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Fourth Time a Charm? The Supreme Court Takes Another Whack at Secondary Liability

By
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As Michael Corleone said in *The Godfather Part III* (an otherwise dreadful movie), "Just when I thought I was out, … they pull me back in." Three times the U.S. Supreme Court has held that there is *no* aider and abettor liability for secondary actors (e.g., lawyers); that to establish a 10b-5 claim under the '34 Act, the traditional elements of fraud/tort (defendants must speak; plaintiffs must show reliance; etc.) must be pleaded and proven. The Securities and Exchange Commission has never really taken "no" for an answer, however, and has continually tried to work a way around it. The Commission is at it again, this time in *Lorenzo v. S.E.C.* (No. 17-1077); oral argument took place at the Supreme Court on December 3rd, and a decision will no doubt come down before the end of the court's current term in June 2019. *Lorenzo* is an important (and somewhat unusual) case; it deserves our attention.

The Supremes Try It Thrice

In 1994, the U.S. Supreme Court first addressed secondary liability in *Central Bank of Denver v. First Interstate of Denver*, 511 U.S. 164 (1994). There, the court held that since the text of §10(b) does not cover those who aid and abet a §10(b) violation, private plaintiffs seeking money damages could not bring an aiding and abetting claim against a secondary actor. At the same time, the *Central Bank* court left open that (1) criminal liability for aiding and abetting was still viable, (2) an SEC enforcement action based upon aiding and abetting was still viable, and (3) traditional secondary actors in the capital markets (e.g., lawyers) could be pursued by private plaintiffs as primary violators "assuming all of the requirements for primary liability under Rule 10b-5 are met."

Just as lawyers began to think the water was safe into which to wade, the third door left ajar by the Supreme Court was pounced upon by the plaintiffs' bar, and there began a wave of new cases, premised upon lawyers (or other secondary actors) being held to the same standard of accountability for fraud as their clients. This attack seemed to reach its height/nadir in *Klein v. Boyd*, 1998 WL 55245, Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. 1998).

In *Klein*, the plaintiff (supported by the Securities and Exchange Commission) argued, and a panel of the U.S. Court of Appeals for the Third Circuit agreed, that a law firm could be held liable as a primary violator of securities fraud, even where the lead lawyer did not sign the document(s) at issue and where the investor was never aware of the lawyer's role in the creation of document(s). In the Third Circuit's view, the law firm was a primary violator because it "elect[ed] to speak" by its authoring or co-authoring of document(s) with alleged material misrepresentations and/or material omissions; according to the Third Circuit, while the firm did not have an obligation to blow the whistle on its client, it did have a duty to correct its own "statements."

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On an en banc review, the SEC made its position even clearer: A law firm should be held accountable for fraud where it helps to "create" a misrepresentation. Prior to a ruling by the entire court of appeals, the case was settled;

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but the original precedent lived on, with the SEC (and the plaintiffs' bar) continuing to espouse such theories of liability, especially in the aftermath of Enron and similar corporate train wrecks.

In the aforementioned corporate train wrecks' aftermaths, various courts reached different results as to lawyers' duties to "speak" to third parties. See, e.g., *Howard v. Everex Systems*, 228 F.3d 1057 (9th Cir. 2000); *Ziemba v. Cascade International*, 2001 U.S. App. LEXIS 15529 (11th Cir. 2001); *In re Enron Corp. Derivative & ERISA Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003); *Simpson v. AOL Time Warner*, 452 F.2d 1040 (9th Cir. 2006). These different results (and disparate outcomes on the issue of secondary actor liability) ultimately became so profound that the Supreme Court in 2007 agreed to revisit the same ground it had gone over in *Central Bank*. In *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008), the court (1) re-affirmed its prior ruling in *Central Bank* (noting that Congress had explicitly declined to establish aiding and abetting liability for civil suits when it had passed various securities legislation since 1994), and (2) rejected the concept of "scheme liability"—a theory consistent with the *Klein v. Boyd* court's rationale—because it failed to require a basic element of a cause of action for fraud (i.e., that the aggrieved plaintiff(s) relied upon some act or omission by an alleged primary violator defendant(s). See *Basic v. Levinson*, 485 U.S. 224, 243 (1998).

Four years later, the Supreme Court felt compelled to weigh in once more, this time in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011). In that case, Janus Capital Group (JCG) was sued for allegedly making misleading statements in various of Janus funds' prospectuses. Although the district court dismissed the complaint, the Fourth Circuit reversed, ruling that even if JCG had not actually written the alleged statements in the fund prospectuses, one of its subsidiaries (Janus Capital Management, (JCM)) must have approved those statements (actually made by a different corporate entity in the Janus family—Janus Investment Fund, (JIF)) (JIF is a separate legal entity owned entirely by mutual fund investors).

Writing for a five-Justice majority which reversed the Fourth Circuit, Justice Clarence Thomas held that the "maker" of a statement is "the person or entity with ultimate authority over the statement"—in this case JIF, citing the court's prior ruling in *Central Bank*. He further observed that to give "make" a broader meaning would substantially undermine *Central Bank* by rendering aider and abettor liability a nullity (and would also undermine the court's *Stoneridge* decision on that score). With respect to the government's argument that the court should adopt the SEC's interpretation of "make," i.e., that "make" is the same as "create," Thomas rejected that argument, writing that such wordsmithing "would permit private plaintiffs to sue a person who 'provides the false or misleading information that another person then puts into the statement'" (citing the government's amicus curiae brief). Such a result, wrote Thomas, would be inconsistent with *Stoneridge*'s rejection of "scheme liability" and countless other Supreme Court precedents.

