Born Under a Bad Sign? Maybe Yes, Maybe No

By C. Evan Stewart

True music aficionados know that Stax Records (based in Memphis, aka Soulsville, U.S.A.) went toe-to-toe in the 1960s with its rival Motown Records (based in Detroit); featuring such artists as Otis Redding, Sam and Dave, Booker T. & The MGs, Isaac Hayes, Wilson Pickett, Carla Thomas, Eddie Floyd, and Albert King, Stax left an enduring legacy of great soul/blues/funk music.

King's 1967 hit, "Born Under a Bad Sign," was a trailblazing song, called by one music historian "one of the most smokingly intense blues recordings of the modern era." And King's innovative guitar style influenced many legendary guitarists, including Eric Clapton, Mike Bloomfield, Jimi Hendrix, and Stevie Ray Vaughan. Written by Booker T. Jones and William Bell, "Born Under a Bad Sign" has been inducted into the Blues Foundation Hall of Fame, the Grammy Hall of Fame, and the National Recording Registry.[1]

The song's opening lyrics are particularly apt (at least to this author):

> Born under a bad sign.
> Been down since I began to crawl.
> If it wasn't for bad luck,
> I wouldn't have no luck at all.

For, as readers of this distinguished journal know, after the U.S. Supreme Court's 2019 ruling in *Lorenzo v. S.E.C.*,[2] I concluded that lawyers with a capital markets practice (like me) had truly been born under a bad sign.[3]

Lorenzo

Before the Supreme Court's ruling in *Lorenzo*, three prior precedents of the Court, as well as case law following those decisions, had been pretty darn clear that primary liability for securities fraud was actionable *only* for the maker of misleading statements under Rule 10b-5(b)—and could not be end-runned by the scheme liability provisions of Rules 10b-5(a) and 10b-5(c).[4] But Justice Breyer (who had written the dissent in the then most recent Supreme Court decision in this area—the *Janus* decision[5]) was now in the majority and changed the Court's jurisprudence as to who could be accountable for securities fraud.

Justice Breyer's first foray into this new jurisprudence emphasized the plain meaning of the words in subsections (a) and (c), and the fact that those words had to have substance beyond the words set forth in subsection (b). Rejecting Lorenzo's argument (and a legion of decisions) that only a "maker" of misstatements could be accountable under subsections (a) and (c),[6] Justice Breyer opined that such a position "would render subsection b of Rule 10b-5 'superfluous'" and (in his view) misunderstood the different and "considerable" overlapping ways the federal securities laws have been layered in to capture as many fraudulent acts and actors as possible.[7]

As for the notion that allowing for actionable claims under subsections (a) and (c) would render *Janus* "a dead letter"—the dissent's view—Justice Breyer wrote: "we do not see how that is so." *Janus* only concerned the "maker" of the misrepresentation(s); there was nothing in *Janus* that addressed the "dissemination of false or misleading information." Thus, in Justice Breyer's view, *Janus* was still good law and would preclude primary liability "where an individual neither makes nor disseminates false information."

As far as his opinion undercutting the whole *raison d'etre* of the Court's prior demarcation in *Central Bank of Denver*[8] between primary and secondary liability (i.e., that, at best, Lorenzo aided and abetted the fraud; he was not a primary violator), Justice Breyer was unconcerned and waved off the notion that his opinion *greatly* expanded potential liability for fraud.[9] He further justified the result by citing to the investors who received Lorenzo's emails (which contained his boss's misrepresentation), and noting that those investors would "not view the deception" as less harmful coming from him, as opposed to coming from the actual "maker."

Finally, as for undercutting/voiding the Court's prior ruling in *Stoneridge*,[10] Justice Breyer first found that unavailing because the SEC, "unlike private parties, need not show reliance [by investors] in its enforcement actions." But even more ominously (in the context of prospective private claims), he then wrote that "Lorenzo's conduct involved the direct transmission of false information intended to induce reliance [which] is far from the kind of concealed fraud at issue in *Stoneridge*." He concluded by rejecting (again) Lorenzo's *arguendo* argument that, at worst, he could only be held secondarily liable (based upon *Stoneridge*, *Central Bank of Denver*, et al.): "That is not what Congress intended. Rather, Congress intended to root out all manner of fraud in the securities industry. And it gave to the Commission the tools to accomplish that job."[11]

