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Does 'Lorenzo' Expand the Scope Of Private Securities Litigation?

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Since the U.S. Supreme Court first recognized almost 50 years ago an implied private right of action under §10(b) of the Securities Exchange Act and SEC Rule 10b-5—the federal securities laws' principal anti-fraud provisions—private shareholder plaintiffs and their lawyers have tried to broaden the scope of that private right of action. In a series of decisions over the last 25 years, however, the Supreme Court has consistently rejected those attempts, strictly limiting the class of potential defendants in private §10(b) litigation. During that time, the court held in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) that private plaintiffs cannot maintain claims for aiding and abetting under §10(b) and Rule 10b-5; in *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008) that private plaintiffs cannot assert claims against secondary actors for "scheme" liability to plead around *Central Bank*; and, in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011), that only the "maker" of an alleged misstatement can be liable for that misstatement.

The Supreme Court's recent decision in *Lorenzo v. Securities & Exchange Commission*, 139 S. Ct. 1094 (2019)—which affirmed a finding of liability under §10(b) and Rule 10b-5 against a defendant who knowingly "disseminated" another party's false statement—appears to reverse this trend and may provide private plaintiffs a basis to argue for more expansive Rule 10b-5 liability. But *Lorenzo* involved an SEC enforcement proceeding. A private plaintiff seeking to rely on

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Lorenzo to assert Rule 10b-5 claims against a defendant for allegedly "disseminating" another party's false statements will still face substantial barriers, including the need to allege—and, ultimately, to prove—that the defendant who disseminated another's allegedly false statement did so with scienter (i.e., "a mental state embracing intent to deceive, manipulate, or defraud," *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007)) and that the plaintiff reasonably relied on the defendant's allegedly deceptive conduct when engaging in a securities transaction. As a result, while the court's decision in *Lorenzo* may lead private plaintiffs to assert claims against secondary actors in securities transactions, the courts are likely under most circumstances to reject those efforts and limit the decision's ultimate effect on private securities litigation.

Four Decades of Narrowing the Scope of the Private Right of Action Under §10(b) and Rule 10b-5. Starting in the 1960s, many courts permitted private plaintiffs to assert claims for aiding and abetting violations of §10(b) and Rule 10b-5. See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969); *Cleary v. Perfectune*, 700 F.2d 774, 777 (1st Cir. 1983); *Kerbs v. Fall River Industries*, 502 F.2d 731, 740 (10th Cir. 1974). Those courts generally justified their decisions on policy grounds, reasoning that §10(b) had broad policy objectives to protect defrauded investors, and, "in the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes." *Brennan*, 259 F. Supp. at 680-81. That broad interpretation of the scope of the private right of action under §10(b) and Rule 10b-5 began to change with a string of Supreme Court decisions in the late 1970s, in particular *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), where the court strictly interpreted the text of §10(b) to limit its application to causes of action involving only "manipulation or deception." *Santa Fe Industries*, 430 U.S. at 473-74. Following these decisions, courts began questioning whether secondary aiding-and-abetting liability under §10(b), which the statute did not expressly provided for, could survive if "the defendant must have committed a manipulative or deceptive act to be liable under §10(b)." *Central Bank*, 511 U.S. at 170.

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Ultimately, in 1994, the Supreme Court held that private plaintiffs cannot assert aiding-and-abetting claims under §10(b). In *Central Bank*, after a public building authority defaulted on $26 million in bonds, bondholders sued various entities involved in the bond issuance, including the building authority, underwriters, the developer, and the indenture trustee. Id. at 167-68. Plaintiffs alleged that the trustee was "secondarily liable under §10(b) for its conduct in aiding and abetting the fraud." Id. In particular, plaintiff alleged that the trustee knew that the sale of the bonds was imminent and that purchasers would be relying on a 1988 appraisal to evaluate the collateral, which plaintiffs contended the trustee knew was inadequate, and that the trustee substantially assisted the primary violators by delaying an independent review of the appraisal. Id. at 168-69. The court determined, however, that while secondary actors such as the trustee could be liable for primary violations of §10(b), "the uncontroversial conclusion, accepted even by those courts recognizing a §10(b) aiding and abetting cause of action," was that "the text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation." Id. at 177.

After *Central Bank*, in 1995, Congress enacted the Private Securities Litigation Reform Act (the Reform Act). Among other changes to the securities laws, the Reform Act expressly provided the SEC—but not private litigants—the right to sue those who allegedly aid and abet securities violations. See 15 U.S.C. §78t(e). In doing so, Congress effectively ratified the Supreme Court's conclusion that private plaintiffs cannot maintain claims for aiding and abetting violations of §10(b).

Thirteen years later, in *Stoneridge*, the court confronted whether a company's investors could maintain a cause of action for "scheme" liability under §10(b) against a company's customers and suppliers who allegedly participated in the company's accounting fraud. 552 U.S. at 154-55. The plaintiffs alleged that the company's financial statements were false and misleading as a result of the accounting fraud. *Central Bank* clearly precluded private plaintiffs from asserting aiding-and-abetting claims against other parties allegedly involved in the accounting fraud. But the plaintiffs in *Stoneridge* argued that the suppliers and customers were liable under §10(b), despite not having made any public statements to investors, because they allegedly participated in the fraud "with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter's revenue." Id. at 160.