On behalf of Justices Ruth Bader Ginsburg, Sonia Sotomayor, and Elena Kagan, Justice Stephen Breyer wrote a dissent, contending that "the majority has incorrectly interpreted [Rule 10b-5's] word 'make.'" After rejecting the direct applicability of *Central Bank* and *Stoneridge*, Breyer then opined that the corporate family structure of the various Janus entities was so closely interwoven (even if legally separate) that, based upon the allegations pleaded, it could be held that JCG "made" materially false statements in the prospectuses issued by JIF: "Unless we adopt a firm rule (as the majority has done here) that would arbitrarily exclude from the scope of the word 'make' those who manage a firm—even when those managers perpetrate a fraud through an unknowing intermediary—the management company at issue here falls within that scope."

'Lorenzo'

In October 2009, Francis Lorenzo, the director of investment banking at a registered broker-dealer, sent allegedly false and misleading statements to two investors; the statements had originally been drafted by his boss (the head of the firm) and had been sent at his boss's behest. At the end of the emails containing the statements, Lorenzo block signed his name and urged the recipients to "call [him] with any questions."

In September 2013, the SEC brought an enforcement proceeding against Lorenzo, his boss, and the broker-dealer; the latter two quickly settled with the Commission. Lorenzo decided to fight, and a SEC administrative law judge subsequently ruled that Lorenzo had "willfully violated the antifraud provisions" of the federal securities laws (Rules 10b-5(a), (b) & (c)). She also opined that Lorenzo's "falsity" had been "staggering" and that his mental state had been at least "reckless." The full Commission, upon review of the ALJ's determinations, affirmed her decision, as well as her "imposition of an industry-wide bar, a cease-and-desist order, and a $15,000 civil penalty." Lorenzo appealed that decision to the D.C. Circuit Court of Appeals.

By a 2 to 1 vote, a D.C. Circuit panel (giving deference to the determinations of the Commission) found that Lorenzo's statements were false or misleading and that he acted with requisite scienter in sending them. See *Lorenzo v. SEC*, 872 F.3d 578, 580 (D.C. Cir. 2017). At the same time, however, the panel ruled that, under *Janus*, Lorenzo was not the "maker" of the statements, because they had been sent "on the behest of his boss" who had drafted and approved them (i.e., the boss had the "ultimate authority"). As a result, the panel found that Lorenzo had *not* violated Rule10b-5(b).

Many observers of the 'Lorenzo' oral argument on December 3rd seem to believe that the court's 'Janus' divide of four to four will likely be the outcome in Mr. Lorenzo's case, leaving the D.C. Circuit's decision in place.

But the panel did not stop there. It also ruled that Lorenzo's conduct *did* violate the scheme liability provisions of 10b-5(a) and 10b-5(c). Rejecting Lorenzo's argument that (at worst) what he had done was to aid-and-abet his boss's conduct, the panel ruled that he was primarily liable under those other two anti-fraud provisions.

The dissenting vote on the D.C. Circuit panel came from none other than then-Judge Brett Kavanaugh. And his dissent was a passionate one. First off, he noted that the factual record and the SEC 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.'" 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 Commission, but should have instead looked de novo at the record developed before the ALJ to assess whether Lorenzo had *in fact* willfully engaged in a scheme to defraud.

Alternatively, Kavanaugh opined that the panel's decision "creates a circuit split by holding that mere misstatement, standing alone, may constitute the basis for so-called scheme liability under the securities laws." Citing contrary decisions directly on point by other circuits—that a scheme liability claim *must* be based upon conduct *beyond* misrepresentations or omissions to be actionable under Rule 10b-5(b) (*Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner*, 655 F.3d 1039, 1057 (9th Cir. 2011); *Lantell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2008)), Kavanaugh attributed his then-colleagues' decision to push the envelope as the result of the "SEC's attempts to unilaterally rewrite" the antifraud provisions of the securities laws—in the face of the Supreme Court's rulings which distinguished between primary and secondary liability: *Janus*, *Stoneridge* and *Central Bank*.

What Comes Next?

On June 18, 2018, the Supreme Court granted Lorenzo's cert petition. On Dec. 3, 2018, the court heard oral argument. In between those two dates, now-Justice Kavanaugh recused himself, so only eight Justices heard the argument and only they will decide the case—and those eight Justices split on *Janus*, four to four!

Many have speculated that the court granted certiorari to once and for all resolve (for the fourth time) that primary liability for use of misleading statements *alone* is actionable only under Rule 10b-5(b) (and that it cannot be end-runned by the scheme liability provisions of Rules 10b-5(a) and 10b-5(c)). This result would be consistent with *Central Bank*, *Stoneridge*, *Janus*, case law following those decisions, and then-Judge Kavanaugh's dissent; it would also preserve the distinction between primary and secondary liability.

But many observers of the *Lorenzo* oral argument on December 3rd seem to believe that the court's *Janus* divide of four to four will likely be the outcome in Mr. Lorenzo's case, leaving the D.C. Circuit's decision in place. If that is in fact the outcome, we may have a very strange state of affairs in the short- to mid-term: For the time-being, there would be an expansive view of 10b-5 liability, allowing the SEC and private plaintiffs to bring primary liability fraud claims against secondary actor individuals (including lawyers) who did not "make" the alleged material misrepresentations; and then—presumably—when the next case reaches the court (with Justice Kavanaugh participating), liability exposure would be returned to the *Central Bank*, *Stoneridge*, *Janus* status quo. This unsettling state of affairs means that, until the issue is resolved, some nice unsuspecting lawyers may end up like Luca Brazi: "sleeping with the fishes" (from the classic, *The Godfather*).