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Client Alert

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U.S. Supreme Court Decision May Limit Scope of Persons Who Can Be Primarily Liable for Securities Fraud Under Rule 10b-5

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The Supreme Court's June 13, 2011, decision in *Janus Capital Group, Inc. v. First Derivative Traders* may provide defendants with additional ammunition in securities class action lawsuits by limiting the scope of persons who can be primarily liable for securities fraud under SEC Rule 10b-5. 17 CFR § 240.10b-5. Rule 10b-5 makes it unlawful for "any person, directly or indirectly . . . [t]o make any untrue statement of material fact" in connection with the purchase or sale of a security. The question presented in *Janus* was who can be considered the "maker" of a statement under Rule 10b-5. In a divided 5-4 decision authored by Justice Clarence Thomas, the Court ruled that only "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it" can "make" a statement, and that persons who merely participate in the drafting of a false statement are not "makers" of the statement who can be primarily liable under Rule 10b-5.

The Decision

Janus involved a class action suit against Janus Capital Management LLC (Janus Management) and its publicly-traded parent, Janus Capital Group, Inc. (Janus Capital) brought by shareholders of Janus Capital. Janus Management served as an investment advisor and administrator for mutual funds operated by Janus Investment Fund (the "Janus Fund"), which was also within the Janus Capital family of entities. The Janus Fund and Janus Management are separate legal entities, but all officers of the Janus Fund were also officers of Janus Management. Janus Capital's share price fell almost 25% following the filing of a complaint by the New York Attorney General alleging Janus Capital and Janus Management permitted market timing in several Janus Funds. The plaintiff shareholders of Janus Capital brought suit to recover damages from the price drop, alleging they were misled by the mutual funds' prospectuses false representations that Janus Management would take steps to curb market timing in the funds. The plaintiffs alleged that Janus Management and Janus Capital had "made" the allegedly false statements in the prospectuses even though the Janus Fund issued them. No statements in the prospectuses were attributed to Janus Management or Janus Capital.

The District Court dismissed the plaintiffs' complaint for failure to state a claim. The United States Court of Appeals for the Fourth Circuit reversed, holding that "by participating in the writing and dissemination of the prospectuses," Janus Management had "made the misleading statements contained in the documents," and could therefore be held liable under Rule 10b-5. (The Fourth Circuit reached the same conclusion as to Janus Capital but also found that investors would not have relied on any statements made by Janus Capital.) The Supreme Court reversed the Fourth Circuit's holding concerning Janus Management. The Court held that Janus Management's mere participation in drafting the prospectuses did not mean that Janus Management had "made" the statements in those prospectuses because the Janus Fund and its Board of Trustees retained ultimate authority and control over the prospectuses, and because none of the statements were attributed to Janus Management. The Court analogized Janus Management to a speechwriter who ultimately cannot control the words uttered by the speech maker, reasoning that "without control" over the content of a statement, a "person or entity can merely suggest what to say, not 'make' a statement in its own right."

The majority reasoned that its decision in *Janus* followed from *Central Bank of Denver, N. A.* v. *First Interstate Bank of Denver*, which ruled that no private right of action exists for aiding and abetting violations of Rule 10b-5, because "[i]f persons or entities without control over the content of a statement could be considered primary violators who 'made' the statement, then aiders and abettors would be almost nonexistent." The Court also found support for its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, which held that Rule 10b-5 liability does not extend to third parties who merely engage in deceptive transactions with the issuers, even when information about those transactions is later incorporated into the issuer's false public statements. *Janus* is therefore another example of the Supreme Court's refusal to expand Rule 10b-5 liability to secondary actors—*i.e.*, those who work with or advise issuers—for false statements made by issuers. The Court also re-affirmed that secondary actors can be found to have indirectly "made" a statement only if the statement is attributed to them at the time the statement is made. As the Court indicated, even attribution is not necessarily enough, and "more may be required." *Janus* thus confirms that outside professionals will not have Rule 10b-5 liability for their clients' statements absent attribution.

As Justice Breyer argued in a dissent joined by Justices Ginsburg, Sotomayor and Kagan, however, *Janus* arguably places new limitations on the enforcement of Rule 10b-5 by private plaintiffs against primary actors. The majority did not limit its rule concerning "ultimate authority" to cases involving secondary actors generally, or to mutual funds advisers in particular. By prohibiting the imposition of Rule 10b-5 liability on all but those with "ultimate authority" over the issuance of a corporate statement, *Janus* may provide corporate officials, especially members of management, with a powerful defense to securities class action lawsuits alleging violations of Rule 10b-5.

Implications

Prior to *Janus*, federal courts applied nominally different tests to determine whether a secondary actor had "made" a false statement, such as whether the person "substantially participated" in drafting the statement, was "intimately involved with" the statement's preparation, or had "materially assisted with" making the statement. *Janus* appears to do away with those inquiries. Mere participation in or involvement with the drafting of a corporate statement is no longer a sufficient basis on which to allege that a defendant "made" that statement. The Court also indicated that "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed," which may leave room for plaintiffs to argue that attribution of a statement to an individual is a proxy for that person's "ultimate authority"

over the statement. In these respects, *Janus* is likely to set off a wave of lower federal court decisions concerning who within a corporation has "ultimate authority" for allegedly false statements contained in public SEC filings and similar public disclosures, and what plaintiffs must allege and ultimately prove to make that showing. In his dissent, Justice Breyer expressed fear that the rule announced by the majority was so broad that, at least in circumstances where "guilty management writes a prospectus (for the board) containing materially false statements and fools the board and public into believing they are true," *no one* will have Rule 10b-5 liability for corporation's misleading statement. Whether Justice Breyer's concern proves prescient will depend on how expansively the lower federal courts interpret and apply *Janus* in the coming years.

Janus will also likely narrow the application of the controversial "corporate/collective scienter" doctrine, which securities plaintiffs have attempted to use to expand the liability of issuers for the fraudulent acts of non-executive level employees. After *Janus*, the focus should only be on the state of mind of the corporate officials who had the "ultimate authority" for the statement, rather than all employees who furnished information or language for the statement.

Similarly, by narrowing the circle of statement "makers" who can be directly liable, *Janus* should also reduce the scope of "controlling person" liability faced by issuers and their directors and officers under Section 20(a) of the Securities and Exchange Act of 1934. This provision has long been used to pursue claims against corporate officials who did not make an allegedly misleading statement but "controlled" someone who did. Post-*Janus*, senior management and/or the board of directors may face less risk of controlling person liability for acts of lower level employees who provided false information used in a corporate statement, but did not "make" the statement because of their lack of "ultimate authority" over the statement.

Thus, although the ultimate implications of *Janus* are not yet clear, the decision will be of significant importance in determining the scope of persons who can be liable in securities fraud cases, and continues the recent trend of high court decisions narrowing private actions under the federal securities laws.