Justice Clarence Thomas, the author of *Janus* (and on behalf of Justice Gorsuch), dissented. *Janus*, he declared, was now a "dead letter," as were the Court's prior decisions in *Central Bank of Denver* and *Stoneridge*, and with them the "bright line" between primary and secondary violators, because "it is undisputed that Lorenzo did not engage in any

conduct involving planning, scheming, designing, or strategizing," as required by subsection (a). And subsection (c), which "seems broader at first blush," does not reach Lorenzo's conduct either (at least under the Court's prior jurisprudence). At bottom, and notwithstanding the majority's dicta suggestion that minor actors (e.g., mail clerks, secretaries) should not be caught up in the liability net, Justice Thomas correctly noted that *any* person (including secondary actors like lawyers who are tasked with regulatory filings and/or play a role in communicating with the investing public) who "knowingly sen[ds] false statements" will now be exposed to primary violator liability.

The Aftermath (Thus Far) of *Lorenzo*

On the heels of the *Lorenzo* decision, the SEC Enforcement Division publicly promised to push the *Lorenzo* ruling beyond "dissemination," and further predicted that the federal judiciary would be sympathetic to such an expansive reading.[12] The commission quickly found a test case.

Dennis Malouf was an executive at two firms: a securities brokerage firm and an investment advisor (UASNM). He sold his interest in the brokerage firm in a transaction that compensated him in installments based on the commissions the firm earned on securities sales. Malouf later steered UASNM clients to the brokerage firm without disclosing to the clients or UASNM his financial interest in the firm and despite knowing that UASNM had represented that Malouf did not have any financial conflicts. Based on the foregoing, the SEC brought an enforcement proceeding against Malouf, and an administrative law judge found that he had violated, among other provisions, Rules 10b-5(a) and (c).

On appeal to the Tenth Circuit, that court *expanded Lorenzo's* theory of scheme liability, finding that Malouf was a primary violator of securities fraud for failing to correct *another party's* material misrepresentations.[13] Thereafter, the commission, thinking it was on a roll, tried to get the Second Circuit to buy into that same theory.

In 2017, the SEC filed a complaint in federal court in New York City against Rio Tinto plc and Rio Tinto Ltd., as well as Rio Tinto's prior CEO and CFO. At issue were a series of alleged misstatements and omissions regarding the value of potential mining territory in Mozambique owned by Rio Tinto. In 2019, the judge dismissed most of the SEC's fraud claims, including all of the scheme liability claims brought under Rules 10b-5(a) and (c).[14] With respect to these later claims, the judge held that "the SEC must allege the performance of an inherently deceptive act that is distinct from the alleged misstatement."[15] At the same time, however, the judge noted that the then pending *Lorenzo* case before the U.S. Supreme Court might "clarify" the standard for claims brought under Rules 10b-5(a) and (c).[16]

After the Court handed down its *Lorenzo* decision, the SEC moved for reconsideration, contending (as it had in *Malouf*) that the defendants should be held liable for failure to prevent misleading statements from being disseminated by others. The judge denied that motion on the ground that the only actions identified by the SEC were "misstatements or omissions," and that *Lorenzo* had only held that those who "disseminate" false or misleading statements can be liable, "not that misstatements alone are sufficient to trigger scheme liability."[17] The SEC thereafter sought interlocutory appeal to the Second Circuit on the applicability of *Lorenzo* and that request was granted.

The Second Circuit rejected the SEC's appeal, ruling that *Lorenzo* did not abrogate existing case law in the Second Circuit (i.e., *Lentell v. Merrill Lynch*).[18] Consistent with the district court's determination, the court noted that *Lentell* requires something *more* than misstatements or omissions for scheme liability.

The Second Circuit's decision is a fascinating needle and thread dissection of Justice Breyer's *Lorenzo* opinion. First off, the court highlighted the *Lorenzo* reaffirmance that *Janus* continues to be good law. It then stressed that *Lorenzo* imposed scheme liability for "dissemination"—that "dissemination" was the *additional* act beyond the misstatements/omissions triggering primary liability (and thus was consistent with *Lentell*). The court then observed that *Lorenzo* did not go further and create primary liability for "participation in the preparation" of misstatements.[19] Finally, the court (again using Justice Breyer's words in response to the Thomas dissent) went on to stress *Lorenzo's* emphasis in purporting to uphold the demarcation between primary and secondary liability. With that emphasis directly in mind, the Second Circuit ruled that to adopt the SEC's argument would eviscerate the primary-secondary demarcation and widen the scope of scheme liability, which would in turn (i) defeat the congressional limitation placed upon the enforcement of secondary liability, (ii) multiply the number of defendants subject to private securities law suits, and (iii) render the statutory provision for secondary liability superfluous.[20]

Where does this circuit split leave us? Clearly better (in one man's view) than where we stood after *Malouf*; but we have a lot more circuit courts before which the SEC will be pressing its agenda in this area aggressively.

