

The Supreme Court's *Janus* decision: no secondary liability, but many secondary questions

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Abstract

Purpose – *The purpose of this paper is to review significant questions raised by the US Supreme Court's June 13, 2011 decision in Janus Capital Group, Inc. v. First Derivative Traders and discuss issues that fund directors and advisers may want to consider as a result.*

Design/methodology/approach – *The paper explains the narrow interpretation of Rule 10b-5 that the Court decision represents and the Court's effort not to allow expansion of secondary liability for aiding and abetting under the federal securities laws. It raises questions about the allocation of liability for prospectus content among fund directors, officers, and advisers. It compares liability of advisers and their affiliates under provisions of Rule 10b-5 and Sections 11 and 12 of the Securities Act of 1933. It recommends three matters that directors should consider concerning the allocation of liability in a case involving a false prospectus: the best way for fund directors to carry out their "due diligence" regarding the content of fund registration statements; the provisions of advisory, administrative and distribution contracts that allocate liability between those entities and the fund for prospectus misstatements and omissions; and various avenues for indemnification and shared liability, including D&O/E&O coverage and an indemnification agreement with the adviser. It introduces the alternative of shared liability in which the adviser signs the fund's registration statement.*

Practical implications – *The paper finds that the Janus decision has caused fund directors, officers and advisers to focus on the allocation of liability for prospectus errors.*

Originality/value – *The paper provides a practical guidance from experienced securities lawyers.*

Keywords *Investment advisers, Hedge funds, Mutual funds, Securities Exchange Act of 1934, Securities regulation, Investments, Advisory services, Hedging, Regulation, United States of America*

Paper type *Technical*

The US Supreme Court's recent decision in *Janus Capital Group, Inc. v. First Derivative Traders* has left many investment company directors wondering whether they should take additional measures either to protect their funds and themselves from liability for prospectus errors or to provide their funds' investment adviser with additional incentive to ensure the accuracy and completeness of fund prospectuses. In point of fact, the *Janus* case did little to change the landscape of liability faced by registered investment companies, their advisers and directors. It may, however, mark a significant moment in the history of the fund business if it causes all affected parties to focus carefully on the allocation of liability for prospectus errors. This Alert reviews significant questions raised by the decision and discusses issues that fund directors and advisers may want to consider as a result.

The *Janus* decision

The *Janus* case is unusual in that the plaintiffs, who alleged that the prospectuses of certain Janus funds contained material misstatements, were not suing as fund shareholders. Rather, they were shareholders of Janus Capital Group, Inc. ("Janus Capital"), the holding company for the funds' investment adviser. Plaintiffs noted that the Janus fund prospectuses stated that the funds were not suitable for market timers. They claimed that when the 2003

market-timing scandal called into question the accuracy of those statements, assets fled the Janus funds and regulators commenced actions against Janus, both of which caused shares of Janus Capital to lose value.

Plaintiffs brought an action under Rule 10b-5, a general anti-fraud provision under the Securities Exchange Act of 1934 ("1934 Act"), complaining that the statements in the fund prospectuses were essentially a fraud on the market for shares of Janus Capital. In a 5-4 decision, the Court ruled in favor of Janus Capital.

From a technical perspective, the Court's decision in *Janus* represents a narrow interpretation of Rule 10b-5. The Court observed that the rule declares it unlawful "to make any untrue statement of a material fact [. . .]" It held that the only person that could be liable under such a provision is the person who actually made the statement, in this case the funds that issued the prospectuses. The Court held that the Janus funds ultimately controlled the content of their own prospectuses; therefore, the funds, and not the other persons or entities who contributed information to the document, were the makers of the statements in question.

From a wider perspective, it is useful to understand just how narrow the Court's decision is. The Court observed that, although the Securities and Exchange Commission (SEC) has authority to bring a case for aiding and abetting violations of Rule 10b-5, under which the various contributors to the prospectus might have been liable, the Supreme Court itself had previously ruled that there is no private right of action for aiding and abetting such a violation. The *Janus* decision represents a determined effort by the Court not to allow such secondary liability to slip in through a back door. The decision is noteworthy for the complete absence of language found in many earlier decisions stating that the federal securities laws are "remedial statutes" and should be interpreted broadly in accordance with their remedial intent.

Allocation of liability after *Janus*

The Court's determination not to allow an expansion of liability under the federal securities laws should give some comfort to all who play a role in issuing or selling securities, including fund directors. Given the structure of the typical investment company complex, however, in which the funds have no employees of their own and employees of the adviser and administrator provide all of the funds' officers and all services necessary to the funds' day-to-day operation, the decision has left many in the industry scratching their heads. If the adviser is not responsible for the prospectus content, who is?

