Going to Get it Right This Time?

Aiding and Abetting & Scheme Liability through *Lorenzo*

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On December 3, 2018, the Supreme Court will hear arguments for *Lorenzo v. SEC* and hopefully bring a conclusion to the confusion surrounding the "scheme liability" provisions of 10b-5(a) and (c). *Lorenzo v. Sec. & Exch. Comm'n*, 872 F.3d 578, 580 (D.C. Cir. 2017), cert. granted sub nom. *Lorenzo v. S.E.C.*, 138 S. Ct. 2650 (2018).

While Rule 10b-5(b) makes it unlawful to "make any untrue *statement* of a material fact ... in connection with the purchase or sale of any security," Rules 10b-5(a) and (c) shift the focus from the statement to the "scheme." 17 C.F.R. § 240.10b-5(b) (emphasis added).

Rule 10b-5(a) prohibits "employ[ing] any device, scheme, or artifice to defraud ... in connection with the purchase or sale of any security," *Id.* § 240.10b-5(a), and Rule 10b-5(c) bars "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person ... in connection with the purchase or sale of any security." *Id.* § 240.10b-5(c).

The Court's decision in *Lorenzo* will answer whether a defendant may be held primarily liable under the "scheme liability" provisions of 10b-5 on the basis of a false or misleading *statement*—even if he is not the "maker" of the statement as defined by *Janus* for purposes of Rule 10b-5(b). 872 F.3d, at 580 (citing *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011)).

This question is connected to an even larger ideological issue and focus of legal precedent: the appropriate delineation between primary and secondary liability. Importantly, private 10b-5 suits and harsher penalties resting on reckless and willful violations are generally reserved for instances of primary liability. If the Supreme Court accepts the D.C. Circuit's conception of scheme liability, the realm of private liability will be significantly expanded, opening the door to more private suits and harsher SEC penalties.

In order to catch up on the Supreme Court's jurisprudence on this subject, so far, we look to three cases in chronological order – *Central Bank, Stoneridge,* and *Janus*.

I. *Central Bank*

Neither Rule 10b–5 or § 10(b) expressly create a private right of action. Instead, the Supreme Court has held that "a private right of action is implied under § 10(b)." *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co*., 404 U.S. 6, 13, n. 9 (1971). That holding "remains the law, but concerns with the judicial creation of a private cause of action caution against its

[1] Mr. Ferrara provided the inspiration and direction for this article, while Ms. Jones provided its intellectual content.

expansion." *Janus*, 564 U.S., at 142 (citing *Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc.*, 552 U.S. 148, 165, (2008)).

The Supreme Court has set limits on this private right of action in cases including *Central Bank. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 167 (1994*).* The case involved an issuance of $26 million worth of bonds on which Central Bank served as a trustee. When the issuer of the bonds defaulted, the bondholders argued that Central Bank was liable for aiding and abetting violations of the securities laws. The Court held that Rule 10b–5's private right of action does not include suits against aiders and abettors. Aiding and abetting is a type of secondary or "add-on" liability, more commonly associated with bank robbery than bank fraud. It is typically patterned on the Restatement of Torts formulation which requires "(i) the existence of a primary violation of § 10(b) or Rule 10b–5, (ii) the defendant's knowledge of (or recklessness as to) that primary violation, and (iii) 'substantial assistance' of the violation by the defendant." *Id.*, at 194.

The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. *See Stoneridg*e, 552 U.S., at 158 (citing *Cent. Bank*, 511 U.S., at 177). Then–SEC Chairman Arthur Levitt even testified before the Senate Securities Subcommittee recommending the establishment of aiding and abetting liability in private claims. *Id.* Congress heeded the call—by telling the SEC to do something. § 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), 109 Stat. 757, directed the SEC, not private plaintiffs, to prosecute aiders and abettors. *Stoneridge* followed, once more considering the reach of the private right of action—this time also addressing arguments for scheme liability. 552 U.S., at 149.

II. *Stoneridge*

In *Stoneridge*, petitioner alleged that Charter Communications had fraudulently inflated the price of its stock thorough engaging in sham transactions with vendors, bringing 10(b) claims against both Charter and the vendors. *Id.*, at 152. The Court reiterated that the § 10(b) private right of action does not extend to aiders and abettors—in this case the vendors—because Congress did not expand the § 10(b) private right of action when revisiting the law. As such, "the conduct of a secondary actor must… satisfy each of the elements or preconditions for § 10(b) liability." *Id.*, at 158. Plaintiff ultimately failed to establish reliance. As such, defendants could not be liable as primary actors under § 10(b).

In addition, the Court viewed petitioner's reference to "scheme liability" as an attempt to revive aiding and abetting liability for securities fraud in private cases. Peter J. Henning, *Are False Statements Enough to Prove Fraud?*, N.Y. TIMES, July 3, 2018, https://www.nytimes.com/2018/07/03/business/dealbook/fraud-sec-false-statements.html. The theory of "scheme liability," that defendants directly participated in a scheme and therefore could be held liable as primary violators, did not suffice to show reliance absent a public misstatement. The Court remarked on petitioner's slippery slope concept of reliance as follows:

- "Were the Court to adopt petitioner's concept of reliance—*i.e.,* that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect—the implied cause of action would reach *the whole*

marketplace in which the issuing company does business." *Stoneridge*, 552 U.S., at 149 (emphasis added).