And while we ponder on this state of affairs, there is another important SEC development to be flagged.

Jarkesy

In 2013, the SEC brought an in-house enforcement case against George R. Jarkesy, Jr. and his investment advisory firm, Patriot28 LLC. The respondents were charged with in-

flating the valuation of two hedge funds in order to increase the fees they received. An in-house SEC administrative law judge (ALJ) found them liable and ordered (i) Jarkesy barred from the securities industry, (2) Jarkesy and Patriot28 to pay a $300,000 civil penalty, and (3) Patriot28 to disgorge approximately $685,000 plus interest. Those determinations were affirmed by the commission itself, but the respondents thereafter sought to overturn them in the Fifth Circuit Court of Appeals.

In its May 18, 2022 decision, a Fifth Circuit panel (by 2-1 vote) vacated the SEC's decision.[21] Although the Dodd-Frank Act allows the commission to bring securities fraud actions for money damages either before an in-house ALJ (without a jury) or before an Article III judge in federal court, the court of appeals found the SEC's in-house proceeding violated the Constitution for three reasons:

- First, that denying Jarkesy his Seventh Amendment right to a jury trial was unconstitutional.[22]
- Second, that Congress' authorizing the SEC to elect in which forum to proceed without any guidance was an unconstitutional delegation.[23]
- Third, that the SEC's ALJs are unconstitutionally insulated from presidential oversight (in violation of the Constitution's "Take Care Clause").[24]

On July 1, 2022, the SEC asked the Fifth Circuit to review the decision en banc.[25] On October 22, 2022, the Court of Appeals denied that petition.[26]

In fiscal year 2021, the SEC brought approximately 350 enforcement actions (excluding delinquent filing cases) before in-house ALJs; for that same year, the commission filed 226 cases in federal court. Presumably (at least while these constitutional issues are fully litigated and resolved), those statistics should dramatically change in light of the Fifth Circuit's decision, and they should.

Practical Problems of the SEC's In-House System

The constitutional issues addressed by the Fifth Circuit are serious ones and it is probable that they will all (at some point) be teed up for resolution by the U.S. Supreme Court. But underlying those weighty matters are other, practical problems with the SEC's in-house jurisprudential process. As Jarkesy's attorney aptly described it, there is "the inherent unfairness of agency administration procedures, when the agency acts as prosecutor, judge[,] and appellate court."[27] One very significant case won by the SEC highlights that unfairness.

As highlighted earlier in this article, in *Lorenzo*, the Supreme Court side-stepped three prior precedents of the Court and expanded Rule 10b-5 liability to individuals who actually do *not* "make" fraudulent misrepresentations (thus eviscerating a previously well-defined line between primary and secondary liability).[28] The factual underpinnings of that case make the decision even more unfortunate. The SEC ALJ opined that Lorenzo's "falsity" had been "staggering" and that his mental state had been at least "reckless." The full commission did not evaluate the factual record developed at trial in affirming the ALJ's decision, and neither did the two-member panel of the D.C. Circuit that also found Lorenzo on the wrong side of Rule 10b-5.