Some have expressed concern that under the *Janus* ruling, fund directors may face increased liability for prospectus errors. They question whether, if the adviser is not the maker of the statements in the fund's prospectus, that leaves fund directors in the position of being the only responsible party. But is that right? The role of a board of directors is generally oversight, not execution. Rather, it is the officers of a corporation who are responsible for its executive function. It is arguable whether even they would be deemed to have made the statements contained in a fund's prospectus under the Supreme Court's new interpretation of Rule 10b-5; but one would think the light would shine on them before it falls on independent directors.

Perhaps more to the point, very few prospectus liability cases are brought under Rule 10b-5. The rule imposes on the plaintiff the burdens of proving that the defendant acted with scienter (or at least with recklessness), and that the plaintiff (or the market) relied on the false statement. Plaintiffs' counsel typically find it much more appealing to bring prospectus cases under Section 11 of the Securities Act of 1933 ("1933 Act"), which imposes liability for losses stemming from a registration statement that was materially false or misleading at the time it went effective. Section 11 liability falls on the fund, its directors, certain officers and anyone who has "expertised" the allegedly false portion of the prospectus (e.g. the auditors). The plaintiff is not required to prove scienter or even recklessness. Defendants in such cases have defenses available, but they are just that – defenses. The burden falls on the defendants to establish those defenses once the plaintiff has asserted a *prima facie* case.

Clearly, the *Janus* case did nothing to change liability under Section 11. And while the adviser itself may not be a defendant in a Section 11 case, the fund's inside directors and

certain officers – all of whom typically are significant players in the advisory organization – likely would be defendants. Fund officers and directors do have available under Section 11 a “due diligence” defense^[1]; however, the officers and inside directors, precisely because they are insiders, may have a more difficult time than would the independent directors in establishing that they did not know the truth of the matter at the heart of the plaintiff’s claim.

Advisers and their affiliates are potentially liable under other provisions of the federal securities laws as well. For example, plaintiffs may sue a fund’s distributor – often an affiliate of the adviser – under Section 12 of the 1933 Act for selling shares by means of a materially false prospectus. Additional provisions of the federal securities laws, available only to the government, also might be used to impose monetary liability and other penalties on an adviser for misstatements in the fund’s prospectus. Thus, the *Janus* case did very little to alter the potential liability of advisers, funds, or fund officers and directors in cases where a fund’s prospectus is arguably false.

That said, however, the discussion generated by the case would seem to present directors with the opportunity to consider several matters that could be important in allocating liability in a case alleging a false prospectus. These matters are:

- the best way for fund directors to carry out their “due diligence” regarding the content of fund registration statements;
- the provisions of advisory, administrative and distribution contracts that allocate liability between those entities and the fund for prospectus misstatements and omissions; and
- various avenues for indemnification and shared liability, including D&O/E&O coverage and an indemnification agreement with the adviser.

Due diligence

As noted, Section 11 of the 1933 Act provides fund directors, among others, with a defense against liability based on their having performed due diligence to assure themselves of the accuracy and completeness of the registration statement. In the wake of *Janus*, some boards of directors are reviewing carefully the manner in which such a defense might be established. Certainly, it may be important to show that a director or his/her delegate (e.g. a board committee or counsel) reviewed the prospectus carefully. In this day of complex securities and investment strategies, however, directors may be well advised to consider additional measures consistent with their traditional oversight role. Some boards are asking how the prospectus is prepared and vetted, and by whom. Who signs off on each section of the prospectus, and what records are kept of the sign-off? Does a person familiar with the risks of the investment program, other than the portfolio manager, review and sign off on the risk disclosure? Does the chief compliance officer or someone else regularly review the portfolio to make sure it remains within the limits stated in the prospectus and statement of additional information? What comments were received from the SEC staff during the initial or annual update filing of the registration statement, and how were they addressed? Does independent board counsel or outside fund counsel play a meaningful role in preparing and vetting the document? Do his or her comments and concerns carry weight with the adviser?

Investment company complexes are different from industrial companies. A fund director cannot perform due diligence by reviewing patent licenses to assure that the company has rights to valuable processes, or the reports of geologists to be sure the company’s wells or mines will produce to a degree consistent with statements made in the prospectus. The investment process is largely intangible, and director due diligence might therefore be enhanced by a focus on process and safeguards.

Contractual provisions

Fund directors also may want to review provisions in the advisory or distribution contracts allocating liability for false statements in or omissions from the prospectus. They may find that the contracts say nothing at all about the subject, or that the fund undertakes to

indemnify the adviser or distributor for such liability, unless it stems from information in the prospectus that was provided to the fund by the adviser or distributor in writing. Directors may want to consider whether such provisions are appropriate in the investment company context, where the adviser typically provides all operating staff for the fund and has the primary knowledge about the fund's activities and processes described in the prospectus.

