability under this decision. Similarly, those who do not disseminate statements directly to investors will have a basis to distinguish *Lorenzo*. As the *Lorenzo* Court recognized,

32 *Id.* at 9 (Thomas, J., dissenting).

33 *Id.* at 10 (Thomas, J., dissenting).

34 *See Central Bank of Denver*, 511 U.S. at 191 (no private liability for aiding and abetting under Rule 10b-5). The SEC, however, can bring aiding-and-abetting claims against any person who "knowingly or recklessly provides substantial assistance to another person" in violating the Exchange Act. 15 U.S.C. § 78(t)(e). The SEC also has standing to bring claims under Section 17(a) of the Securities Act, whereas private plaintiffs must bring securities fraud claims under the Exchange Act. *See Thompson* v. *RelationServe Media, Inc.*, 610 F.3d 628, 652 n.25 (11th Cir. 2010) ("[T]his circuit has expressly refused to read a private right of action into § 17."); *Carol Gamble Trust 86* v. *E-Rex, Inc.*, 84 Fed. App'x 975, 978 n.1 (9th Cir. 2004) ("There is no private right of action under Section 17(a)."); *Finkel* v. *Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (same).

35 *Janus*, 564 U.S. at 142–43.

its ruling "may present difficult problems of scope in borderline cases," and "[p]urpose, precedent, and circumstance could lead to narrowing the[] reach [of the antifraud provisions] in other contexts."[36]

Following *Lorenzo*, we expect litigants and courts to grapple with the scope of primary liability for alleged misstatements that a defendant did not "make." In contexts where the defendant may be further down in the disclosure drafting chain, has not reviewed or approved the final statement, is peripherally involved in disseminating a false statement, or is an undisclosed participant in the formulation or publication of the statement, there are also very strong arguments that primary liability should not attach. It will fall to lower courts to analyze the interplay between *Lorenzo* and *Janus*, and apply those decisions to the wide variety of factual circumstances that the Supreme Court could not have anticipated and did not purport to address in *Lorenzo*.[37]

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[36] *See Lorenzo* v. *SEC*, No. 17-1077, slip op. at 6–7.

[37] The Supreme Court also did not address the issue of whether the SEC's interpretation of the federal securities laws is entitled to deference under *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The *Lorenzo* Court appeared to agree with the SEC's legal position even in the absence of deference. Questions of agency deference are likely to resurface later this Term.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel +1-212-373-3553 sbuergel@paulweiss.com	Geoffrey R. Chepiga +1-212-373-3421 gchepiga@paulweiss.com	Andrew J. Ehrlich +1-212-373-3166 aehrlich@paulweiss.com
Brad S. Karp +1-212-373-3316 bkarp@paulweiss.com	Daniel J. Kramer +1-212-373-3020 dkramer@paulweiss.com	Jane B. O'Brien +1-202-223-7327 jobrien@paulweiss.com
Walter Rieman +1-212-373-3260 wrieman@paulweiss.com	Richard A. Rosen +1-212-373-3305 rrosen@paulweiss.com	Kannon K. Shanmugam +1-202-223-7325 kshanmugam@paulweiss.com
Audra J. Soloway +1-212-373-3289 asoloway@paulweiss.com	Daniel J. Juceam +1-212-373-3697 djuceam@paulweiss.com	

Associates Sarah J. Prostko and Sierra A.Y. Robart contributed to this client memorandum.