March 28, 2019

Lorenzo v. *SEC* — Supreme Court Issues Decision on "Scheme Liability" Under Rule 10b-5

U.S. Supreme Court Rules That Defendants Can Be Held Primarily Liable for Securities Scheme Fraud for Knowingly Disseminating the Misstatements of Others

SUMMARY

Yesterday, in a widely watched securities case, the U.S. Supreme Court held in *Lorenzo* v. *SEC*[1] that a defendant who disseminates the material misstatement of another—and thus cannot be liable under SEC Rule 10b-5(b) for "making" the statement—can nevertheless be liable under other provisions of the securities laws that proscribe "any device, scheme, or artifice to defraud" or "any act, practice or course of business which operates or would operate as a fraud or deceit." The Court's decision may affect long-standing case law in various federal circuits—including those covering New York and California—which had held that alleged frauds solely involving material misstatements or omissions could not be pursued under provisions other than Rule 10b-5(b). Although *Lorenzo* potentially broadens the scope of conduct subject to securities fraud liability based on dissemination of material misstatements, the opinion emphasizes certain factual circumstances present in this case that may limit its future application in other circumstances.

BACKGROUND

Lorenzo was a follow-on case to a 2011 U.S. Supreme Court decision, *Janus Capital Group, Inc.* v. *First Derivative Traders*, in which the Court held that a defendant may be held liable for securities fraud under SEC Rule 10b-5(b), which prohibits materially misleading statements or omissions, only if the defendant actually "made" the statement, *i.e.*, was "the person or entity with ultimate authority over the statement,

including its content and whether and how to communicate it."[2] Accordingly, under *Janus*, someone who merely disseminated another person's false statement—despite knowing that the statement was false—could not be held liable under Rule 10b-5(b).

In *Lorenzo*, defendant Francis Lorenzo was the Director of Investment Banking at registered broker-dealer Charles Vista, LLC.[3] During the relevant period, Lorenzo's only client was Waste2Energy Holdings, Inc., a company attempting to develop technology that would convert solid waste into clean renewable energy.[4] Short on funds, Waste2Energy conducted an offering of $15 million in convertible debentures, which were secured only by Waste2Energy's earning power.[5]

At the direction of his manager (the broker-dealer's owner), Lorenzo sent two emails that his manager had drafted and approved to prospective investors in the Waste2Energy debentures.[6] The emails falsely stated that Waste2Energy possessed $10 million in "confirmed assets," when Waste2Energy had previously acknowledged publicly that its assets were in fact worth less than $400,000.[7] Lorenzo signed the email in his capacity as "Vice President—Investment Banking" and included a note for investors to contact him with any questions.[8] Lorenzo did not challenge the Court of Appeals' finding that he acted with scienter, and the Supreme Court "t[ook] for granted that he sent the emails with 'intent to deceive, manipulate, or defraud' the recipients."[9]

The SEC brought enforcement actions against the broker-dealer, its owner, and Lorenzo.[10] The Commission ultimately found that Lorenzo had violated Section 10(b) of the Exchange Act, Rule 10b-5, and Section 17(a)(1) of the Securities Act.[11] In relevant part, Section 10(b) makes it unlawful for a person, in connection with the purchase or sale of a security, "[t]o use or employ . . . any manipulative or deceptive device or contrivance" in contravention of an SEC rule.[12] SEC Rule 10b-5, which implements this provision, makes it unlawful, in connection with the purchase or sale of any security:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) 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, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[13]

Section 17(a)(1), which mirrors Rule 10b-5(a), provides that it is unlawful, in connection with the offer or sale of a security, "to employ any device, scheme, or artifice to defraud."[14]

Lorenzo appealed the Commission's decision to the D.C. Circuit. He argued that he lacked the fraudulent intent necessary to establish the violations found by the Commission, but the court rejected this argument.[15] Lorenzo further contended that he could not be held liable under Rule 10b-5(b) in light of the Supreme Court's holding in *Janus*, because he did not have authority over the statements at issue.[16] The D.C. Circuit agreed that Lorenzo was not liable under Rule 10b-5(b),[17] but nevertheless affirmed the

Commission's determination that Lorenzo *was* liable under SEC Rule 10b-5(a) and (c), and the similarly worded Section 10(b) and Section 17(a)(1).[18]

The Supreme Court agreed to review Lorenzo's case to resolve a split among the various circuits regarding whether material misstatements that are not actionable under Rule 10b-5(b) (because the defendant did not "make" them) can nonetheless form the basis for liability under Rule 10b-5(a) and (c).

THE SUPREME COURT'S DECISION

In a 6-2 opinion by Justice Breyer,[19] the Supreme Court held that persons who disseminate materially false or misleading statements to potential investors with the intent to defraud may be held liable under Rule 10b-5(a) and (c) and Section 17(a)(1)—even assuming that Lorenzo did not "make" the statements under Rule 10b-5(b) as interpreted in *Janus*.[20]

The Court rested its conclusion on its view of the plain language of the relevant statutory and regulatory provisions, which the Court viewed as "sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud."[21] Pointing to dictionary definitions of the relevant terms, the Court reasoned that by "sending emails he understood to contain material untruths," "with 'intent to deceive, manipulate, or defraud,'" "Lorenzo 'employ[ed]' a 'device,' 'scheme,' and 'artifice to defraud' within the meaning of subsection (a) of the Rule, § 10(b), and § 17(a)(1)," and by "the same conduct, he 'engage[d] in a[n] act, practice, or course of business' that 'operate[d] . . . as a fraud or deceit' under subsection (c) of the Rule."[22]

