Securities Liabilities Of Attorneys, CPA's And Other Professionals

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LIABILITY OF COLLATERAL PARTICIPANTS AFTER *CENTRAL BANK OF DENVER, N.A., STONERIDGE INVESTMENT PARTNERS, L.L.C.* AND *JANUS CAPITAL GROUP, INC.*

The current era is widely referred to as one of contraction with respect to the private right of action under Rule 10b-5.[1] Three decisions in particular have contributed to the narrowing of the 10b-5 remedy, namely:

1) *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S.Ct. 1439 (1994) - There exists no aiding and abetting liability with respect to actions under Rule 10b-5.

2) *Stoneridge Investments Partners, LLC v. Scientific-Atlanta, Inc.,* 128 S. Ct. 761 (2008) - For actions under the scheme, device artifice prong of Rule 10b-5, the plaintiff must be aware of and rely on the defendant's scheme.

3) *Janus Capital Group, Inc. v. First Derivative Traders,* 131 S.Ct. 2296 (2011) - For actions under the misrepresentation prong of Rule 10b-5 it is the "maker" of a misleading statement who may be liable, and "maker" status is restrictively defined as the person or entity with "ultimate authority over the statement.

Beyond these three decisions, contraction of the 10b-5 private right of action is evident, from a historical perspective, with respect to treatment of the action since its recognition by the United States Supreme Court in 1971:

1964 *J.I. Case Company v. Borak,* 377 U.S. 426 (1964) – In *Borak,* the United States Supreme Court held that shareholders have a private cause of action for violations of the proxy rules.

1971 *Superintendent of Insurance of State of New York v. Bankers' Life & Casualty Company,* 404 U.S. 6 (1971) – In *Superintendent of Insurance of State of New York v. Bankers' Life & Casualty Company,* the United States Supreme Court held that there is a private cause of action for violation of Rule 10b-5. Lower courts had been implying such a private cause of action for years before the United States Supreme Court came to this conclusion.

1975 *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 737 (1975). – In *Blue Chip Stamps,* the United States Supreme Court stated:

[w]hen we deal with private actions under Rule 10b-5, ***we deal with a judicial oak which has grown from little more than a legislative acorn.*** Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it…But it would be disingenuous to suggest that either Congress in 1934 or the Securities & Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5... (emphasis supplied).

1976 *Ernst & Ernst v. Hochfelder,* 96 S. Ct. 1375 (1976). – The United States Supreme Court in *Hochfelder* held that allegations of negligence are

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1 Piper, "A Fatal Flaw: The Ninth Circuit Further Restricts Liability in 10b-5 private security fraud cases in *Reese v. BP,"* 53 BCL Rev. E-Supplement 101 (2012); Seitz, "Securities Law – The Implied Right Of Action Under Rule 10b-5 does not extend liability to aiders and abettors. *Janus Capital Group v. First Derivative Traders,* 131 S. Ct. 2296 (2011). Rule 10b-5 provides:
It shall be unlawful for any person, directly or **indirectly** by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
(1) to employ any **device, scheme, or artifice** to defraud.
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

insufficient to establish an action under Rule 10b-5. The Supreme Court in *Hochfelder* also reserved the issue whether there exists an action for aiding and abetting under Rule 10b-5 stating:

In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under Section 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the Section and the Rule, nor the elements necessary to establish such a cause of action. 96 S. Ct. at 1380 n. 7.

1977 *Santa Fe Industries, Inc. v. Green,* 97 S. Ct. 1292 (1977). – In *Santa Fe Industries, Inc.,* the United States Supreme Court held that allegations of breach of fiduciary duty are insufficient to support an action under Rule 10b-5.

1983 *Herman & McClean v. Huddleston,* 459 U.S. 375, 379 n. 5 (1983). – In *Huddleston,* the United States Supreme Court again reserved the issue whether there exists aiding and abetting liability under Rule 10b-5 stating:

[t]he trial court also found that Herman & McClean had aided and abetted violations of Section 10(b). While several courts of appeal have permitted aider and abettor liability, . . . we specifically reserved this issue in *Ernst & Ernst v. Hochfelder, supra.* . . .

1994 *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S.Ct. 1439 (1994). – In *Central Bank of Denver, N.A.,* the United States Supreme Court held that there is no private cause of action for aiding and abetting under Rule 10b-5. Justice Kennedy authored the Opinion of the Court and was joined by Justices Renquist, O'Connor, Scalia, and Thomas. Justice Stevens dissented, joined by Justices Blackmun, Souter, and Ginsburg.

1995 *Gustafson v. Alloyd Company, Inc.,* 513 U.S. 561 (1995). – In *Gustafson,* the Untied States Supreme Court narrowed the scope of Section 12(2) of the 1933 Act. Section 12(2) creates a cause of action for rescission against any person who "offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact. . . ." In *Gustafson,* the United States Supreme Court held that "[t]he term 'prospectus' relates to public offerings by issuers and their controlling shareholders. . ." not to private agreements to sell securities.

2008 *Stoneridge Investments Partners, LLC v. Scientific-Atlanta, Inc.,* 128 S. Ct. 761 (2008). In *Stoneridge Investment Partners,* the United States Supreme Court held that the plaintiffs failed to establish reliance. The Court explained that "[r]espondents had no duty to disclose; and their deceptive acts were not communicated over to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability. ***In order to establish a private action under Rule 10b-5, the plaintiff must rely on the defendant's participation in the scheme."*** Although plaintiff's alleged "scheme liability" they did not in fact rely on the defendants' deceptive conduct. The defendants were not liable as primary actors under Rule 10b-5. (emphasis supplied)

Before *Stoneridge Investment Partners,* there was a split in the circuits as to whether a claim in primary liability may be stated against a person who had no duty to disclose and who made no misleading statement. The United States Ninth Circuit Court of Appeal had ruled that it was possible, under certain circumstances, for liability to be found under this scenario. *Simpson v. AOL Time Warner, Inc.,* 452 F.3d 1040, 1048 (9th Cir. 2006). The United States Fifth and Eighth Circuit Courts of Appeal had concluded that no 10b-5 claim is stated under this scenario. *In Re Charter Communication, Inc. Securities Litigation,* 443 F.3d 987, 991 (8th Cir. 2006); *Regents of the University of California v. Credit Suisse First Boston (USA, Inc.),* 482 F.3d 372, 388 (5th Cir. 2007).

6/13/11*Janus Capital Group, Inc. v. First Derivative Traders,* 131 S.Ct. 2296 (2011). The United States Supreme Court held that a defendant could not be liable under Rule 10b-5 because it was not the maker of the allegedly misleading statement. The "maker" of an allegedly misleading statement is "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." 131 S.Ct. at 2302. A fund manager which participated in the creation of offering materials on behalf of an investment fund which was a separate legal entity was not the maker of statements contained in the fund's offering materials. The investment manager therefore was not liable under Rule 10(b)-5.

The trilogy of cases on which this paper focuses, *Central Bank of Denver, N.A., Stoneridge Investments Partners, LLC,* and *Janus Capital Group, Inc.,* revolve around the scope of the implied cause of action and the universe of defendants which may be reached through that action. It is important to remember, however, that plaintiffs bringing an action under Rule 10b-5 must satisfy certain basic requirements, and the failure to satisfy any element requires dismissal. The elements of a 10b-5 action include:

(1) The purchaser seller requirement - The plaintiff must be a purchaser or seller of a security. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975);

(2) The "in connection with" requirement - The misrepresentation, omission, or deceptive conduct must be "in connection with" the purchase or sale of a security. *SEC v. Texas Gulf Sulphur Company,* 401 F.2d 833, 860-61 (2nd Cir. 1968);

(3) The scienter requirement -The defendant must have scienter beyond mere negligence. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 199 (1976);

(4) The reliance requirement - The plaintiff must rely on the misrepresentation, omission, or deceptive practice. *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 153-54 (1972);

(5) The materiality requirement - The misrepresentation, omission, or deceptive practice must be material. *SEC v. Texas Gulf Sulphur,* 401 F.2d 833 (2nd Cir. 1968), *cert denied sub-nom, Coates v. SEC,* 394 U.S. 976 (1969); see also *TSC Industries v. Northway,* 426 U.S. 438 (1976);

(6) The causation requirement - The plaintiff must prove that the defendant's violation proximately caused economic loss. *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb, Inc.,* 967 F.2d 742, 747, (2d Cir. N.Y. 1992); *Schlick v. Penn-Dixie Cement Corp.,* 507 F.2d 374, 380, (2d Cir. N.Y. 1974), *cert. denied* 421 U.S. 976, 44 L. Ed. 2d 467, 95 S. Ct. 1976; *McCoy v. Goldberg,* 883 F. Supp. 927, 939, (S.D.N.Y. 1995); *Commercial Union Assurance Co. PLC v. Milken,* 17 F.3d 608, 613, (2d Cir. N.Y. 1994), partial summ. judgment granted 848 F. Supp. 1119 (S.D.N.Y.), later proceeding 155 F.R.D. 71 (S.D.N.Y.), later proceeding 170 B.R. 61 (S.D.N.Y.) and mot. granted 882 F. Supp. 1371, (S.D.N.Y.), later proceeding 888 F. Supp. 551, (S.D.N.Y.), costs/fees proceeding 913 F. Supp. 256 (S.D.N.Y.) and cert. denied 513 U.S. 873, 130 L. Ed. 2d 130, 115 S. Ct. 198.

(7) The interstate commerce requirement - The fraud must be by a means of interstate commerce.

Central Bank of Denver, N.A., Stoneridge Investment Partners, LLC, and *Janus Capital Group, Inc.,* all adopted a textual analysis of Rule 10b-5. For instance, the United States Supreme Court in *Central Bank of Denver, N A,* explained that it created a remedy for private litigants by implying a cause of action; however, that cause of action, according to the Court, is limited by the text of the Rule, which does not include liability for aiding and abetting. The three cases have significantly changed the available remedies against collateral participants in securities transactions.

