U.S. Supreme Court Sides with SEC in Interpreting "Scheme Liability"

March 29, 2019

In a much-anticipated decision interpreting the scope of liability under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), the U.S. Supreme Court ruled on March 27 in *Lorenzo v. SEC* that dissemination of a false or misleading statement with intent to defraud can subject a person or entity to liability under Exchange Act Rules 10b-5(a) and (c)—the so-called "scheme liability"[1] provisions of the federal securities laws—even if the person or entity lacks ultimate authority over the statement's contents.[2] In so ruling, the Supreme Court resolved a circuit court split on the question of whether distributing a material misstatement when one is not the "maker" of the statement is sufficient to be held primarily liable under Rule 10b-5(a) or (c). In *Janus Capital Group, Inc. v. First Derivative Traders*,[3] the Supreme Court previously limited liability under Rule 10b-5(b), which prohibits misstating a material fact in connection with the purchase or sale of a security, to only the "*maker* of a statement[. . . .,] the person or entity with ultimate authority over the statement."

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The *Lorenzo* decision is a victory for the U.S. Securities and Exchange Commission ("SEC") because it now blurs the distinction between the subsections of Rule 10b-5 by expanding the type of conduct that can be deemed a "scheme" or "practice" to include participation in the distribution of alleged misstatements or omissions. Significantly, the Court's decision is also a victory for private plaintiffs because the scope of primary liability under Rules 10b-5(a) and (c) now includes conduct that might otherwise have been viewed as simply aiding and abetting others' statements, a form of secondary liability not available to private plaintiffs.

Background. Francis V. Lorenzo was the head of investment banking at the broker-dealer Charles Vista LLC. His firm was hired to sell convertible debentures for energy company Waste2Energy Holdings Inc. Although Waste2Energy had publicly disclosed

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1 In connection with the sale of a security, Rule 10b-5(a) makes it unlawful to "employ any device scheme or artifice to defraud" and Rule 10b-5(c) makes it unlawful to "engage in act, practice, or course of business which operates . . . as a fraud or deceit." 17 CFR §240.10b-5. Together, these two provisions are often referred to as "scheme liability."

2 *Lorenzo v. SEC*, No. 17-1077, slip op. (Mar. 27, 2019).

3 564 U.S. 135 (2011).

(and Lorenzo was informed) that the company had total assets of less than $400,000, Lorenzo, at the instruction of the owner of the broker-dealer, sent two emails to prospective investors in which Lorenzo copied and pasted misleading statements about the investments, including that the company had $10 million in "confirmed assets" and invited investors to contact him with questions.[4]

An administrative law judge and, subsequently on appeal, the full Commission found that Lorenzo had violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Section 17(a)(1) of the Securities Act of 1933 (the "Securities Act").[5] The Commission ordered Lorenzo to pay a $15,000 penalty and permanently barred him from the securities industry. Lorenzo appealed to the U.S. Court of Appeals for the District of Columbia Circuit, which affirmed the Commission's finding with respect to violations of Rules 10b-5(a) and (c), but rejected the SEC's Rule 10b-5(b) claim in light of *Janus* because Lorenzo had not "made" but had only transmitted the fraudulent statement. Lorenzo successfully petitioned to the Supreme Court for *certiorari*.

The Supreme Court's Decision. Justice Breyer, writing for the 6-2 majority,[6] analyzed the "relevant language, precedent, and purpose" of Rule 10b-5 and concluded that the "dissemination of a false or misleading statement with intent to defraud can fall within the scope of" Rules 10b-5(a) and (c). The Court rejected the argument that each of the subsections of Rule 10b-5 governed different and mutually exclusive spheres of conduct, noting instead that the Court and the SEC have "long recognized considerable overlap among the subsections[.]" The Court then examined Lorenzo's conduct against the "wide range of conduct" that the "plain language" of Rules 10b-5(a) and (c) proscribe and concluded that, by sending directly to investors the emails in question that Lorenzo knew to contain materially false information, he "'employ[ed]' a 'device,' 'scheme,' and 'artifice to defraud' . . . [and] 'engage[d] in a[n] act, practice or course of business' that 'operate[d] . . . as a fraud or deceit.'"[7] Importantly, the Court "took for granted that [Lorenzo] sent the emails with 'intent to deceive, manipulate, or defraud'"[8] because the D.C. Circuit had ruled, and Lorenzo did not contest, that he acted with the requisite mental state. Foreshadowing the potential challenges for district courts in future cases, however, Justice Breyer acknowledged that because the provisions of Rule 10b-5 capture a "wide range of conduct," applying the provisions can "present difficult problems of scope in borderline cases." In *Lorenzo*, however, the Court saw "nothing borderline" about the conduct, which it viewed as so egregious as to fit squarely within the plain language of Rule 10b-5.

