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SECOND CIRCUIT REVIEW

Expert Analysis

Alleging Scheme Liability In the Wake of 'Lorenzo'

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On July 15, 2022, the U.S. Court of Appeals for the Second Circuit issued an opinion in *SEC v. Rio Tinto plc*, — F.4th —, 2022 WL 2760323 (2d Cir. 2022), ruling that claims under Rule 10b-5(a) and (c) ("scheme liability claims") may not be based on allegations of misstatements and omissions alone. In doing so, the Second Circuit affirmed that its holding in *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) remains good law after *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019).

In the unanimous opinion, Judge Dennis Jacobs, joined by Judges Richard Wesley and William Nardini, rejected the SEC's view that *Lorenzo* expanded the scope of scheme liability to encompass actions based *solely* on alleged misrepresentations and omissions and reaffirmed its prior holding in *Lentell*, finding that "misstatements and omissions can form *part* of a scheme liability claim, but an actionable scheme liability claim also requires something *beyond* misstatements and omissions, such as dissemination." *SEC v. Rio Tinto plc*, — F.4th —, 2022 WL 2760323, *1 (2d Cir. 2022).

The Securities Exchange Act and Rule 10b-5

The Securities Exchange Act (Exchange Act) prohibits the use of "any manipulative or deceptive device" in connection with the purchase or sale of securities in the United States. 15 U.S.C.A. §78j. Rule 10b-5 implements §10(b) and prohibits "mak[ing] any untrue statement" or omission of material fact in connection with a securities transaction, 17 C.F.R. §240.10b-5(b), and prohibits the use of any "device, scheme, or artifice to defraud" as well as any "act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" in connection with a securities transaction. 17 C.F.R. §240.10b-5(a), (c).

Claims brought under Rule 10b-5(b) are subject to additional requirements than those brought under Rule 10b-5(a) or (c). For example, the Supreme Court in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135, 142 (2011) held that the "maker of a statement is the person or entity with ulti-

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mate authority over the statement, including its content and whether and how to communicate it," and those that do not "make" a statement, cannot be liable under Rule 10b-5(b). Relatedly, private plaintiffs bringing claims under Rule 10b-5(b) are subject to heightened requirements under the Private Securities Litigation Reform Act (PSLRA). 15 U.S.C.A. §78u-4(b)(1). Private plaintiffs, unlike the Securities and Exchange Commission (SEC) are also unable to bring claims for aiding and abetting securities violations. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

In *Lorenzo*, the Supreme Court was confronted with whether an individual who did not "make" a misstatement under Rule 10b-5(b), but did disseminate the misstatements with scienter, could still be liable under Rule 10b-5(a) or (c). 139 S. Ct. at 1099. The Supreme Court held that the individual could be liable because the dissemination of a material misstatement with intent to defraud met the dictionary definition of a "device" or "scheme." See id. at 1101. In reaching its conclusion, the Supreme Court emphasized that the decision in *Janus* would continue to have force, and that there would continue to be a line separating primary and secondary liability. Id. at 1103.

Background

In 2017, the SEC alleged that defendants Rio Tinto PLC and Rio Tinto Ltd. (Rio Tinto) and Rio Tinto's former CEO, Tom Albanese, and CFO, Guy Elliott, made a series of alleged misstatements and omissions in connection with the value of an undeveloped, exploratory mining asset in Mozambique that Rio Tinto acquired in 2011 for $3.7 billion. Defendants moved to dismiss in March 2018.

> In the unanimous opinion, Judge Dennis Jacobs, joined by Judges Richard Wesley and William Nardini, rejected the SEC's view that 'Lorenzo' expanded the scope of scheme liability to encompass actions based solely on alleged misrepresentations and omissions and reaffirmed its prior holding in 'Lentell'.

In March 2019, U.S. District Judge Analisa Torres dismissed the vast majority of the claims in the action, including all of the scheme liability claims brought under Rule 10b-5(a) and (c), as well as under §17(a)(1) and (a)(3). With respect to the Rule 10b-5(a) and (c) claim, Judge Torres held that "the SEC must allege 'the performance of an inherently deceptive act that is distinct from an alleged misstatement.'" *SEC v. Rio Tinto plc*, 2019 WL 1244933, *15 (S.D.N.Y. 2019) (citing *SEC v. Kelly*, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011)). Judge Torres noted, however, that the pending Supreme Court decision in *Lorenzo v. SEC* "may clarify" the standard for Rule 10b-5(a) and (c) claims. See id. at n.9.

Nine days after Judge Torres issued the order on the motion to dismiss, the Supreme Court issued its decision in *Lorenzo*. *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019). The SEC filed a motion in the district court for reconsideration, which was denied in March 2021. Judge Torres affirmed her prior ruling, explaining that the only actions identified by the SEC are "misstatements or omissions," and *Lorenzo* only held that those who "disseminate" false or misleading statements can be liable, "not that misstatements alone are sufficient to trigger scheme liability." *SEC v. Rio Tinto PLC*, 2021 WL 818745, *2 (S.D.N.Y. March 3, 2021).

Following the denial of reconsideration, the SEC requested interlocutory appeal, and the

review was granted.

Second Circuit Order

The Second Circuit affirmed the district court opinion, reiterating that "misstatements and omissions can form part of a scheme liability claim, but an actionable scheme liability claim also requires something beyond misstatements and omissions, such as dissemination." See *SEC v. Rio Tinto plc*, 2022 WL 2760323, *1 (2d Cir. 2022).

The SEC argued that "*Lorenzo* expanded the scope of scheme liability so that allegations of misstatements and omissions alone *are* sufficient to state a scheme liability claim." Id. The Second Circuit rejected that argument because the SEC's attempt to "shoehorn its allegations into a claim for scheme liability" would undermine two main features of liability under Rule 10b-5(b). Id. at *4.

First, the SEC's position would undermine *Janus*'s requirement that primary liability be limited to the "maker" of the statement. Id. Neither Mr. Albanese nor Mr. Elliott were the "makers" of any of the alleged misstatements, yet under the SEC's expanded interpretation they could be "primarily liable under the scheme subsections for *participation* in the making of the misstatements." Id.

Second, the SEC's expanded interpretation would undermine the heightened pleading requirements for the PSLRA because private plaintiffs could plead liability under Rule 10b-5(a) or (c), instead of the heightened standard of Rule 10b-5(b). See id. at *7. The Second Circuit's ruling prevents "private litigants [from] repackag[ing] their misstatement claims as scheme liability claims." See id.

As a result of the its holding, the Second Circuit has preserved two main arguments for companies facing securities lawsuits under §10(b).

Third, the Second Circuit expressed concern that the SEC's expansive reading could also "muddle primary and secondary liability," and "defeat the congressional limitation on the enforcement of secondary liability. Id.

Finally, the Second Circuit rejected the SEC's argument that *Lentell* only applies in cases brought by private litigants. Id. at *6.

Conclusion

As a result of the its holding, the Second Circuit has preserved two main arguments for companies facing securities lawsuits under §10(b). It confirms that plaintiffs must identify the individuals with ultimate authority over the statement to prevail on Rule 10b-5(b) claims, and that private litigants cannot simply plead around the PSLRA's heightened requirements for Rule 10b-5(b).

While the Second Circuit affirmed that *Lentell* was not abrogated, the Second Circuit was only addressing that legal question. Id. at *5. The Second Circuit left open the possibility that there may be other cases that "blur the distinctions between the misstatement subsections and the scheme subsections." Id. at *6. As a result, in the future, the Second Circuit may be called upon to determine what qualifies as conduct "beyond misstatements and omissions" in other cases.