The Context of *Janus Capital Group, Inc. v. First Derivative Traders,* 130 S. Ct. 3499 (June 28, 2010)

After *Central Bank* eliminated aiding and abetting as a theory in implied 10b-5 actions, plaintiffs attempted to recast their allegations to describe as primary violators those who previously would have been sued as aiders and abettors. Before *Janus Capital Group*, *Inc.* the courts dealt with such allegations of primary liability in different ways.

Certain courts adopted a "bright line test." Liability under the bright-line test required a showing of two elements: first, that the defendant "actually [made] a false or misleading statement," and second, that the statement (or omission) was "attributed to that specific actor at the time of public dissemination." *Wright v. Ernst & Young LLP,* 152 F.3d 169,175 (2d Cir. 1998).[2] Theoretically, utilization of these two requirements drew a "bright line" between primary and secondary liability. Using the "bright line" test, the *Wright* court found that a CPA was not liable.

In *Wright,* the CPA had approved financial information that was included in a client's press release. However, the press release stated that the information was unaudited. According to the court, there was insufficient ***attribution*** to hold the CPA responsible. Variations of the "bright line" test were adopted by the United States Fifth Circuit

2 *S.E.C. v. Lucent Technologies, Inc.,* 363 F. Supp. 2d 708 (D.N.J. 2005) (under the "bright-line test the court declined to hold the CFO liable because the material misstatements or omissions were not ***attributable*** to her);*Shapiro v. Cantor,* 123 F.3d 717, 720 (2d Cir. 1997) ("if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be it is not enough to trigger liability"). The Second Circuit Court of Appeal's approach required that an individual actually make a false or misleading statement and that the statement be **attributed** to the individual. *Wright v. Ernst & Young, LLC,* 152 F.3d 169 (2nd Cir. 1998); *Lattanzio v. Deloitte & Touche, LLP,* 476 F.3d 147, 153 (2nd Cir. 2007); *Shapiro v. Cantor,* 123 F.3d 717 (2nd Cir. 1997).

Court of Appeal,[3] Eighth Circuit Court of Appeal,[4] Eleventh Circuit Court of Appeal and Tenth Circuit Court of Appeal.[5]

The Substantial Participation Test

The United States Fourth Circuit Court of Appeal created a different test to determine whether a defendant "made" an allegedly misleading statement. It adopted a test which came to be known as the "substantial participation" test, finding that "the **attribution** determination is properly made on a case by case basis by considering whether interested investors would **attribute** to the defendant a substantial role in preparing or approving the allegedly misleading statement." *Mutual Funds Inv. Litigation,* 566 F.3d 111, 124 (4th Cir. 2009) *cert. granted sub nom Janus Capital Group, Inc. v. First Derivative Traders,* 130 S.Ct. 3499 (June 28, 2010). The substantial participation test had also been employed by the United States First Circuit Court of Appeal. *S.E.C. v. Tambone,* 597 F.3d 436, 456 (1st Cir. 2010).

The Creation Test Advocated by the SEC

The SEC favored a "creation" standard between the bright line and the substantial participation tests. Under the creation test, a defendant would be liable when he creates a misrepresentation even if it is ultimately published by others and not publicly attributed to the defendant. *In Re Enron Corp. Securities Derivative and ERISA Litigation,* 235 F. Supp. 2d 549, 586-91 (S.D. Tex. 2002).

Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 180 L. Ed. 2d 166 (2011)

Facts of *Janus Capital Group, Inc.* –The Court considered whether an investment advisor (Manager) of a mutual fund (Fund) could be held liable for participating in the writing and dissemination of allegedly false statements in prospectuses for shares of the Fund where the Fund was a separate legal entity. The plaintiffs also sued the parent (Group) of the investment advisor (Manager).

Though it was alleged that the misleading statements were contained in offering materials for Fund, it is not investors in Fund who were suing. Investors in Fund had already recovered. The chain of events by which shareholders of Group came to sue on account of misleading statements in materials soliciting investors for Fund is attenuated:

- New York Attorney General sues Group and Manager.

- Publicity from lawsuit causes investors to exit Fund.

- Fund loses value.

- Fund ends up paying Manager less because Manager's compensation is based on the value of Fund. A larger portion of Group's income is from fees paid by Manager. Manger is earning less because of diminished receipts from Fund. Management begins to send less money through to Group.

- The price of Group's stock decreases.

Group's shareholder files suit.

Janus Capital Group, Inc. – Players

FIRST DERIVATIVE
(Plaintiff)
Owns Shares of Group

GROUP
(Defendant)

3 *Regents of University of California v. Credit Suisse First Boston USA, Inc.,* 482 F.3d 372, 386-90 (5th Cir. 2007); *Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.,* 625 F.3d 185, 195 (5th Cir. 2010) ("The **attribution** requirement that we adopt today makes clear the boundary between primary violators-who are open to liability in private securities actions-and aiders and abettors, to whom the private right of action under section 10(b) does not extend."). The United States Seventh Circuit Court of Appeal likewise required that the attorney prepare a signed Opinion for the use of the plaintiff. *Baker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490, 493 (7th Cir. 1986) (law firm not liable as its name did not appear on documents); *Renovitch v. Kaufman,* 905 F.2d 1040 (7th Cir. 1990) (attorney did not prepare offering statement).

4 *In Re Charter Communications, Inc. Securities Litigation,* 443 F.3d 987, 992 (8th Cir. 2006).

5 *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1226, 1227, (10th Cir. 1996) ("Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver,* we conclude that in order for [defendants] to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement.""). In *Anixter v. Home-Stake Production Company,* 77 F.3d 1215, 1226, 33 Fed. R. Serv. 3d 1389 (10th Cir. 1996), the United States Tenth Circuit Court of Appeal found that an accountant could be held liable with respect to his involvement in preparing several documents released to the public such as registration statements, opinion letters, and prospectuses'.

The United States Tenth Circuit Court of Appeal did not required public attribution of the statement to the defendant as part of the bright line test. *SEC v. Wolfson,* 539 F.3d 1249, 1259-60 (10th Cir. 2008) ("we have never adopted an attribution requirement in a private securities case, let alone in a Commission enforcement action").

Owns Management
Created Fund

MANAGEMENT
(Defendant)

FUND
(FUND Is Not A Defendant!)

Procedural Posture – A class of stockholders filed a private action under rule 10(b)(5). The U.S. District Court for the District of Maryland dismissed the complaint, and the shareholders appealed. The U.S. Court of Appeals for the Fourth Circuit reversed and remanded. Certiorari was granted, and the Supreme Court of the United States reversed the Fourth Circuit.

Holding – The Supreme Court further limited the scope of primary liability under the federal securities laws. The Court held that only the party "with ultimate authority over the statement, including its content and whether and how to communicate it," makes a statement for purposes of § 10(b). The Court adopted a very limited interpretation of the verb "to make," holding that "[o]ne 'makes' a statement by stating it ... it is the speaker who takes credit—or blame—for what is ultimately said."

The *Janus Capital Group, Inc.* Court rejected the substantial participation test employed by the United States Fourth Circuit Court of Appeal. The Supreme Court held that a party-defendant must make a material misrepresentation to be liable and that the maker is the entity with ultimate authority over the statement. The Court explained that:

[t]his rule might be best exemplified by the relationship between a speech writer and a speaker. Even when a speech writer drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes the credit – or the blame – for what is ultimately said.

Id. at 2302.

Publishing The Statement Of Another

Significantly, Justice Thomas, writing for the majority in *Janus Capital Group Inc.,* stated that "[o]ne who ... publishes a statement on behalf of another is not its maker." *Id.* He added explanation about defendant Manager placing allegedly misleading statements on the Manager website, stating:

that JCM[Manager] provided access to Janus Investment Fund's prospectuses
on its Web site is also not a basis for liability. Merely hosting a document on a
Web site does not indicate that the hosting entity adopts the document as its
own statement or exercises control over its content.

Id. at 2304, n. 12.[6]

Attribution

Regarding attribution, the *Janus Capital Group Inc.* Court stated:" .. [a]nd 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. This rule might best be exemplified by the relationship between a speechwriter and a speaker..." *Id.* at 2302. Thus, attribution is evidence that the attributed party is the maker.

Of course this begs the question. Courts attempting to apply the *Janus Capital Group, Inc.* decision will need to define what constitutes "attribution." Defendants to whom statements are not expressly attributed will surely contend that surrounding circumstances are insufficient to amount to implied attribution while plaintiffs will no doubt argue that such circumstances constitute attribution on an implied basis.

Multiple Makers

The United States Supreme Court hinted in *Janus Capital Group Inc.* that it may in the future find that a statement may have only one maker. It stated "... 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." *Id.* It continued stating," [w]e draw a clean line between the two—the maker is the person or entity with ultimate authority over a statement and others are not." *Id.* at n.6.(emphasis supplied).

