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Supreme Court Expands the Scope of Potential Liability for Secondary Actors in Private Actions for Securities Fraud

by James J. Boland

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

The Supreme Court's holding in *Lorenzo* significantly increases the potential liability for secondary actors in private actions under the federal securities laws. Persons who participate in some way in a false statement made by another, may now face liability for their conduct, provided they act with the requisite knowledge or intent.

On March 27, 2019, the United States Supreme Court held that persons who do not themselves make false or misleading statements in connection with the purchase or sale of securities can be primarily liable for those statements in private securities fraud actions if they knowingly participate in disseminating them. *Lorenzo v. Securities and Exchange Commission*, 587 U.S. ___ (2019).

Securities and Exchange Commission Rule 10b-5, promulgated under Section 10(b) of the Securities and Exchange Act, 17 U.S.C. 78(j)(b), makes it unlawful to, among other things, "make any untrue statement of a material fact … in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(b). In *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), the Supreme Court held that only persons who "make" statements may be liable under this rule, and that for purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, its content, and whether and how the statement is communicated. Because there is no private right of action under Section 10(b) or Rule 10b-5 for aiding and abetting, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), the Court held in *Janus* that secondary actors who merely assist a primary violation – e.g., by preparing or disseminating a false statement made by someone else – cannot be liable in a private action under Rule 10b-5(b).

In *Lorenzo*, the SEC sanctioned Francis Lorenzo, an investment bank director, for having duped investors after he sent emails seeking investors for a startup company's debt offering even though he knew its energy-from-waste technology did not work. The SEC found Lorenzo liable in a scheme to defraud investors even though did not personally make the fraudulent statements in the emails he sent.

"Lorenzo significantly increases the potential liability for secondary actors in private actions under the federal securities laws. Persons, such as lower level company employees following the directions of superiors, who participate in some way in a false statement made by another, may now face liability for their conduct, provided they act with the requisite knowledge or intent."

The SEC fined Lorenzo $15,000 and barred him from working in the securities industry for life. Lorenzo appealed to the U.S. Court of Appeals for the D.C. Circuit. The D.C. Circuit held that in light of *Janus*, only the "maker" of a statement is liable for its falsity under SEC Rule 10b-5(b), Lorenzo could not be charged with "making" false statements under Rule 10b-5(b) because his supervisor asked Lorenzo to send the emails, supplied the central content of the emails, and approved the emails for distribution. Lorenzo's supervisor was therefore the "maker" of those false statements. Even so, the D.C. Circuit sustained the SEC's finding that by knowingly disseminating false information to prospective investors, Lorenzo violated other subsections of Rule 10b-5.

The Supreme Court affirmed and Justice Stephen Breyer wrote for the majority that "Congress intended to root out all manner of fraud in the securities industry. And it gave to the commission the tools to accomplish that job." Although a secondary actor could not be primarily liable for making a false statement under Rule 10b-5(b), the actor could be primarily liable under other provisions of the rule and the securities laws. Specifically the Court held that a person who knowingly disseminates a false statement could be primarily liable for employing a "device, scheme or artifice to defraud" in violation of Section 10(b), Rule 10b-5(a) and Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77q(a)(1), or engaging in an "act, practice, or course of business which operates or would operate as a fraud or deceit," in violation of Rule 10b-5(c).

Lorenzo significantly increases the potential liability for secondary actors in private actions under the federal securities laws. Persons, such as lower level company employees following the directions of superiors, who participate in some way in a false statement made by another, may now face liability for their conduct, provided they act with the requisite knowledge or intent.

To learn more about how this could affect you and your company, contact James Boland at (312) 360-6548.

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