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4 *Lorenzo*, at 3.

5 Securities Act §17(a)(1) contains language very similar to Rule 10b-5 and is typically interpreted similarly.

6 Justice Kavanaugh recused himself because of his involvement in the D.C. Court of Appeals proceedings.

7 *Lorenzo*, at 6 (quoting Rule 10b-5).

8 *Id.* (citing *Aaron v. SEC*, 446 U.S. 680, 686 (1980)).

Responding to the dissent's argument that the majority opinion effectively guts *Janus*, Justice Breyer noted that *Janus* "would remain relevant (and preclude liability) where an individual neither *makes* nor *disseminates* false information…."[9] Again, the majority's analysis seemed colored by the egregious nature of the fraud and the fear that "plainly fraudulent [behavior] might otherwise fall outside the scope of the Rule," as *Janus* would appear to immunize Lorenzo from primary liability under Rule 10b-5(b).[10]

Finally, the Court rejected Lorenzo's and the dissent's argument that by holding him primarily liable, it would collapse the distinction between primary liability and secondary (*i.e.*, aiding and abetting) liability under the Exchange Act. The Court pointed out that it is not unusual for someone to be both primarily and secondarily liable for the same course of conduct; indeed, "[t]hose who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c), §10(b), and §17(a)(1), even if they are secondarily liable under Rule 10b-5(b)."[11]

Takeaways. To the extent that *Janus* limited the scope of who could potentially be liable for misstatements, this decision appears to reopen that issue and permit the SEC or private plaintiffs to more easily "re-label [a] person's involvement [in an alleged misstatement or omission] as an 'act,' 'device,' 'scheme,' or 'artifice' that violates Rule 10b-5(a) or (c)."[12] As noted above, the Court appears to have tried to narrow its holding somewhat to the "plainly fraudulent" conduct at issue in this case, noting it assumed *Janus* would continue to preclude liability in cases where a defendant "neither *makes* nor *disseminates* false information."[13] Despite the Court's efforts to define a limiting principle for its holding, this decision could still have broad-reaching effects, especially in the context of private securities claims. Unless lower courts adhere to the narrow view (seemingly put forth by the Court) that the affirmative act of "dissemination" of knowingly false information is necessary for Rules 10b-5(a) and (c) liability, private plaintiffs will, as the dissent notes, seek to use the Court's decision to argue that "any person who assists with the making of a fraudulent misstatement [is] primarily liable."[14]

While the Court's decision is certainly a victory for the SEC and private plaintiffs, it remains to be seen how district courts will apply *Lorenzo* in the borderline cases that the Court recognized will surely arise. The majority opinion acknowledged that these

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9 *Id.* at 10.

10 *Id.* at 9–10.

11 *Id.* at 11.

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

13 *Lorenzo*, at 10.

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

different circumstances "could lead to narrowing the[] reach of [Rules 10b-5(a) and (c)] in other contexts."[15]

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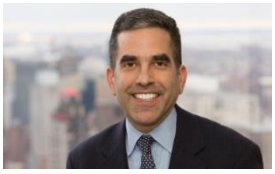

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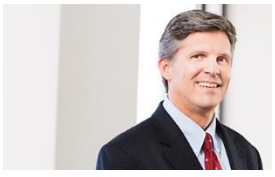

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[15] *Lorenzo*, at 7.