The Aftermath of *Janus*

The decision of the Court in *Janus Capital Group, Inc.* produced several effects in the realm of 10b-5 securities fraud litigation. Many litigants searched for ways to avoid application of *Janus Capital Group Inc.*

The Advent Of Litigation Over *Devices, Schemes, Artifices,* and *Deceits*

Before *Janus Capital Group Inc.*, most 10b-5 litigation focused on the portion of Rule 10b-5 which

6 With this reasoning, the Court was adopting the rationale of cases such as *S.E.C. v. Tambone,* 597 F.3d 436 (1st Cir. 2010). In *Tambone,* the SEC brought a 10(b)(5) securities fraud action against officers of a primary underwriter for a group of mutual funds. The United States District Court for the District of Massachusetts granted defendants' motion to dismiss. The U.S. Court of Appeals for the First Circuit reversed and remanded. This ruling was made following a granting of *en banc* review. The First Circuit rejected the S.E.C.'s theory that dissemination of a statement constitutes "making" that statement under Rule 10b-5.

makes it unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." After *Janus Capital Group Inc.*'s limitation of misrepresentation liability under Rule 10b-5 to the "maker" of the misleading statement, together with its restrictive definition of the "maker," litigants began to structure their cases to fit into aspects of Rule 10b-5 other than the "untrue statement of material fact" prong. Rule 10b-5's prohibition of "devices," "schemes," "artifices," and "deceits" became a major focus of litigants. The portion of the Rule now in vogue with plaintiffs is as follows:

It shall be unlawful for any person, directly or **indirectly** by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any **device, scheme, or artifice** to defraud.... or

(3) to engage in any act, practice, or course of business which operates or would operate as a **fraud or deceit** upon any person, in connection with the purchase or sale of any security.

(emphasis supplied).

The court in *Lopes v. Viera* found that the Rule's prohibition against devices, schemes, and artifices was available to litigants independent of the "untrue statement" aspect of the Rule. 2012 WL 691665 (E.D. Cal. Mar. 2, 2012) The *Lopes* approach permits plaintiffs to name defendants who do not qualify as "makers" under the rule of *Janus Capital Group Inc,* and thereby avoid the stringent requirements imposed by it.

The *Lopes* decision arose in the context of a motion in *limine*. The defendant claimed that allegedly misleading statements were inadmissible as to him on the ground that he did not "make" the statements under standards articulated in *Janus Capital Group Inc.* The court denied the motion in *limine*, explaining that the misleading statements were admissible with respect to plaintiffs' claims of "scheme" liability under Rule 10b-5, even if the defendant was not a "maker" under *Janus Capital Group, Inc.*[7]

The *Lopes* plaintiffs were shareholders in Valley Gold Corporation. They alleged that defendant Viera induced them, individually and through Central Valley Dairymen, to invest in the formation of Valley Gold. They also alleged that Viera induced them to supply millions of dollars worth of milk to Valley Gold, for which they were never paid. Plaintiffs asserted that defendant caused them to believe, fraudulently, that Valley Gold would manufacture cheese for which there was a ready market. Viera was one of the principal organizers of Valley Gold and was the chief executive officer of Central Valley Dairymen. Central Valley Dairymen had been dismissed. Viera sought "an order prohibiting plaintiffs from presenting evidence or argument that he violated federal or state securities laws…related to the statements made in the offering memorandum for Valley Gold." Defendant's motion in *limine* attempted to use *Janus Capital Group Inc* to preclude plaintiffs from introducing evidence or arguments that he made a misrepresentation in violation of federal or state securities laws.

The court limited *Janus Capital Group Inc's* application to the misstatement aspect of Rule 10b-5 concluding that it had no application to the "scheme" aspect of that Rule. The court explained:

The [*Janus]* Court further clarified "as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient."…The [*Janus]* Court continued, "in this case, we need not define precisely what it means to communicate a 'made' statement indirectly because none of the statements in the prospectuses were attributed, explicitly or implicitly, to JCM. Without attribution, there is no indication that Janus Investment Fund was quoting or otherwise repeating a statement originally 'made' by JCM…More may be required to find that a person or entity made a statement indirectly, but attribution is necessary…Here, unlike in *Janus,* the offering statement specifically attributes information to defendant and specifically reports that the financial information provided in it, including the figures and

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7 The defendant in *Lopez v. Viera* lost on both his "untrue statement" and "device," "scheme," and "artifice" contentions. The court found that the defendant was a "maker" of the allegedly misleading statements explaining:

> The [*Janus]* Court further clarified "as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient." . . . The [*Janus]* Court continued, "in this case, we need not define precisely what it means to communicate a 'made' statement indirectly because none of the statements in the prospectuses were attributed, explicitly or implicitly, to JCM. Without attribution, there is no indication that Janus Investment Fund was quoting or otherwise repeating a statement originally 'made' by JCM. . . . More may be required to find that a person or entity made a statement indirectly, but attribution is necessary. . . . Here, unlike in *Janus,* the offering statement specifically attributes information to defendant and specifically reports that the financial information provided in it, including the figures and projections, were based upon information provided by Defendant and Land O'Lakes. . . . Given the explicit attribution to Defendant, *Janus* does not preclude liability based upon Defendant making an indirect statement to plaintiffs. . . .

The *Lopez v. Viera* court further concluded that even if the defendant were not a "maker" the statements would be admissible on the plaintiff's claim relating to "device," "scheme," or "artifice."

projections, were based upon information provided by Defendant and Land O'Lakes…Given the explicit attribution to Defendant, *Janus* does not preclude liability based upon Defendant making an indirect statement to plaintiffs…**In any event, under Rule 10b-5(a) and (c), "a defendant who uses a 'device, scheme, or artifice to defraud,' or who engages in 'any act, practice or course of business which operates or would operate as a fraud or deceit,' may be liable for securities fraud." . . . Generally, a claim asserting a fraudulent scheme "cannot be premised on the alleged misrepresentations or omissions that form the basis of a Rule 10b-5(b) claim.". . . However, a defendant may "be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations. . . . Here, plaintiffs allege that in addition to the alleged misrepresentations in the offering, Defendant committed other acts that comprised a "scheme" to defraud them. For example, plaintiff alleged that Defendant misrepresented the causes of Central Valley Dairymen's financial problems, the size and strength of the cheese and milk markets, and other misrepresentations related to the operations of Valley Gold that misstated the likelihood of Valley Gold's success. Thus, *Janus* would not preclude imposition of liability.**

Id. at *5-6 (emphasis supplied).

The court in *In Re Smith Barney Transfer Agent Litigation,* likewise found that the "scheme" and "device" aspects of the Rule were not restricted by the holding of the United States Supreme Court in *Janus Capital Group, Inc.* 2012 WL 3339098 (S.D.N.Y. Aug. 15, 2012). In *In Re Smith Barney,* the plaintiffs, investors in Smith Barney mutual funds, sued the funds' investment adviser and the adviser's CEO, alleging that the defendants concocted a fraudulent scheme to move transfer agent functions in-house without passing on savings created by the change. One of the defendants moved to dismiss pointing to the *Janus Capital Group, Inc.* decision. The court denied the motion in part because it found that *Janus Capital Group Inc.* did not apply to the "scheme" aspect of Rule 10b-5. The *Smith Barney* Court explained as follows:

B. *Deceptive Conduct*

Defendants next assert that Plaintiffs' scheme liability theory is improper because the scheme depended on misleading statements, rather than deceptive conduct. **Of course, "[c]onduct itself can be deceptive." *Stoneridge,* 552 U.S. at 158. Accordingly, parties may incur primary liability under Rule 10b–5(a) and (c) without making an "oral or written statement," and courts refer to such liability as "scheme liability."** *Stoneridge,* 552 U.S. at 158–59. Nevertheless, the three subsections of Rule 10b–5 are distinct, and courts must scrutinize pleadings to ensure that misrepresentation or omission claims do not proceed under the scheme liability rubric. "Courts have not allowed subsections (a) and (c) of Rule 10b–5 to be used as a 'back door into liability for those who help others make a false statement or omission in violation of subsection (b) of Rule 10b–5.' *SEC v. Kelly,* 817 F.Supp.2d 340, 343 (S.D.N.Y.2011) (quoting *In re Parmalat Sec. Litig.,* 376 F.Supp.2d 472, 503 (S.D.N.Y.2005)). Thus, where "the core misconduct alleged is in fact a misstatement, it [is] improper to impose primary liability ... by designating the alleged fraud a 'manipulative device' rather than a 'misstatement.' " *SEC v. KPMG LLP,* 412 F.Supp.2d 349, 377–78 (S.D.N.Y.2006). Rather, "[s]cheme liability under subsections (a) and (c) of Rule 10b–5 hinges on the performance of an inherently deceptive act that is distinct from an alleged misstatement." *Kelly,* 817 F.Supp.2d at 344; *see also WPP Lux. Gamma Three Sarl v. Spot Runner, Inc.,* 655 F.3d 1039, 1057 (9th Cir.2011) ("A defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b–5(a) and (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions."); *Pub. Pension Fund Grp. v. KV Pharm. Co.,* 679 F.3d 972, 987 (8th Cir.2012) (same).

Here, Plaintiffs allege that Defendants engaged in deceptive conduct separate from any alleged misstatements or omissions. . . . Accordingly, Plaintiffs' adequately allege that Defendants engaged in a deceptive scheme under section 10(b) and Rule 10b–5(a)and(c).

Id. (emphasis supplied).

Not all plaintiffs have been successful at circumventing the restrictions of *Janus Capital Group, Inc* by recasting their claims under the "scheme" liability aspects of Rule 10b-5(1) and(3). If the only devices, schemes or artifices involved in the matter are misleading statements, the weight of authority prohibits acceptance of the case under scheme liability. Certain courts have been quick to examine the essence of the plaintiffs' claims, recast claims mischaracterized as scheme cases to misrepresentation cases, and then dismiss the misrepresentation cases by applying *Janus*

Capital Group, Inc.

One decision which exemplifies such recharacterization is *In re Coinstar Inc. Sec. Litig.,* 2011 WL 4712206 (W.D. Wash. Oct. 6, 2011). Coinstar, Inc. and five individual Coinstar executives were sued by plaintiff Employees' Retirement System of the State of Rhode Island. The plaintiff alleged that the defendants provided misleading statements about expected revenues and failed to disclose risks while being aware of factors adversely affecting the business. Plaintiff purchased stock in Coinstar allegedly based on the defendants' misleading statements.