The court rejected this "scheme" theory of liability because the plaintiffs could not establish that they relied on the defendants' alleged fraudulent conduct when deciding to purchase the stock, which is an essential element in a private §10(b) claim. While the plaintiffs may have relied on the company's allegedly false financial statements, the court explained that the plaintiffs could not show that they actually relied on the alleged misconduct of the company's suppliers and customers because they "had no duty to disclose; and their deceptive acts were not communicated to the public," meaning "no member of the investing public had knowledge, either actual or presumed, of [their] deceptive acts." Id. at 159.

While private plaintiffs may in some circumstances invoke a presumption of reliance on public statements (like the company's publicly filed financial statements in *Central Bank*) because those statements result in a "fraud on the market," the court in *Central Bank* held that the "fraud on the market" presumption did not apply where the defendants themselves were not alleged to have made any public statements. See id. In reaching this conclusion, the court explained that if it had allowed the case to move forward based on alleged scheme liability without requiring the plaintiffs to show reliance on the defendants' conduct, it would have made "any aider and better liable under §10(b) if he or she committed a deceptive act in the process of providing assistance," contravening *Central Bank* and Congress's decision to ratify *Central Bank*'s holding in the Reform Act. Id. at 162.

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In 2011, in *Janus*, the court further circumscribed the class of defendants potentially liable under Rule 10b-5(b)—which proscribes making an "untrue statement of material fact" in connection with a securities transaction—only to those defendants who "make" such statements. *Janus* involved alleged misstatements in a prospectus filed by an investment fund and fund investors' effort to maintain a class action against the fund's investment advisor. 564 U.S. at 139-40. Reinstating the district court's dismissal of the case, the Supreme Court explained that the "maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Id. at 142. Therefore, the court concluded that an investment advisor who merely "participates in the drafting of a false statement" cannot be held liable for "making" a false statement under Rule 10b-5(b). Id. at 145.

The 'Lorenzo' Opinion. Less than two years after *Janus*, the SEC brought an enforcement action under §10(b) and Rule 10b-5 against an investment banker, Francis Lorenzo, who sent emails to investors containing false statements about a potential investment. 139 S. Ct. at 1099. Lorenzo sent the emails; however, his boss drafted the false statements, and the emails stated that Lorenzo sent them at the boss's direction. Notably, there was no dispute that the emails contained false statements or that Lorenzo *knew* the emails contained false statements. But Lorenzo argued that an SEC judgment against him should be reversed under *Janus* because "his boss 'asked Lorenzo to send the emails, supplied the central content, and approved the messages for

distribution,'" and "it was the boss that had 'ultimate authority' over the content of the statement 'and whether and how to communicate it.'" Id. at 1100.

The D.C. Circuit agreed that Lorenzo was not liable under Rule 10b-5(b) because his boss had ultimate authority over the false statements, and, thus, Lorenzo was not the "maker" of the statements under *Janus*. But the court nonetheless affirmed the judgment against Lorenzo, finding that Lorenzo had violated the other provisions of Rule 10b-5, subsections (a) and (c), which, respectively, prohibit 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." See id.

The Supreme Court affirmed the D.C. Circuit's judgment. The court's majority reasoned that the language in Rule 10b-5(a) and (c) "capture[s] a wide range of conduct." And, just as the court relied on the dictionary definition of "make" to limit the scope of liability in *Janus*, the majority in *Lorenzo* observed that the dictionary definitions of the prohibited conduct—"device," "scheme," "artifice," "act" and "practice"—are "expansive," reflecting congressional intent to "root out all manner of fraud in the securities industry." Id. at 1101. Thus, "someone who is not a 'maker' of a misstatement … can nevertheless be found to have violated the other subsections of Rule 10b-5 … when the only conduct involved concerns a misstatement." Id. at 1100. The majority may have been motivated by the egregious facts in *Lorenzo*, where the defendant knowingly conveyed fraudulent information to solicit investments from his banking clients.

In dissent, Justice Thomas—who wrote the majority opinion in *Janus*—argued that the majority opinion effectively "eviscerate[d]" the distinction between primary and secondary liability recognized in *Central Bank* and *Stoneridge* and nullified the court's decision in *Janus*, because a party who had not "made" the false statement—and thus could not be liable under Rule 10b-5(b)—could still be liable for "facilitating" that same statement under Rule 10b-5(a) or (c). Id. at 1106, 1108.

Potential Ramifications of 'Lorenzo' on Private Securities Litigation. Justice Thomas's concern may be misplaced. To be sure, private plaintiffs may view *Lorenzo* as a blueprint for asserting claims against a wider range of potential defendants that disseminate statements to investors based on conduct beyond just alleged misstatements. But, as discussed above, forty-plus years of Supreme Court precedent has restricted the type of defendants and conduct giving rising to private litigation under Rule 10b-5, particularly with respect to the scienter and reliance elements. Nor does *Lorenzo* alter the heightened standards for private securities plaintiffs under the Reform Act.