The dissenting vote on the D.C. Circuit panel came from none other than then-Judge Brett Kavanaugh. As an initial matter, he noted that the factual record and the ALJ's legal determinations did not "square up": "At most, the judge's factual findings may have shown some mild negligence on Lorenzo's part. . . .[I]t is impossible to find that Lorenzo acted 'willfully'."[29] Kavanaugh then opined that the commission had "simply swept the judge's factual and credibility findings under the rug" in its rush to judgment. In his view, the D.C. Circuit panel should not have given deference to the SEC, but should instead have looked *de novo* at the record developed before the ALJ in assessing whether Lorenzo had in fact willfully engaged in a scheme to defraud. Of course, the majority of the panel did not do so, and neither did the U.S. Supreme Court in its determination to expand Rule 10b-5 liability.[30]

Since individuals mainly litigate with the commission (regulated corporations cannot take on that risk), the Seventh Amendment rationale of the Fifth Circuit is well justified. And given the Supreme Court's recent decision in *West Virginia v. EPA*[31]—where the Court struck down the EPA's far-reaching fossil-fuel regulations as delegated "power beyond what Congress could reasonably be understood to have granted"—the Fifth Circuit's impermissible delegation rationale seems to be in line with current jurisprudence (and, of the three prongs of the Fifth Circuit's decision, it will likely prove to be the most impactful beyond the SEC). As for the third prong of the court's decision, it would appear that that issue may well soon be resolved by the Supreme Court.[32]

Conclusion

The developments detailed above in these two important areas are indeed important. As is equally obvious, however, there is more news to come in both. Stay tuned!

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Endnotes

1. Released on April 26, 1967, the song peaked at #49 on the Billboard's R&B/Soul Singles Chart.
2. 587 U.S. ___, 139 S. Ct. 1094, 203 L. Ed.2d 484 (2019).