The *Coinstar* court found that three of the officers should be dismissed from the action because they did not make any of the allegedly misleading statements. While the Supreme Court in *Janus Capital Group, Inc.* considered whether a business entity could be held liable for a prospectus issued by a separate entity, the court found that the *Janus Capital Group, Inc.* analysis applies equally to whether the executives may be held liable for the misstatements of their co-defendants. The three officers did not violate Rule 10b-5 as "makers" of misleading statements.

The plaintiffs contended that in spite of the court's ruling that the defendants were not "makers," the defendants should nevertheless be held liable under the scheme of liability. The court rejected the plaintiffs' contention, ruling that the essence of the claim was one based on allegedly misleading statements, not one that arose from any scheme. The court held that the defendants were not proper 10b-5 defendants under a scheme theory. It explained:

Second, Kaplan, Rench and Smith [the Coinstar executives] are not liable under § 10b–5(a) or (c) of the Exchange Act. Under Rule 10b–5(a) or (c), i.e., scheme liability, a defendant who uses a "device, scheme, or artifice to defraud," or who engages in "any act, practice, or course of business which operates or would operate as a fraud or deceit," is liable for securities fraud. 17 C.F.R. § 240, Rule 10b–5. A plaintiff does not make out a scheme liability claim under Rule 10b–5(a) and (c) when the sole basis for such claims is alleged misrepresentations or omissions. *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.,* —— F.3d ——, 2011 WL 3673116 at *14 (9th Cir. Aug.23, 2011) (quoting *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 177 (2d Cir.2005)). Here, Plaintiff alleges Defendants "engaged in the preparation, creation, development, and dissemination of the false financial guidance and suppressed the revised internal forecast." (Pltf's Resp. Br. at 32.) At oral arguments, Plaintiff suggested the Defendants' mere attendance at the November conferences subjects them to liability. The Court finds Plaintiff's argument goes too far and declines to draw an inference of scheme liability based on attendance at a conference. Since the sole basis for Plaintiff's § 10b–5(a) or (c) against Kaplan, Rench, and Smith is based on allegations underpinning a § 10b–5(b) claim, the Court DISMISSES the scheme liability claims against Rench, Smith and Kaplan for failure to state a claim.

Id. at * 11.

Defendants faced with "scheme" liability claims may rely on cases such as *In re Coinstar Inc. Securities Litigation,* to contend that the claims are actually in the nature of misrepresentation claims and advocate for application of all *Janus Capital Group Inc.* restrictions.

Use Of A Failed Securities Claim As a RICO Predicate Act

The Private Securities Litigation Reform Act ("PSLRA") amended the RICO statute with a provision that provides that "no person may rely upon any conduct that would have been ***actionable*** as fraud in the purchase or sale of securities to establish a violation of Section 1962" (emphasis supplied).[8] Legislative history of the PSLRA RICO amendment indicates that the amendment is meant to remove securities fraud as an available RICO predicate act if the securities "offenses are based on conduct that would have been actionable as securities fraud." Senate Report No. 104-98,2 USCCAN 679, 698 (1995).

Ironically, in certain instances, deficient 10b-5 allegations may potentially be raised as RICO predicate acts precisely ***because*** they are deficient and therefore are not actionable under the securities laws. *See, e.g., Renner v. Chase Manhattan Bank,* 1999 WL 47239 (S.D. N.Y. 1999). In *Renner,* the court concluded that the securities fraud which the plaintiff alleged could potentially be utilized as RICO predicate acts because the conduct was not actionable as securities fraud. The court nevertheless dismissed the plaintiff's RICO claim under Federal Rule of Civil Procedure 12(b)(6) on grounds specific to the RICO statute.

The plaintiff in *Renner* had invented a snow clearing machine. He was involved with the defendants in an effort to manufacture and sell the invention. His complaint alleged 10(b)-5, RICO, and other violations. Plaintiff invested $3 million in an entity named Townsend Financial to facilitate

8 The PLSRA provides a "conviction exception" when the defendant has been convicted of the Securities Fraud Predicate Act. 1995 Amendments Pub. L. 104-67, Title 1 Section 107.

the project. The funds were placed in Townsend's Chase account. When Chase became concerned about Townsend's business practices, it forced Townsend to close its account. Funds were withdrawn by Townsend. Plaintiff requested but did not receive return of his funds and thereafter, plaintiff sued Chase and one of Chase's vice-presidents.

Chase moved to dismiss under Rule 12(b)(6). The plaintiff's aiding and abetting securities claims against Chase were dismissed based on *Central Bank.* Since the plaintiff's securities claim was not "actionable," the PSLRA prohibition was inapplicable and was not used by the court as a basis on which to dismiss the plaintiff's RICO claim. The court reasoned that "[u]nder *Central Bank,* secondary liability for "aiding and abetting" no longer is a basis for a § 10(b) claim…[a]ccordingly, plaintiff's claim under the securities laws would fail in any event as against these defendants." *Id.* at *3-4.

The *Renner* Court continued that "[b]ecause plaintiff's claim would not have been "actionable" against Chase under the securities law, the mere fact that plaintiff baselessly asserted it in his complaint would not bar a RICO claim against [sic] the Reform Act…" *Id.*[9]

Defendants facing RICO claims based on RICO securities fraud predicate acts should rely on the United States Second Circuit Court of Appeal's interpretation of the PLSRA Amendment in *MLSMK Investment Company v. J.P. Morgan Chase & Company,* 651 F.3d 268, 269 (2nd Cir. 2011). In *MLSMK Investment Company,* the Second Circuit held that the PLSRA amendment "bars a plaintiff from asserting a civil RICO claim premised upon . . . securities fraud . . . even where the plaintiff [can] not bring a private securities law claim against the same defendant." *Id.* at 280.

Several district courts have also held that the PLSRA Amendment eliminates securities predicate acts, even when the plaintiff has no actionable claim under the securities laws. *See, e.g., Fezzani v. Bear Stearns & Company,* 2005 WL 500377 (S.D. N.Y. 2005); *Thomas H. Lee Equity Fund v. L.P. Mayer Brown, Rowe & Maw LLP,* 612 F. Supp. 2d 261, 281 (S.D. N.Y. 2009); *Picard v. Kohn,* 2012 WL 566298 (S.D.N.Y. 2012) (following *MLSMA Investment Company).*

Plaintiffs attempting to escape the restrictions of *Central Bank of Denver, N.A., Stoneridge Investment Partners, LLC,* and *Janus Capital Group, Inc.* may plead RICO claims and argue that in the event their securities claims fail, those claims are not "actionable" for purposes of the PLSRA RICO Amendment. Relying on *Renner, OS Recovery, Inc.* and similar cases, such plaintiffs will contend that the RICO Amendment does not bar a RICO claim based on *their* securities predicate acts because under *Central Bank of Denver, N.A., Stoneridge Investment Partners, LLC,* and *Janus Capital Group, Inc.*, their securities predicates are not "actionable" under securities laws. Response to such a counter intuitive contention should include reliance on the *MLMSK Investment Company* line of cases and the argument that the PLSRA bars use of all securities predicates, whether or not they are actionable under federal securities laws.

The Advent of Private Litigation Under Section 20(b) of the Exchange Act

Both counsel and the Justices of the Supreme Court made repeated references to "the dummy statute," Exchange Act Section 20(b), during oral argument in the *Janus Capital Group, Inc* matter.[10] It was suggested that the plaintiffs could have, but did not, invoke section 20(b). Likewise both the *Janus Capital Group Inc.* majority and the dissenters mentioned Section 20(b) in their respective opinions.

Currently there is a dearth of precedent interpreting Section 20(b). In fact, courts have not even determined whether there exists a private right of action under Section 20(b). This inactivity regarding Section 20(b) will likely change as litigants perceive their opportunities under Rule 10b-5 as diminishing. Section 20(b) of the Exchange Act states:

(b) Unlawful activity through or by means of any other person

It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for

9 *See also, OS Recovery, Inc. v. One Group International, Inc.,* 354 F. Supp. 2d 357 (S.D. N.Y. 2005) (PLSRA Amendment only bars RICO claims arising from securities predicates that the plaintiffs could have pursued against the particular defendant); *Javitch v. First Montauk Financial Corp.,* 279 F. Supp. 2d 931 (N.D. Ohio 2003) (predicate acts were conduct "that would have been actionable as fraud in the purchase or sale of securities" and "[i]n light of this determination, . . . the claims . . . cannot be litigated under RICO."

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such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

15 U.S.C.A. § 78t (West).

The *Janus Capital Group Inc.* dissent indicated its conviction that Section 20(b) creates a private cause of action and suggested a remand to permit the private litigant to amend to allege the 20(b) action, stating:

If the majority believes, as its footnote hints, that § 20(b) could provide a basis for liability in this case, *ante*, at 10, n.10, then it should remand the case for possible amendment of the complaint. "There is a dearth of authority construing Section 20(b)," which has been thought largely "superfluous in 10b-5 cases." 5B A. Jacobs, Disclosure and Remedies Under the Securities Law § 11- 8, p. 11-72 (2011). Hence respondent, who reasonably thought that it referred to the proper securities law provision, is faultless for failing to mention § 20(b) as well.

The *Janus Capital Group Inc.* majority, however, did not take a position on the issue whether Section 20(b) creates a private right of action. Instead it stated: [w]e do not address whether Congress created liability for entities that act through innocent intermediaries in 15 U.S.C.A. § 78t(b). See Tr. of Oral Arg. 6, e61.

One commentator advocates in favor of a private right of action under Section 20(b), stating:

Does Section 20(b) create a private right of action? Section 20(b) should provide a private right of action if the underlying unlawful act itself permits a private right of action.··· Even when no private right of action exists, Section 20(b) is an available remedy for SEC and criminal actions.

