CAN A PLAINTIFF RE-LABEL AND RE-FILE A SECURITIES FRAUD CLAIM?

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The federal securities laws have long prohibited two types of misconduct: making fraudulent statements and employing fraudulent schemes, both in connection with the offering or sale of securities. Only a person who has "ultimate authority" for a misstatement may be held liable under the former prohibition. [1] The latter prohibition — enshrined in Section 17(a)(1) of the Securities Act of 1933 and SEC Rules 10b-5(a) and (c) — is often referred to as imposing "scheme liability" because such claims "make deceptive conduct actionable, as opposed to . . . deceptive statements." [2]

With its December 3, 2018, argument in *Lorenzo v. Securities and Exchange Commission*, the U.S. Supreme Court is now poised to resolve an issue at the intersection of these two prohibitions: may a securities fraud claim proceed under a "scheme liability" theory if the only alleged misconduct is fraudulent misstatements that the defendant himself never made?

The facts of *Lorenzo* are fairly straightforward. In February 2009, while he was the director of investment banking at Charles Vista, LLC ("Charles Vista"), Francis Lorenzo ("Lorenzo") emailed links to two SEC filings by Waste2Energy Holdings, Inc. ("W2E"), to various Charles Vista brokers. Lorenzo did not read the SEC filings in detail before doing so, and thus he was purportedly unaware that the filings disclosed that W2E's intangible assets had no value. Thereafter, "at the request of" his boss and a Charles Vista broker, Lorenzo separately emailed potential investors about investing in a W2E debenture offering. Lorenzo's emails made no mention of the devaluation of W2E's intangible assets.

The SEC subsequently began enforcement proceedings against both Lorenzo and his boss. After hearing testimony and other evidence, the SEC administrative law judge ("ALJ") concluded that Lorenzo did not read the portions of the emails that he sent at his boss's request and that Lorenzo "sent the emails without even thinking about the contents." Nevertheless, citing other evidence, the SEC ALJ ruled that Lorenzo had "willfully" violated the securities laws, both by making fraudulent misstatements and by participating in a scheme to defraud potential investors in connection with W2E's offering. The SEC itself subsequently confirmed the ALJ's ruling.

On appeal, the D.C. Circuit unanimously reversed the SEC's finding that Lorenzo was liable under a "fraudulent misstatements" theory, finding that, because he had no authority over the misstatements — which were instead sent at his boss's request — Lorenzo was not the "maker" of those statements under the Supreme Court's prior precedent in *Janus Capital Group, Inc. v. First Derivative Traders*. [3] But, by a 2-1 vote, the D.C. Circuit upheld the SEC's sanctions against Lorenzo on the ground that Lorenzo was liable under a "scheme liability" theory. [4]

The D.C. Circuit's decision exacerbated an existing split among the circuit courts of appeal over how to interpret the Supreme Court's decision in *Janus*. Since 2005, each of the Second, Eighth, and Ninth Circuits has held that

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fraudulent misstatements, standing alone, cannot form the basis for "scheme liability" under the federal securities laws in light of *Janus*. [5] But, the Eleventh and D.C. Circuits have both held otherwise, concluding that *Janus* did not expressly address scheme liability and, therefore, that mere misstatements may be sufficient, without more, to establish such liability. [6]

The Supreme Court will presumably try to resolve this circuit split by deciding, among other things, how far its *Janus* precedent extends and whether the Court should revisit — or reaffirm — its longstanding precedent, eliminating secondary, aiding-and-abetting liability in private securities fraud litigation, which the *Lorenzo* petitioners have emphasized will be weakened if the D.C. Circuit's decision is affirmed. [7] At oral arguments on December 3, 2018, a number of Supreme Court Justices — including Justices Alito, Kagan, and Sotomayor — expressed sympathy for the SEC's position, noting that Lorenzo's email seemed to fall squarely within the definition of "scheme liability." [8] Other justices expressed skepticism, however, with Chief Justice Roberts in particular expressing concern that a decision for the SEC in this case could essentially nullify the Court's decision in *Janus*.

The Supreme Court's decision is anticipated sometime before July 2019. In its ruling, the Supreme Court may determine, perhaps once and for all, whether the line between securities fraud claims based on fraudulent statements and those based on fraudulent schemes is a bright one or a blurry one.

NOTES

[1] *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

[2] *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 643 n.29 (3d Cir. 2011), *abrogated on other grounds by Amgen Inc. v. Connecticut Ret. Plans and Trust Funds*, 568 U.S. 455 (2013).

[3] *Lorenzo v. SEC*, 872 F.3d 578, 586-88 (D.C. Cir. 2017) (citing *Janus*, 564 U.S. at 142).

[4] *Lorenzo*, 872 F.3d at 588-96. Then-Judge, and now Justice, Brett Kavanaugh was the lone dissenter at the D.C. Circuit and has recused himself from hearing the appeal now before the U.S. Supreme Court. *Id.* at 596-602.

[5] *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005), *and Desai v. Deutsche Bank Sec., Ltd.*, 573 F.3d 931, 939-41 (9th Cir. 2009), *and WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011) ("Courts have generally held that a [scheme liability] claim cannot be premised on the alleged misrepresentations or omissions that form the basis of a [fraudulent misstatements] claim."), *and Public Pension Fund Group v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012) ("We join the Second and Ninth Circuits in recognizing a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under [SEC] Rule 10b-5(b).").

[6] *See SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 796 (11th Cir. 2015) (citing another case for the proposition that "*Janus* does not extend to claims based on schemes to defraud"); *SEC v. Monterosso*, 756 F.3d 1326, 1334 (11th Cir. 2014) ("*Janus* only discussed what it means to 'make' a statement for purposes of Rule 10b-5(b) and did not concern [scheme liability under] section 17(a)(1) [of the Securities Act of 1933] or [SEC] Rule 10b-5(a) or (c)."); *Lorenzo*, 872 F.3d at 592 (D.C. Cir. 2017) ("[A] number of decisions have held that securities-fraud allegations involving misstatements can give rise to liability under related provisions even if the conduct in

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question does not amount to 'making' a statement under *Janus* . . . We reach the same conclusion here with respect to the role played by Lorenzo . . . .").

[7] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

[8] Notably, Lorenzo did not challenge the SEC's finding of scienter at the Supreme Court.

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