3. *See Lawyer Liability: In the Cross-Hairs Again!* N.Y. Bus. L.J. (Vol. 24, No. 1) (Summer 2020). Of course, not everyone was downcast by the *Lorenzo* decision: SEC staffers (and ex-staffers) loved it! *See* J.D. Redwood, *Back from the Brink: The Supreme Court Saves the SEC's Rule 10b-5 From the Grim Reaper*, 89 *UMKC L. Rev.* 57 (2020).
4. *Central Bank of Denver v. First Interstate of Denver*, 511 U.S. 164 (1994); *Stoneridge Investment partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008); *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2021). *See, e.g.*, *Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2nd Cir. 2005).
5. *See supra* note 4.
6. This point had been the basis of rejecting scheme liability in countless prior decisions. *See supra* note 4.
7. For proposition, Justice Breyer cited, *inter alia, United States v. Naftalin*, 441 U.S. 768, 77 (1979); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972); *SEC v. N.J. Howey Co.*, 328 U.S. 293 (1946); *In re R.D. Boyle & Co.*, 19 S.E.C. 73 (1945); *In re Arthur Hayes & Co.*, S.E.C. 271 (1939).
8. *See supra* note 4.
9. Justice Breyer did seem to acknowledge that his opinion would expand fraud liability to "capture a wide[r] range of conduct." And that "[a]pplying [this new standard] may present difficult problems of scope in borderline cases." He then postulated, however, that "[p] urpose, precedent, and circumstances could lead to narrowing their reach in other contexts." As we will see in the aftermath of *Lorenzo*, Justice Breyer's confidence on this score may not have been well grounded.
10. *See supra* note 4.
11. Justice Breyer cited no authority for this sweeping pronouncement. That is not surprising given that the Court had *explicitly* acknowledged the *contrary* in its prior decisions. *See, e.g.*, *Central Bank of Denver* and *Stoneridge* (*see supra* note 4). Justice Breyer's imaginative interpretation of congressional intent would appear to be consistent with his theory of "delegated democracy," whereby he believes the Court should review and interpret legislation based upon what it believes a "reasonable member of Congress" must have meant when she passed a bill. *See* S. Breyer, *Active Liberty*, pp. 85-101 (Knopff 2005).
12. *See Securities Law 360* (April 13, 2019).
13. *See Malouf v. SEC*, 933 F.3d 1248 (10th Cir. 2019).
14. The judge also dismissed parallel claims under §§ 17(a)(c) and (a)(3). [12].
15. *See SEC v. Rio Tinto plc*, 2019 WL 1244933 *15 (S.D.N.Y. March 18, 2019), applying the standard set forth by *Lentell v. Merrill Lynch* (*see supra* note 4).
16. *See id.* at *15 n. 9.
17. *See SEC v. Rio Tinto plc*, 2021 WL 818745 *2 (S.D.N.Y. March 3, 2021).
18. *See supra* note 4. The SEC argued that *Lentell* only applies to private plaintiffs' claims, but that was rejected by the Second Circuit as having no credible basis (and the SEC cited no circuit authority in support of its argument).
19. *Citing Geoffrey A. Orley Revocable Trust v. Genovese*, 2020 WL 611506, at *7-8, *as amended* (S.D.N.Y. Feb. 7, 2020) (Ramos, J.). The Second Circuit also was worried that an "overreading" of *Lorenzo* "might allow private litigants to 'evade the pleading requirements imposed in misrepresentation cases.'" (*Citing In Alstrom SA*, 406 F.Supp.2d 433, 475 (S.D.N.Y. 2005)(Marrero, J.).
20. While in this author's view these reasons are sound and quite consistent with pre- *Lorenzo* Supreme Court precedent, a good argument could be made that they are not in jibe with the text and tenor of Justice Breyer's opinion in *Lorenzo*. *See supra* notes 9 & 11 and accompanying text.
21. *Jarkesy v. S.E.C.*, No. 20-61007 (5th Cir. May 18, 2022). That is not to say that the SEC has not had other, notable litigation losses in the past. *See, e.g.*, C.E. Stewart, *The SEC and Litigation: Oil and Water?* N.Y.L.J. (Nov. 8, 2011); C.E. Stewart, *The SEC's Setbacks in Litigation*, N.Y.L.J. (May 17, 2007).
22. For Seventh Amendment purposes, the court of appeals delineated between Congress authorizing an administrative agency to sue to enforce a statutory "public right" as opposed to a traditional private action sounding in tort, contract, or property law. Where (as in Jarkesy's case) the SEC was pursuing a traditional tort claim (fraud) and seeking a monetary remedy, the court held that a right to a jury is constitutionally required.
23. Perhaps harkening back to pre-New Deal jurisprudence (*see* C.E. Stewart, *Sick Chickens in the Second Circuit Threaten FDR's New Deal*, Federal Bar Council News (February 2008)), the Court of Appeals (following Supreme Court precedent) ruled that Congress can only delegate regulatory power to an administrative agency if it provides an "intelligible principle" or guidance to the agency on how to exercise that power. Congress's grant of exclusive and unfettered discretion to the SEC in which forum to bring cases was held to violate that principle. In footnote nine of its decision, the court ruled that this was an alternative holding of its decision (thus also constituting binding precedent).
24. This is likely the least surprising part of the court of appeals' decision, given the U.S. Supreme Court's ruling in *Lucia v. SEC*, 585 U.S. ___, 138 S. Ct. 2044 (2018). In *Lucia*, the Court held that ALJs are subject to the Appointments Clause of the Constitution and that the SEC's hiring processes violated that clause. Moreover, just before the Fifth Circuit's decision, the Supreme Court agreed to hear two circuit court decisions – *SEC v. Cochran*, 20 F.4th 194 (5th Cir. 2021) and *Axon Enterprise Inc. v. FTC*, 986 F.3d 1173 (9th Cir. 2021), where the constitutionality of ALJs' tenure protection under the "Take Care Clause" is directly at issue.
25. The SEC's petition for *en banc* review cited the court's decision as being in conflict with *Decker Coal v. Pehringer*, 8 F.4th 1123 (8th Cir. 2021), which upheld the same removal restrictions for ALJs in the Labor Department that the Fifth Circuit panel found as constitutionally infirm and the third basis for its ruling. The commission also contended that the federal securities laws are in fact "public rights" and that the Seventh Amendment is not implicated.
26. W. Konnath, *Full 5th Circuit Won't Reconsider SEC In-House Courts Challenge*, LAW360 (October 22, 2022) (the court voted 10-6 not to re-hear the matter).
27. J. Hill, *Fifth Circ. Says SEC's In-House is Unconstitutional*, LAW360 (May 19, 2022) (S. Michael McColluch).
28. *See supra* notes 2-11 and accompanying text.
29. Thus, according to Kavanaugh the ALJ's decision violated "basic due process. . . . [because] *mens rea* is essential to preserving individual liberties," citing, *inter alia*, *Morissette v. United States*, 342 U.S. 246, 250-51, 263 (1952) (Justice Jackson).
30. For some reason, Lorenzo's lawyer did not include the scienter issue in his cert petition. Thus the Court did not consider the evidentiary record (observing "the relevant facts are not in dispute").
31. No. 20-1530 (June 30, 2022). *See A Supreme Court Watershed*, Wall Street Journal A14 (October 1, 2022).
32. *See supra* note 24.