Jacobs, 5B Disclosure & Remedies Under the Sec. Laws § 11:8.

As litigants add Section 20(b) to their arsenals, the contours of a Section 20(b) private action, if any, will be developed. The majority in *Janus Capital Group, Inc.* may have previewed its interpretation of Section 20(b). In reserving the issue whether there exists a private right of action under Rule 20(b), the *Janus* court indicated that Section 20(b) may be confined to instances in which a culpable source acts through an "innocent intermediary."[11]

The *Janus Capital Group, Inc.* majority may have given other clues relating to the scope of Section 20(b) as well. One scholar commented that Section 20(b) "address[es] the liability of the source of a false statement when third parties disseminate that statement."[12] Whether or not Section 20(b) creates liability for the speaker who communicates through an intermediary, the *Janus Capital Group Inc.* majority stated that the intermediary is not liable under the "statement" prong of Rule 10(b)-5. Justice Thomas for the *Janus Capital Resources, Inc* majority wrote that "[o]ne who ... publishes a statement on behalf of another is not its maker." *Janus,* 131 U.S. at 2302 He added comments about defendant JCM [Manager] placing allegedly misleading statements on the JCM website, stating, "that JCM provided access to Janus Investment Fund's prospectuses on its Web site is also not a basis for liability. Merely hosting a document on a Web site does not indicate that the hosting entity adopts the document as its own statement or exercises control over its content." *Id.* at 2304 n.12. One commentator disagrees with an approach that absolves the intermediary.[13]

The issue whether liability under Section 20(b) requires attribution has not been decided by the courts. One commentator speculates that while Rule 10b-5 requires attribution of the misleading statement to the "maker, " Section 20(b) probably will not be interpreted to include any attribution requirement,[14] and it is true that the face of the statute does not address attribution. However, the text of Rule 10(b)-5, which we now know includes an attribution requirement, at least in its "statement" prong, also contains no facial attribution requirement. The absence of an attribution requirement from the text of Section 20(b) may not necessarily mean that attribution is superfluous under Section 20(b). In defending claims under Section 20(b) it is safe to say that defense counsel will advocate for imposition of an attribution requirement in Section 20(b) cases.

Case law also has not addressed the mental state required for liability under Section 20(b). Section 20(b) claims are necessarily tied to another liability provision. The Section makes it a violation to indirectly violate another securities prohibition. Logically therefore, the mental state required for Section 20(b) liability should be no less than the scienter requirement of the statute or

11 *Janus Capital Group Inc.* ; 5B Disclosure & Remedies Under the Sec. Laws § 11:8

12 5B Disclosure & Remedies Under the Sec. Laws § 11:8

13 *Id.*

14 *Id.*

Rule being indirectly violated.

To summarize, in defending Section 20(b) claims brought against the source of an allegedly misleading statement, counsel may contend that:

(a) there exists no private right of action under Section 20(b);

(b) attribution is required;

(c) the intermediary in the particular case is not innocent, barring or cutting off liability on the part of the source of the statement; and

(d) scienter of a degree at least as high as the provision indirectly violated should be required for Section 20(b) liability.

Increase In Litigation Under Control Person Sections Of The Securities Act And The Exchange Act

It has been said that *Janus Capital Group, Inc.* will open 'the way to extensive litigation over the scope of control person liability and that "it is time to dust off Sections 20(a) and 20(b)."[15] At oral argument for *Janus Capital Group, Inc.*, it was suggested that Section 20(a) is an alternate remedy that may fill any void in available remedies that might be created by a decision in favor of the defendant investment adviser. The argument was as follows:

JANUS CAPITAL GROUP, INC., et al., Petitioners,
v.
FIRST DERIVATIVE TRADERS.
No. 09-525.
Tuesday, December 7, 2010

ORAL ARGUMENT OF MARK A. PERRY ON BEHALF OF THE PETITIONERS [JANUS]

JUSTICE SOTOMAYOR: That's the control person statute?

MR. PERRY: **No. There is also 20(a), which is the control person statute, also not invoked by these plaintiffs.**

Those are forms of secondary liability, Your ***7** Honor. In fact, the Court's questions go to the distinction between primary and secondary liability.

* * *

JUSTICE KENNEDY: Is there an **alternate theory** that JCM is really the day-to-day managers in day-to-day active control of the Fund, and therefore, it should be chargeable as if it and the Fund are the same for purposes of making the statement?

***14** MR. PERRY: Your Honor --

JUSTICE KENNEDY: And we would say that that's different from, say, an outside law firm or an auditor?

MR. PERRY: Your Honor, the word "control" appears more than a hundred times in the briefs on the plaintiff's side of this case in this Court, and the Congress has dealt with control. Section 20(a) provides a separate cause of action against those who control another entity.

JUSTICE SOTOMAYOR: Except that I, as I read your brief, and you can correct me if I'm wrong, you were arguing that since there was an independent board of directors, presumably because there are two corporate -- different corporate funds -- two different corporate forms, that there couldn't be control person liability under 20(a). You seem that -- I thought, reading your brief, that's what you were alleging.

So you can't have your cake and eat it, too. Either the independence of the board makes no difference or it does, so which is your position?

MR. PERRY: Our position, Your Honor, is that the Congress has dealt with the situation where you have two separate companies and to make a claim against the second company, you have to prove control. Whether ***15** or not they could in this case, none of us knows, because they never brought that claim. They represented to the district court --

JUSTICE SOTOMAYOR: Under what theory would you defend an allegation that the investment manager who had control over the everyday affairs of the company, drafted or helped draft the prospectus, hired the lawyers who helped draft it, wouldn't be a control person? How would you defend that?

MR. PERRY: Your Honor, the investment company, the mutual funds, are separately owned, separately governed.

JUSTICE SOTOMAYOR: Exactly. So you -- you're -- if they can't be control persons because they're separate companies, then how do they escape being primary violators?. . .

15 King, "The Effects of an Undefined "Ultimate Authority" standard For Rule 10B-5 claims. Janus Capital Group, Inc. v. First Derivative Trades, 16 N.C. Banking Institute, 405 (March 2012).

* * *

JUSTICE GINSBURG: Okay. And all that the Fourth Circuit said is, it goes beyond; it has to go further. And the -- the impression that I got from the Fourth Circuit's opinion is -- and it could be reduced to a very simple statement. They say: JCM was in the ***27** driver's seat. It was running the show. And if that can be proved, they thought that they would have a good case under --

MR. PERRY: And, Your Honor, no court, no case from this Court or any court of appeals has ever held that the driver's seat exception, the central bank, exists. And that is an expansion.

* * *

ORAL ARGUMENT OF DAVID C. FREDERICK ON BEHALF OF THE RESPONDENT [PLAINTIFF]

JUSTICE SCALIA: What isn't clear from all ***34** of those things is that JCM made any representation to the public. The representation was made in the prospectus issued by the Fund, not by JCM.

Now, the Fund may have a cause of action against JCM, but what's crucial here is whether -- whether you can establish that it is JCM who made the representation to the public, and I don't see how you can get there. You might proceed under the control provision, but not by saying that they made the representation.

MR. FREDERICK: Justice Scalia, they wrote the prospectus. They're --

JUSTICE SCALIA: That's fine. Just like writing a speech for somebody.

* * *

JUSTICE KAGAN: Mr. Frederick, a substantial part of the power of your argument comes from this notion that, as Justice Ginsburg said, that JCM was in the driver's seat, that JCM had control, that they were -- Janus was at most an alter ego of JCM and maybe something more, that it was just a creature of JCM. But the securities legislation seems to deal with that in section 20. And your case is not brought under section 20, and because of the relationship between mutual funds and their investment advisors, presumably could not be brought under section 20.

So, why should we think relevant the kind of controlled relationship that you're talking about?

MR. FREDERICK: Because you don't want to create a road map for other people to commit fraud, Justice Kagan, and that's what their theory does. What their theory does is it says is we set up shell companies or if we dupe people to make statements, we can commit securities fraud with impunity, because we won't be held liable to having made the statement, even though we wrote it, we had substantive control over it, et cetera.. . .

* * *

JUSTICE SOTOMAYOR: Counsel, could you have -- you just admitted if there -- if the company was duped, you couldn't have aiding and abetting liability. Could you impose a 20(b) or 20(b) control person liability?

MR. GANNON: The control person liability also needs to have a primary violator under the terms of ***57** 20(a).

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Control

The issue of "control" is one which appears throughout the securities laws. The Securities Act of 1933 requires registration of securities sold by "issuers" and "underwriters." Securities Act Section 2(11) defines "issuer" to include "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect, control with the issuer." Regulation S-K requires certain information be disclosed with respect to affiliates and subsidiaries of an issuer. For purposes of Regulation S-K, an "affiliate" is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."

Certain provisions of the Securities Exchange Act of 1934 relate to broker/dealer regulation and discipline. Such provisions refer to persons "associated with" a particular broker or dealer. Securities Exchange Act Section 3(a)(18) and 3(a)(21) define persons associated with a broker to include "any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer…"

The Securities Act and the Securities Exchange Act each include express provisions which impose liability on those typically considered to be secondary

violators. Section 15 of the Securities Act provides that:

Every person who, by or through stock ownership, agency or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more persons by or through stock ownership, agency, or otherwise, controls any person liable under Section 11 or 12 shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 20(a) of the Securities Exchange Act provides:

Every person who, directly or indirectly controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Section 15 of the Securities Act creates joint and several liability for those who control violators of Section 11 (misrepresentations in a registration statement), Section 12(1) (unlawful sale of unregistered securities), or Section 12(2) (misrepresentations in the sale of securities) of the Securities Act. Section 20(a) of the Securities Exchange Act creates such liability in persons who control others who violate Rule 10b-5, Rule 14a-9 (fraud in proxy solicitations), or Section 18(a) (misrepresentations in filed documents).