First, notwithstanding Justice Thomas's concerns, nothing in *Lorenzo* alters the holdings of *Central Bank* and *Stoneridge*, as reinforced by the Reform Act, that private securities fraud actions cannot be maintained against secondary actors based on an aiding-and-abetting or scheme-liability theories. See id. at 1104. If secondary actors, such as accountants, underwriters, or lawyers, are to be subject to liability under §10(b) for statements they did not make, plaintiffs still must allege a primary claim with all of the requisite elements. In particular, plaintiffs still must show that each defendant engaged in deceptive conduct, rather than simply assisting another in doing so.

Second, private plaintiffs still must plead and prove scienter. And, in enacting the Reform Act in 1995, Congress imposed heightened pleading requirements for pleading scienter under §10(b), requiring plaintiffs to plead with particularity facts raising "a strong inference" that a defendant acted with intent to deceive. 15 U.S.C. §78u-4. This already heavy burden will be even more difficult to carry in a potential claim against defendants who allegedly disseminate false statements made by others. The court did not address the scienter element in *Lorenzo* because Lorenzo did not dispute in the Supreme Court the lower courts' findings that he acted with scienter. 139 S. Ct. at 1100. But in the typical case, the requirement to plead and prove scienter against secondary actors will impose a heavy burden on private plaintiffs.

Third, unlike the SEC, private plaintiffs must demonstrate reliance. Private securities plaintiffs

typically seek to meet this element by invoking the fraud-on-the-market doctrine, which provides a rebuttable presumption of reliance on public statements about a company whose stock trades in an efficient market because public statements are presumed to be reflected in the stock's market price. See, e.g., *Halliburton Co. v. Erica P. John Fund*, 573 U.S. 258, 268 (2014) ("*Halliburton II*"). (Indeed, to maintain a §10(b) class action, private plaintiffs *must* show that they are entitled to a presumption of class-wide reliance. Otherwise, individual issues of reliance will predominate, precluding class certification. Id. But, in *Stoneridge*, the court confirmed that there is no presumption of reliance on alleged "schemes" or other forms of deceptive conduct. See 552 U.S. at 159-62. And the court again affirmed this reasoning in its 2014 decision in *Halliburton II*, explaining that expanding Rule 10b-5 liability to "new categories of defendants who themselves had not made any material, public misrepresentation … would have eviscerated the requirement that a plaintiff prove that he relied on a misrepresentation made *by the defendant*." 573 U.S. at 275 (emphasis in original). Thus, as the Second Circuit has explained, "If a plaintiff must rely on a secondary actor's own deceptive conduct to state a claim under Rule 10b–5(a) and (c), it stands to reason that a plaintiff must also rely on a secondary actor's own deceptive statements." *Pac. Inv. Mgmt. Co. v. Mayer Brown*, 603 F.3d 144, 155-56 (2d Cir. 2010).

The court did not address §10(b)'s reliance element in *Lorenzo* because, unlike private plaintiffs, the SEC is not required to show reliance in its enforcement proceedings. 139 S. Ct. at 1104. But the court nonetheless reiterated that private plaintiffs cannot bring suit against defendants "based on undisclosed deceptions upon which the plaintiffs could not have relied." Id. Because of the requirement that private plaintiffs show that they relied on the defendants' allegedly deceptive conduct, it appears unlikely that private plaintiffs in the typical securities class action case will be able to maintain claims against secondary actors who merely disseminated, but did not make, allegedly false statements. In particular, the inability to invoke a class-wide presumption of reliance should preclude private plaintiffs from maintaining §10(b) class actions against secondary actors under *Lorenzo*. That being said, one court in the Southern District of New York recently applied *Lorenzo* and allowed a §10(b) class action to go forward against a broker-dealer that "facilitated" a securities offering despite knowing shares were improperly issued. *In re Longfin Sec. Litig.*, 2019 WL 1569792 (S.D.N.Y. April 11, 2019). In so holding, the court did not analyze whether plaintiffs had adequately pleaded reliance on the broker-dealer's conduct.

Conclusion

For decades, private shareholder plaintiffs have consistently sought to expand the universe of potential defendants under §10(b). As a result, there can be little doubt that some plaintiffs will attempt to argue that *Lorenzo* permits them to assert claims against secondary actors in securities transactions. But, in *Lorenzo*, the court did not address either the scienter element or the reliance element of a private securities claim, leaving existing precedent on these issues undisturbed. As a practical matter, the requirements to plead and prove both reliance and scienter should preclude private plaintiffs from expanding Rule 10b-5(a) and (c) liability to secondary actors. Thus, while *Lorenzo* may provide the SEC with a new enforcement tool, it should not be construed as expanding the scope of class actions under Rule 10b-5.