- "Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Id.,* at 157 (citing *Central Bank*, 511 U.S., at 180).

III. *Janus*

While the case's namesake was famously two-faced, the Court's ruling in 2011 was clear: to be liable in a private action under 10b-5(b), the person or entity must "make" a statement. *Janus,* 564 U.S., at 142. Janus Capital Group and its investment advisor subsidiary were sued for making misleading statements in prospectuses filed by Janus Investment Fund. The Court narrowed the private cause of action by defining the maker of a statement as the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id*., at 142. As such, the investment advisor and parent capital group were not makers. *Janus* drew its conclusions in line with *Central Bank and Stoneridge*:

- "This rule follows from *Central Bank*, which held that Rule 10b–5's private right of action does not include suits against aiders and abettors who contribute 'substantial assistance' to the making of a statement but do not actually make it. Reading 'make' more broadly, to include persons or entities lacking ultimate control over a statement, would substantially undermine *Central Bank* by rendering aiders and abettors almost nonexistent. The Court's interpretation is also suggested by *Stoneridge*, and accords with the narrow scope that must be given the implied private right of action." *Janus*, 564 U.S., at 135 (internal citations omitted).

- "The Court rejects the Government's contention that 'make' should be defined as 'create,' thereby allowing private plaintiffs to sue a person who provides the false or misleading information that another person puts into a statement. Adopting that definition would be inconsistent with *Stoneridge*, which rejected a private Rule 10b–5 suit against companies involved in deceptive transactions, even when information about those transactions was later incorporated into false public statements." *Id.* (internal citations omitted).

From Janus, Stoneridge, and Central Bank, a couple of core philosophies emerge. First, a reticence to expand the judicially inferred private right of action under 10b-5 paired with a corresponding effort to distinguish secondary and primary liability. Second, a refusal to obviate Court precedent. These philosophies will likely inform the Supreme Court's approach to Lorenzo.

IV. *Lorenzo*

Francis Lorenzo, director of investing banking at a broker-dealer, sent two emails to investors containing material misrepresentations about his only client. *See Lorenzo*, 872 F.3d, at 581. However, the emails were written by and sent at the direction of his boss—a "copy and paste" situation, of sorts. *Id.*, at 587. As it stands, the D.C. Circuit held that, while Lorenzo was

not a "maker" of a false or misleading statement under *Janus*, he could still face primary liability under Rule 10b-5(a), Rule 10b-5(c), Section 10(b), and Section 17(a)(1) based solely on the statements contained in the emails at issue.

In his dissent below, Judge—now Justice—Kavanaugh, who has recused himself for the Supreme Court hearing, said that the majority's conclusion eliminated the distinction between primary and secondary (aiding and abetting) liability. *See id.,* 872 F.3d, at 600 (Kavanaugh, J., dissenting). He characterized the invocation of scheme liability as an effort to repackage aiding and abetting liability, noting that other courts "have instead concluded that scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others." *Id.* (Kavanaugh, J., dissenting) (collecting cases).

Through a focus on factual variations between *Lorenzo, Janus,* and *Stoneridge,* the D.C. Circuit majority found that its opinion would not subvert the Supreme Court's efforts to distinguish primary and secondary liability. The majority said that "to the extent the *Janus* Court's concerns about aiding-and-abetting liability in private actions under Rule 10b-5(b) should inform our interpretation of [the] other four provisions, the conduct at issue in *Janus* materially differs from Lorenzo's actions in this case." *Id.,* at 590. For instance, "Lorenzo*,* unlike the defendants in *Janus* and *Stoneridge*, transmitted misinformation directly to investors, and his involvement was transparent to them." *Id.*, at 591. The D.C. Circuit's factual distinction brought it to the conclusion that Lorenzo's transparent "transmission" of the statement[2] was sufficient to find that he willfully engaged in a scheme under 10b-5(a) and 10b-5(c)—even though his failure to "make" the statement clearly insulated him from 10b-5(b) liability under *Janus*.

On Monday, the Supreme Court will either: 1) agree with Justice Kavanaugh that the D.C. Circuit's combined legal rulings created an "oddity," *Id.*, at 601 (Kavanaugh, J., dissenting); 2) affirm the majority decision, retreating from *Central Bank*, *Stoneridge*, and *Janus* to broaden primary liability as we know it; or 3) find itself split 4:4, allowing the decision below to stand.

The third option seems the most likely. The dissenters in *Janus*—Justices Breyer, Ginsburg, Sotomayor, and Kagan—are likely to uphold the D.C. Circuit's broader idea of primary liability, as they advocated for a broader definition of "make" in *Janus*. On the other side, Justices Thomas, Roberts, and Alito, are likely to see the D.C. Circuit's decision as a disregard of the aiding-and-abetting concerns raised in *Janus* and overrule. With Justice Kavanaugh having recused himself, the decision will lay with Justice Gorsuch who will likely agree with the conservative bloc. A 4-4 tie will effectively uphold the decision of the D.C. Circuit, leaving the door open for private plaintiffs to characterize aiding and abetting liability as primary scheme liability moving forward.

[2] Lorenzo sent the emails from his account, included his email signature on the emails, and asked potential investors to call him with questions. *Lorenzo*, 872 F.3d, at 582.