Neither Section 20(a) nor Section 15 creates strict or absolute liability; defenses to each are available. Section 15 provides that a controlling person may avoid liability if he "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." Section 20(a) provides that the controlling person may avoid liability if he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

In order to defend a claim under Section 15, it is generally held that the defendant must prove that he was not negligent.[161] For a defense under Section 20, the only necessary proof is that the defendant acted in good faith and did not directly or indirectly induce the acts constituting the violation. Although there is some disagreement in the jurisprudence, it is generally held that the plaintiff has the burden of proving control but the defendant has the burden of proof with respect to lack of culpability.[172]

In a minority of cases, to establish liability, the plaintiff must establish not only control and the violation of the controlled person, but also culpability of the controlling person. The United States Third Circuit Court of Appeal in *Rochez Bros., Inc. v. Rhoades,* 527 F.2d 880 (3rd Cir. 1975), stated:

We hold, therefore, that secondary liability cannot be found under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud.

527 F.2d at 884-90.

Neither the Securities Act nor the Securities Exchange Act define "control." The Securities Exchange Commission has attempted to fill this void with Securities Act Rule 405. Rule 405 defines "control" for purposes of the 1933 Act. Securities Exchange Act Rule 12b-2 defines "control" for certain purposes under the Exchange Act. The rules provide:

The term "control" (including the terms "controlling," "controlled by," and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

Many cases have held that a broker/dealer is a controlling person with respect to its registered representatives. *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564 (9th Cir. 1990); *Martin v. Shearson, Lehman, Hutton, Inc.,* 986 F.2d 242 (8th Cir. 1993). In some instances, this control is not found to be as a matter of law but rather must be proven as a matter of fact. *Harrison v. Dean Witter Rentals, Inc.,* 974 F.2d 873 (7th Cir. 1992); *Hunt v. Miller,* 908 F.2d 1210 (4th Cir. 1990).[183]

The widely used definition of control was explained by the court in *Metge v. Baehler,* 762 F.2d 621, 631 (8th Cir. 1985) as requiring the plaintiff "to establish that the defendant . . . actually participated in (i.e., exercised control over" the operations of the corporation in general . . . [and] that the defendant

16 [1] *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976).

17 [2] *Paul F. Newton & Company v. Texas Commerce Bank,* 630 F.2d 1111 (5th Cir. 1980); *G. A. Thompson & Company, Inc. v. Partridge,* 636 F.2d 945 (5th Cir. 1981).

18 [3] In *Straub v. Vaisman & Company,* 540 F.2d at 595-96, the United States Third Circuit Court of Appeal held a brokerage firm liable under Section 20(a). The president of the firm used the firm to sell worthless stock to a customer. The firm was a market maker in the stock. The court stated:

Vaisman [the firm] was held liable . . . under Section 20(a) of the Securities Exchange Act, 15 U.S.C.

possessed the power to control the specific transaction upon which the primary violation is predicated." The "power to directly or indirectly control or influence corporate policy," or the "power to control the general affairs" of a corporation may be sufficient to establish control. *G.A. Thompson & Company, Inc. v. Partridge,* 636 F.2d 945 (5th Cir. 1981); *Abbott v. Equity Group, Inc.,* 2 F.3d 613, 620 (5th Cir. 1993).

The court in *Donohoe v. Consolidated Operating & Production Corp.,* 982 F.2d 1130 (7th Cir. 1992) held that two shareholders of a corporation controlled the third shareholder who was the prime operator of a scam to drill dry oil wells. The court explained that:

This court recently articulated a two prong test for determining control person liability. The court will look first to whether the alleged control person actually exercised general control over the operations of the entity principally liable. . . . Control person liability will attach if such person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, even if such power was not exercised. . . . Applying these standards to this case, there is sufficient evidence that Nortman and Berrettini [defendants] controlled Bridges [the prime operator and third shareholder]. Together, the defendants owned 60% of Copco's stock. They could out vote Bridges on the board of Copco, and Copco ran the limited partnerships. Further, until Bridges managed to take control . . ., . . . [they] controlled the flow of money. . . . [I]t is difficult to imagine how they could have had more involvement in the fraud without perpetrating it themselves. They helped to put the offerings together, solicited investments and made reports to investors. . . . [They] were not disinterested outside directors, but rather were principal officers of a three-man corporation, heavily involved in the day-to-day running of Copco and the partnerships.

Id. at 1138-39.

On the other hand, control was not established in *Paracor Finance, Inc. v. General Electric Capital Corp.,* 79 F.3d 878 (9th Cir. 1996). The defendant lender was not a controlling person. It had provided a loan relating to a corporate acquisition. The plaintiffs alleged that the lender controlled the target company. However, the Court disagreed explaining that:

Regarding GE Capital [lender], the Investors have introduced evidence that it had a strong hand in Casablanca's [the target's] debenture offering. GE Capital's bridge loan…was conditioned on the debenture offering taking place. GE Capital retained Shearson to market the debentures. GE Capital may have indirectly contributed to the Placement Memorandum by working with Casablanca's management to come up with assumptions for their long-term projections. GE Capital had the right to select the lead investor and exercise its right to select Elders Finance. Finally, GE Capital participated in the drafting and negotiating of the Purchase Agreement.

However, the Investors have not shown any of the traditional indicia of control of Casablanca in a broader sense. GE Capital had no prior lending relationship with Casablanca. GE Capital did not own stock in Casablanca prior to the closing and did not have a seat on its Board. GE Capital's bridge loan was unsecured by any of Casablanca's assets. In short, there is no evidence that GE Capital exercised any influence whatsoever over Casablanca on a day-to-day basis…GE Capital did not exercise control over the management and policies of Casablanca, nor did it direct its day-to-day affairs in any sense. As we hold that at least some indicia of such control is a necessary element of "controlling person" liability, the Investors cannot sustain a secondary liability claim against GE Capital.

Id. at 889-90.

Concepts of separate legal entity status which appear in the *Janus Capital Group Inc.* analysis of "ultimate authority" also appear in determining control person liability. The court in *Fulton County Employees Ret. Sys. v. MGIC Inv. Corp.*, 675 F.3d 1047 (7th Cir. 2012), held that managers of one entity were not controlled by a separate legal entity. In *MGIC Inv. Corp.*, investors in MGIC, a mortgage loan insurer, brought securities fraud class actions against MGIC and certain MGIC managers under Rule 10b-5 and Section 20(a). The investors alleged that a press release issued by MGIC was deceptive.[19] *Id.* at 1048. The court found the statement to be true, finding MGIC not liable for fraud. *Id.*[20]

19 The press release stated: "[w]ith respect to liquidity, the substantial majority of C–BASS's on-balance sheet financing for its mortgage and securities portfolio is dependent on the value of the collateral that secures this debt. C–BASS maintains substantial liquidity to cover margin calls in the event of substantial declines in the value of its mortgages and securities. While C–BASS's policies governing the management of capital risk are intended to provide sufficient liquidity to cover an instantaneous and substantial decline in value, such policies cannot guarantee that all liquidity required will in fact be available."

20 The court stated, "Fulton does not contend that any of the information that led to the price decline and thus the margin calls was specific to C–BASS. This means that MGIC's managers did not have any private information that they could have revealed. The problem was market-wide. If MGIC's managers

The investors also claimed that some statements made during a conference call by the CEO and COO of a separate company C-BASS were fraudulent, independent of the press release. *Id.* at 1051. The investors wanted to hold MGIC liable as a Section 20(a) control person with control over individual officers employed by the separate company C-Bass.[21] The *MGIC* court held that, "it would be inappropriate to hold MGIC liable under § 20(a) for statements made by managers of a different firm that MGIC could not control without the assent of a third party holding an equally large bloc." *Id.* MGIC was not responsible as a controlling person for purposes of Rule 10(b)-5.

Defendants faced with control person lawsuits may defend contending that they did not:

(1) actually exercise control as a general matter and did not have the power to control the specific transactions;

(2) satisfy the statutory definition. For Section 15 this means that the controlling person "had no knowledge of or reasonable ground to believe in the existence of the fact by reason of which the liability of the controlled person is alleged to exist." For Section 20(a), this means that the defendant "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action"; and

(3) since controlling person liability is derivative, exculpation of the controlled party absolves the controlling person.

One further matter with respect to controlling person liability merits discussion. Courts are currently in disagreement as to whether and to what extent control person statutes supplant the law of vicarious liability. *Rochez Bros.,* 527 F. 2d at 891 (respondeat superior as a doctrine which may impose liability without culpability "should not be widely expanded in the area of federal securities regulation"); *Hollinger,* 914 F.2d at 1564 (control person statutes do not supplant vicarious liability).

In *Central Bank v. First Interstate Bank,* Justice Stevens predicted that the view that 20(a) coexists with respondeat superior liability "appear[s] unlikely to survive the court's decision" in *Central Bank*. 114 S. Ct. 1439, 1458 n. 12 (1994). The issue whether control person statutes preempt vicarious liability will be at the forefront if, as predicted, *Janus Capital Group, Inc.* produces an increase of litigation under §20(a).

Litigation Over The Person With "Ultimate Authority" Over The Allegedly Misleading Statement

"Ultimate Authority" When The Alleged Maker Is A Separate Legal Entity

Janus Capital Group Inc involved a situation where the defendant was a separate legal entity and parent of the publisher of the misleading statement. Certain courts have been reluctant to apply *Janus Capital Group, Inc.* to absolve parent corporations.