Directors also may want to consider how such provisions will operate in practice. Given the process by which prospectuses typically are drafted, involving a lengthy exchange of information and comments among employees of the adviser or distributor (who may also be fund officers) and fund counsel, could one ever reconstruct in retrospect which information had been "provided by" an officer of the adviser, acting as such?

Insurance, indemnification and shared liability

Fund directors also may want to consider whether they and their funds can improve the benefits they might expect to receive under liability insurance, indemnification provisions or other approaches.

D&O/E&O Insurance

While fund directors generally assume that they have insurance coverage for prospectus liability, some insurers have argued that Section 11 claims are not covered. In making such arguments, certain insurers have focused on the definition of "Loss," which in certain policies contains a carve-out excluding from coverage amounts paid that are "uninsurable" as a matter of public policy. Certain insurers have argued that public policy should preclude coverage for Section 11 claims on the basis that such claims arguably seek disgorgement or restitution of an ill-gotten gain. Policyholders have vigorously contested such arguments, and courts have reached mixed results based on the policy language at issue and controlling law. In certain cases, policyholders have argued that, when an insurer has expressly afforded broad coverage for "Securities Claims" (which is often defined to include claims under the 1933 Act and the 1934 Act), an insurer should not be able to rely on a vague "public policy" exception to deny coverage for Section 11 claims.

Policyholders also have contested whether Section 11 claims in fact seek disgorgement of an ill-gotten gain. Further, policyholders have argued that "public policy" should not preclude coverage for the settlement of a disputed claim when there has been no judgment establishing that some illegal conduct occurred. These arguments might have particular force with respect to directors (as opposed to the fund or adviser), given that directors receive only a set fee from the fund for their services and do not share in amounts obtained through an allegedly false prospectus. In any event, it should be noted that many insurers are now offering new policy language or endorsements that expressly confirms the intent to provide coverage for Section 11 claims. Policyholders may wish to ensure that their policies contain the broadest language available.

Indemnification

In the wake of *Janus*, some have raised the prospect of fund directors seeking an agreement that the adviser will indemnify the fund and the directors for liability resulting from a prospectus misstatement. Such indemnification presumably would be available only when the parties could not obtain payment under the insurance policy or when the directors could not obtain indemnification from the fund under its charter and bylaws.

Some have questioned whether an agreement for such director indemnification would be legally enforceable. Section 17(h) of the Investment Company Act of 1940 does provide a limit on director indemnification, in that it prohibits "any . . . instrument pursuant to which [a registered investment company] is organized or administered" from containing:

[. . .] any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

However, an agreement between an investment adviser and each director of a fund would not seem to be “an instrument pursuant to which [a registered investment company] is organized or administered”[2]. Furthermore, the fact that an investment company director has been found liable under Section 11 does not mean that the director necessarily has engaged in “willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.” Rather, it implies only that the plaintiff made a *prima facie* case that the registration statement was false when it became effective, and that the director failed to establish the defense of having made a “reasonable investigation” of the facts underlying the statements in question.

The SEC also asserts that it may be “against public policy” for directors to receive indemnification for Section 11 liability. The SEC argues that such indemnification tends to undermine the purpose of such liability, which is to strongly encourage directors to do their jobs in probing the accuracy of prospectus disclosure. Be that as it may, such a position would seem to stand public policy on its head where it is used to prevent indemnification by the party that is in the best position to assure the accuracy of the registration statement.

None of these questions would seem to affect an agreement whereby the adviser undertakes to indemnify the fund for prospectus liability costs.

Shared liability

Directors might avoid all of these questions with another approach – asking the advisory organization to sign the fund’s registration statement. Section 11, besides imposing liability on the issuer and its officers and directors, also imposes liability on “every person who signed the registration statement.” All parties except the fund, but including the adviser, would have access to Section 11’s due diligence defense. As between the adviser and the outside fund directors, however, the adviser would seem to be in the weaker position to establish such a defense. Accordingly, such a practice would seem to rectify any imbalance that fund directors believe may have been created by the *Janus* decision.

Such an arrangement would certainly provide additional assurance – if any is needed – that the adviser has a strong financial interest in the accuracy of the fund’s prospectus. It may, however, raise other concerns, such as whether the “deep pockets” of the adviser would attract more strike suits. These questions must be considered carefully before proceeding.

Notes

1. Section 11(b)(3) of the 1933 Act provides that a director of the issuer is not liable under Section 11(a) if he or she can “sustain the burden of proof” that “after reasonable investigation” the director had “reasonable ground to believe and did believe,” at the time the registration statement became effective with the SEC, “that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading [...]”.
2. If an investment adviser believes that such an indemnification agreement should be accompanied by a higher advisory fee to compensate it for added risk – advisory fees that would fall on fund shareholders and would have to be approved by the independent directors – difficult questions of fiduciary duty may arise.

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