The Court proceeded to reject the two primary arguments advanced by Lorenzo (and by Justice Thomas, who was joined by Justice Gorsuch, in dissent). *First*, Lorenzo contended that misconduct relating to misstatements was governed exclusively by Rule 10b-5(b), and that the majority's broad construction of Rule 10b-5(a) and (c) and Section 17(a) rendered that provision superfluous and *Janus* a dead letter. The Court rejected what it viewed as the premise of this argument—"that each of [the relevant] provisions should be read as governing different, mutually exclusive, spheres of conduct."[23] It concluded, to the contrary, that there exists "considerable overlap among the subsections of the Rule and related provisions of the securities laws."[24]

Second, Lorenzo pointed out that he would qualify as only an aider and abettor of a violation of Rule 10b-5(b) under *Janus*, and argued that the majority's rule would weaken the distinction between primary and aider and abettor liability. The Court was unpersuaded, observing that "it is hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another."[25] The Court also made clear that the primary liability at issue attached only to "[t]hose who *disseminate* false statements with intent to defraud."[26] *Finally*, the Court noted that its interpretation of the rule would allow defendants like Lorenzo to be held liable in circumstances where secondary liability might not be available.[27]

The Court acknowledged that, under its interpretation, Rule 10b-5(a) and (c) and Section 17(a) could "capture a wide range of conduct" involving the dissemination of material misstatements, potentially leading to "difficult problems of scope in borderline cases" that might require "narrowing their reach."[28] The Court believed that this was not such a borderline case, however, stressing that Lorenzo "[knowingly] sent false statements directly to investors, invited them to follow up with questions, and did so in his capacity as vice president of an investment banking company."[29] It suggested that, in contrast, "liability would typically be inappropriate" for "other actors tangentially involved in dissemination—say, a mailroom clerk."[30]

IMPLICATIONS

The SEC and private parties may, in different factual settings, attempt to rely on the Court's ruling in *Lorenzo* to pursue Rule 10b-5(a) and (c) claims against persons who did not "make" the statements at issue, but who knowingly disseminated the statements with the intent to defraud investors. The ruling may diminish the importance of *Janus* as a limitation on liability in misstatement cases, although the Court assumed both knowledge of material falsity and the intent to defraud. Thus, for example, re-transmitting false statements by others with knowledge of falsity and the intent to defraud (*e.g.*, as part of a short-selling scheme) would seem to fall within the Court's interpretation of Rule 10b-5(a) and (c). On the other hand, even knowing participation in drafting a false statement that someone else intends to make may not fall within the Court's interpretation of Rule 10b-5(a) and (c), given the Court's emphasis on "dissemination" of materially false information and the limitations on "scheme" liability set forth in *Stoneridge* and other cases.[31] The practical effects associated with *Lorenzo* will be most significant in the Second, Eighth, and Ninth Circuits, which had previously ruled that liability under Rule 10b-5(a) and (c) must be based on conduct beyond mere misstatements and omissions.[32]

Future litigation can be expected to focus on what kinds of factual differences from *Lorenzo* are material enough to warrant "narrowing" the scope of liability under Rule 10b-5(a) and (c). Because those provisions require that defendants "*employ*" a "device, scheme, or artifice to defraud" (subsection (a)) or to "engage" in an "act, practice, or course of business" that operates as a fraud (subsection(c)), Defendants who are more tangentially connected to the dissemination of allegedly false statements can argue that *Lorenzo* should be limited to its facts, where Lorenzo himself disseminated the false statements with the intent to defraud. Fact patterns that do not reflect as clear an intention to deceive by a defendant disseminating false statements may cause courts to act on the Court's acknowledgment that different circumstances may call for a different approach.

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ENDNOTES

[1] *Lorenzo* v. *SEC*, __ U.S. __, No. 17-1077, slip op. at 2 (March 27, 2019).

[2] 564 U.S. 135, 142 (2011).

[3] *Lorenzo*, slip op. at 2.

[4] *Id.*

[5] *Id.* at 3 (quoting Black's Law Dictionary 486 (10th ed. 2014)).

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.* at 6.

[10] *Id.* at 3.

[11] *Id.*

[12] 15 U.S.C. §78j(b).

[13] 17 C.F.R. § 240.10b–5.

[14] 15 U.S.C. § 77q(a).

[15] *Lorenzo*, slip op. at 4.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] Justice Kavanaugh took no part in the consideration or decision of this case, likely because he was on the D.C. Circuit panel that decided Lorenzo's appeal from the Commission.

[20] *Lorenzo*, slip op. at 2.

[21] *Id.* at 5-6.

[22] *Id.* at 6 (quoting *Aaron* v. *SEC*, 446 U.S. 680, 686, n.5 (1980)).

[23] *Id.* at 7.

[24] *Id.*

[25] *Id.* at 11.

[26] *Id.* (emphasis added).

[27] *Id.* at 12.

[28] *Id.* at 6-7.

[29] *Id.* at 7.

[30] *Id.*

[31] *See Stoneridge Inv. Partners, LLC* v. *Scientific Atlanta, Inc.*, 552 U.S. 148 (2008).

[32] *See Pub. Pension Fund Grp*. v. *KV Pharm. 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 (2d Cir. 2005).

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