In *City of Roseville Employees' Ret. Sys. v. Energy Solutions, Inc.,* 814 F. Supp. 2d 395 (S.D.N.Y. 2011), the court found that a separate legal entity to which allegedly misleading statements were not expressly attributed could nonetheless be considered the "maker" of the statements. Pension funds had brought a securities action on behalf of a proposed class of purchasers of common stock of depository shares of an engineering company ("ES"). A group of investors in three investment companies formed ES by purchasing and integrating existing companies through a company named ENV Holdings ("ENV"). At the time of the public offerings, ENV was the sole stockholder of ES. After the public offerings, ES announced that its revenue and earnings estimates would need to be significantly reduced. The company's stock fell significantly that day and in the following month.

The plaintiffs alleged that the statements made by the defendants in the offerings contained false or misleading statements or omitted material facts. The plaintiffs sued a number of defendants for these alleged misstatements. The defendants moved to dismiss. There was no dispute that ES and each of the individual defendants who signed the registration statements "made" the statements under *Janus Capital Group, Inc.* However, in determining liability of the parent company ENV, the court examined *Janus Capital Group, Inc.* **The court said that the statements at issue created significant differences between the plaintiffs' claim against ENV and the claim rejected in *Janus Capital Group Inc.*. Here, the statements**

saw the collapse coming, so could anyone else who studied the markets." *Id.* at 1050.

21 Section 20(a) provides: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter ... shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable ..., unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.*

made clear that ENV controlled the actions of ES (including its sale of stock) and that control was exerted through ENV. ENV therefore had "ultimate authority" over the offerings.

The court stated that a reasonable jury could find that, on the facts alleged here, ENV's role went well beyond that of a "speechwriter drafting a speech," because, with regard to ES's sales of shares, ENV had control over the content of the message, the underlying subject matter of the message, and the ultimate decision of whether to communicate the message. Thus, ENV was different from the affiliated companies which were separate legal entities in *Janus Capital Group, Inc.*. As a result, the court denied the defendants' motion to dismiss.

The *City of Roseville* court attempted to contrast the degree of authority which ENV possessed with the degree of authority that Group had over its subsidiary Manager in *Janus Capital Group, Inc.* As a practical matter, however, the differences between the two cases are not great. *City of Roseville* involves the precise issue raised by *Janus Capital Group, Inc.* – implicit attribution of a statement with respect to an alleged "maker" which is a completely separate legal entity. The parent/subsidiary relationship is the same in both cases. *City of Roseville* and cases like it distinguish and refrain from applying *Janus Capital Group* although the fact pattern of the two cases are similar. Litigants will undoubtedly rely on cases such as *City of Roseville Employees' Retirement System*, arguing that a plethora of indicators show implicit attribution and warrant maintaining an action against the parent as a "maker."

"Ultimate Authority" When The Alleged Maker Is A Corporate Officer, Director, Or Insider

The *Janus Capital Group Inc* dissenters were concerned that the holding of the majority might be used to shield from liability the most culpable actors, including guilty officers, directors and corporate insiders, in business transactions. Questions at oral argument by Justices who would ultimately dissent in *Janus Capital Group Inc* made this concern evident. The interaction at oral argument was as follows:

JANUS CAPITAL GROUP, INC., et al., Petitioners,
v.
FIRST DERIVATIVE TRADERS.

ORAL ARGUMENT OF MARK A. PERRY ON BEHALF OF THE PETITIONERS

* * *

JUSTICE BREYER: What happens if the president of the oil company, knowing that the statement is false, says: We have discovered 42 trillion barrels of oil in Yucatan. He writes it on a piece of paper; he gives it to the board of trustees; they think it's true and they issue it. Joe Smith buys stock and later loses money.

Can Joe Smith sue the president of Yucatan, of the oil company, for having made an untrue statement ***20** of material fact?

MR. PERRY: If he's an authorized agent of the same company that issued the statement?

JUSTICE BREYER: What he is -- he didn't issue it. What he did was he gave it to the board of trustees, who issued it.

MR. PERRY: If the board of trustees of his company, so that the statement --

JUSTICE BREYER: He's the president of the company.

MR. PERRY: And the distinction here, Justice Breyer, is --

JUSTICE BREYER: No, no. I'm asking what happens. Is there recovery?

MR. PERRY: If he is an authorized agent, he may be sued as --

JUSTICE BREYER: He is running the business, the daily affairs, of the company. Of course the president of a company is an authorized agent of the company, and so, yes.

MR. PERRY: He may be subject to liability, then.

JUSTICE BREYER: Now, if he is subject to liability, why isn't your firm, your client, subject to liability, who, after all, run every affair of the Fund?

***21** MR. PERRY: Your Honor, they run the management of the Fund. The investment of --

JUSTICE BREYER: Yes, that's what a president does. The president of a company manages the company. And if the president is liable, why isn't the group of people who do everything for the company -- why aren't they liable?

MR. PERRY: Because the corporate form has meaning in the Federal law and in State law, and where --

JUSTICE BREYER: No, you have to explain it to me more.

I'm not being difficult. I understand this less well than you think I do, and I want to know. That's an obvious, naive

question, and I would like an answer that anyone could understand.

MR. PERRY: The answer is, Your Honor: These funds are managed -- governed, excuse me, is a better word -- by the trustees. That is disclosed in these documents. In fact, the documents say -- it's at page 258A of the Joint Appendix -- the trustees are responsible for all the policies.

They have outsourced, if you will, certain functions, operational functions: Which stock to buy, which stock to sell, which transfer agent to hire. ***22** Those are functions that could be kept in house, but could be --

JUSTICE BREYER: I get it. In other words, you're saying on the papers here, it's -- it's the trustees that manage everything.

MR. PERRY: That govern everything.

2010 WL 4956290

* * *

JUSTICE KENNEDY: Just -- just to clarify Justice Breyer's hypothetical. In your -- in the hypothetical you gave where the president gives an innocent board of directors false information and the prospectus goes out, is the company liable because their agent -- is the company liable under 10b-5?

MR. PERRY: The company may be sued under 10b-5. It has got to meet all the elements.

JUSTICE KENNEDY: Yes.

MR. PERRY: But yes, it is an authorized agent making a statement on behalf of the company.

***25** JUSTICE KENNEDY: So what you're saying is that the -- the agency relation that the president of the company holds is different that than the agency relation that JCM holds?

* * *

The fears of the *Janus* dissenters may have been realized in *Hawaii Ironworkers Annuity Trust Fund v. Cole,* 2011 WL 3862206 (N.D. Ohio Sept. 1, 2011), *as amended* (Sept. 7, 2011). Even though *Janus Capital Group, Inc.* involved an alleged "maker" which was a legal entity, in *Cole,* the court applied *Janus Capital Group, Inc.* to shield from liability corporate officers who had allegedly made misleading statements.

Cole was a suit by former shareholders of the Dana Corporation against the company's former officers. The gravamen of the complaint was that the defendants worked together to falsify financial information, which contributed to overly optimistic public statements by company officials. Plaintiff's suit contended that the defendants were primarily liable for the role their misconduct played in an ensuing bankruptcy.

The defendants asserted that because they at no time personally made any statements to the investing public, no one could have relied on them. Plaintiff Shareholders were improperly seeking to find them primarily liable on a claim that actually amounted to no more than alleged aiding and abetting others in perpetrating a fraud on the investing public.

The *Cole* court had previously denied the defendants' motion to dismiss, but was now reconsidering that opinion in light of the *Janus Capital group, Inc*. ruling. The plaintiff contended that *Janus Capital Group Inc.* arose in the context of a separate legal entity and should not be extended to protect from liability a corporate insider. The Court explained that

[p]laintiff contends that Janus should not alter my prior holding in this case

for the simple reason that here defendants are corporate insiders.

Because the defendant in *Janus* was a legally separate entity, plaintiff

argues, the Court's rationale cannot apply to the facts at hand. Plaintiff

asserts that, "[i]n essence, *Janus* involves a secondary actor" and thus

"*Janus* does not analyze whether corporate executives can be liable.

The court determined that even though *Janus* involved legally separate entities, its holding should also be applied to corporate insiders. The court held that the complaint did not state a claim for primary liability under Janus, because the defendants did not have that requisite ultimate authority over the content of the statement. It also concluded that *Janus* applies in the context of corporate insiders and is not limited to separate legal entities. In applying *Janus Capital Group, Inc.* and dismissing the plaintiff's complaint, the court explained:

Thus, nothing in the Court's decision in Janus limits the key holding—the definition of the phrase "to make ... a statement" under Rule 10b–5(b)—to legally separate entities. Instead the Court defined primary liability as requiring "ultimate authority." Id. The degree of separation between entities naturally will inform the analysis of where ultimate authority lies. In Janus, the fact of legal separation was persuasive evidence that

the defendants did not have ultimate authority. I am not the only reader of Janus to interpret the Court's decision this way. The dissent agreed that the Court's holding applies to corporate insiders, noting that the complaint does not state a claim for primary liability under Janus, because the defendants did not have ultimate authority over the content of the statement. . . . The complaint does not state a claim for primary liability under Janus, because the defendants did not have ultimate authority over the content of the statement.

The Court found that the defendant officers could have no 10b-5 liability because they were pressured by the CEO and the CFO to provide the optimistic forecasts. This pressure was seen by the Court as removing the defendant's authority over the statements, and as the court stated, "[t]he defendants sent the results that they were commanded to send."

Application of the *Janus Capital Group, Inc.* holding to officers, directors and corporate insiders has been far from uniform, however. Other courts have confined *Janus Capital Group, Inc.* to its facts, concluding that it applies only to the situation where an independent legal entity is accused of "making" a misleading statement. Other courts have found that the principles espoused in *Janus Capital Group, Inc.* are just as applicable to individual corporate officers.

For instance, the court in *City of St. Clair Shores Gen. Employees' Ret. Sys. v. Lender Processing Services, Inc.,* 2012 WL 1080953 (M.D. Fla. Mar. 30, 2012), found that while *Janus Capital Group, Inc* applies to defendants which are independent legal entities, it does not necessarily apply to individual corporate officers. The plaintiff in *City of St. Clair Shores,* was the City of St. Clair Shores General Employees' Retirement System. The plaintiff filed a class action against Defendants, Lender Processing Services, Inc. ("LPS"), and individual defendants, claiming violations of the federal securities laws. Plaintiffs sued under Rule 10b-5 and Section 20(a). LPS was a publicly-traded company providing mortgage-related services. Plaintiffs were persons or entities who purchased or acquired shares of LPS during the class period. Plaintiffs alleged that during the relevant period, defendants engaged in a fraudulent scheme, relying on illicit business practices to artificially inflate LPS's revenue and stock price, resulting in millions of dollars in losses to the shareholders.

The individual defendants were board members and officers of LPS. The case arose in the context of the individual defendants' motion to dismiss which the court denied. These defendants relied on *Janus Capital Group, Inc.* for the proposition that Plaintiff had not adequately alleged that they had "made" the alleged misstatements. The court however ruled that Plaintiffs sufficiently alleged that the individual defendants had ultimate authority over the statements.

The *City of St. Clair Shores* court stated that the individual defendants made statements and were quoted in press releases and articles in their official capacities. Thus, they made such statements as agents of LPS, which is distinguishable from *Janus Capital group, Inc.,* where the statements were on behalf of a separate, independent entity.

The Court in *In re Merck & Co., Inc. Sec., Derivative, & ERISA Litig.,* also came to a different conclusion than the *Cole* Court. The *in Re Merck Co.* court found that *Janus* did not protect the corporate insiders who were appearing as defendants before it. In *in re Merck & Co.,* revolved around the prescription arthritis medication Vioxx which had been sold by defendant Merck & Co., until being withdrawn from the market due to safety concerns. Plaintiffs in this putative class action were persons and entities who acquired Merck stock. They maintained that Merck overstated the commercial viability of Vioxx by deliberately, or at the very least recklessly, downplaying the possible link between Vioxx and an increased risk of heart attack or other cardiovascular events, while allegedly having evidence that strongly indicated these results were possible. Plaintiffs contended that Merck's misstatements of fact and belief regarding Vioxx artificially inflated the stock price, the value of which fell sharply when the truth about Vioxx's safety profile began to emerge.

Defendant Scolnick, a former President of Merck Research Labs, was being accused of intentionally misrepresenting Vioxx's safety profile. He made public statements that could be construed as an endorsement of Vioxx as a safe product. In opposing the lawsuit, he argued that he could not be held liable for these statements because the Complaint did not allege that he had "ultimate authority over the statement" as required by Janus.

The court decided that Scolnick's role in the statements attributed to him was in no way analogous to role of the *Janus Capital Group Inc.* defendants' relationship to the statements at issue in that lawsuit. Scolnick was, at the time of each attributed statement, an officer of Merck. He signed SEC filings and was quoted in articles and reports in his capacity as an officer of Merck. He made the statements at issue pursuant to his responsibility and authority to act as an agent of Merck, not as in *Janus Capital Group, Inc.*, on behalf of some separate and independent entity.

The court concluded that *Janus Capital Group, Inc.* did not alter the well-established rule that "a corporation can act only through its employees and agents." Thus, *Janus Capital Group, Inc.* could not be read to restrict liability for Rule 10b–5 claims against corporate officers to instances in which a plaintiff can show that officers—as opposed to the corporation itself—had "ultimate authority" over the statement. The court acknowledged that Scolnick's contention would absolve corporate officers of primary liability for most Rule 10b–5 claims, because ultimately, statements are, for the most part, within the control of the corporation which employs the officer. The court permitted the §10(b) claim to proceed against Scolnick insofar as it was predicated on misrepresentations about Vioxx's safety profile that were made by and attributed to him.

The court in *Red River Resources, Inc. v. Mariners Systems, Inc.,* 2012 WL 2507517 (D. Ariz. 2012) applied *Janus* to reject claims against certain corporate officers but found that it did not shield all corporate officers. Certain officers could be "makers" of the allegedly misleading statements about which the plaintiffs were complaining.

Individual defendants sued in 10(b)(5) actions for allegedly misleading statements may rely on jurisprudence extending *Janus Capital Group, Inc.'s* protection beyond separate legal entities. Such individual defendants may also contend that they had no "ultimate authority" over the allegedly misleading statements because a higher authority such as a client or a supervisor intervened.

"Ultimate Authority" When The Allegedly Misleading Statement Is Indirectly Communicated To The Plaintiff

In *In Re Allstate Life Ins. Co. Litigation,* 2012 WL 1900560 (D. Ariz. 2012), the effect of express attribution of a statement was seen. As the United States Supreme Court instructed, express attribution is a strong indication that the person to whom the statement is expressly attributed is its "maker," even when the statement is indirectly communicated to the plaintiff. In *In Re Allstate,* Allstate and other investors sued on account of alleged misstatements in official statements which they claimed induced them to purchase bonds from the town of Prescott Valley, Arizona. The bonds were being sold to finance construction of an event center. The official statements contained disclosures which were attributed to several groups of defendants. Allstate sued under rule 10(b)-5 and Section 20(a) of the Exchange Act.

The Court found that despite *Janus Capital Group, Inc.* the defendants' Motion to Dismiss should be denied. It concluded that the defendants had "ultimate authority" over the statements, even though the statements were indirectly communicated to the plaintiff. "Ultimate authority" was found primarily because of the express attribution of the statements to the defendants.

The *Allstate* Court explained:

[M]any of the allegedly misleading disclosures in the Official Statements are explicitly attributed to the Fain Group…Such explicit attribution to the Fain Group of particular disclosures within the Offering Statement makes it likely that the Fain Group exercised ultimate authority over those disclosures. To be sure, the disclosures were not made directly to Plaintiffs, but rather were, with the Fain Group's knowledge, incorporated into the Official Statements. Nonetheless, Rule 10b-5 imposes liability on statements made to plaintiffs either directly *or indirectly*…*Janus* did not abolish Rule 10b-5's restriction on misrepresentations made indirectly…The Court in *Janus* determined that the investment advisor had not made an indirect misrepresentation because neither the prospectuses nor the disclosures within them were attributed to the advisor…In short, the Fain Group's disclosures were made to Plaintiffs indirectly – they were placed in the Official Statements and the Official Statements were then given to Plaintiffs. Nonetheless, given the Official Statements' explicit attribution of the disclosures to the Fain Group, it appears to have had the requisite "ultimate authority" over those disclosures. Plaintiffs have therefore pleaded facts which make it plausible that the Fain Group violated Rule 10b-5.

Id. at *3-4.

The precise contours of the "direct or indirect" language of Rule 10b-5 are not established. Express attribution is an indicator that the attributed person is the maker. Further, Supreme Court dicta indicates that it is the source not the publisher of a misleading statement who may be responsible.

***Janus Capital Group Inc.* and State Law Claims**

In many areas of federal securities law, state law and Blue Sky Actions have been interpreted *in pari materia* with corresponding federal security remedies. This has not been the case with respect to the *Janus Capital Group, Inc.* decision. Many courts decline to apply *Janus Capital Group, Inc.* to claims arising under state law. For instance, in *In re Optimal U.S. Litigation,* 837 F.Supp.2d 244 (S.D.N.Y. 2011)

Janus Capital group, Inc. was not followed on state law claims.

The judge's decision in this *Optimal* concerned whether the group pleading doctrine for common law fraud claims is still viable after *Janus Capital Group, Inc.* The judge found no reason to believe that the decision of a federal court interpreting federal statutory law would have any impact on the scope of a common law fraud claim. He refused to apply the holding of *Janus* to limit New York common law fraud claims.

May More Than One Person Have "Ultimate Authority" Over A Statement?

An area of uncertainty after *Janus Capital Group, Inc.* involves the issue whether two persons may qualify as "makers" of a single statement. One scholar opines that "to some degree, it is almost contradictory to say that two entities can both have ultimate authority." [22]

At oral argument in the *Janus Capital Group, Inc.* case, counsel for defendant JCM[Manager] indicated that there could be only a single maker of the statement at issue in the *Janus Capital Group, Inc.* case. The argument was as follows:

JUSTICE KENNEDY: Well, let's say that JCM's principal officers and managers wrote the statement. You still say there's nobody?

MR. PERRY: Absolutely, Justice Kennedy, because when the statement is adopted by the issuer, it becomes the issuer's statement. Only an issuer can make the statement.

JUSTICE KENNEDY: Yes. It's not attributable, at least publicly, to JCM.

However, the court in *City of Pontiac Gen. Employees' Ret. Sys. v. Lockheed Martin Corp.,* 2012 WL 2866425 (S.D.N.Y. July 13, 2012), held that there may be more than one person with ultimate authority over a statement and therefore multiple makers of the statement. It explained:

As for *Janus Capital,* that case addressed only whether *third parties* can be held liable for statements made by their clients. Its logic rested on the distinction between secondary liability and primary liability, *see Janus Capital,* 131 S.Ct. at 2302, and has no bearing on how corporate officers who work together in the same entity can be held jointly responsible on a theory of primary liability. It is not inconsistent with *Janus Capital* to presume that multiple people in a single corporation have the joint authority to "make" an SEC filing, such that a misstatement has more than one "maker." *See City of Roseville,* 814 F.Supp.2d at 417 n.9

In *City of Roseville, supra,* a parent named ENV was accused of making misleading statements, and ES, its wholly owned subsidiary, was sued as a defendant with respect to the same statements. Although the statements at issue did speak in the voice of ES and were signed by the individual defendants in their capacities as directors or officers of ES, these explicit attributions did not preclude attribution to ENV as well.

Based on the rationale that only one person or entity may have "ultimate authority" over a statement, one defense to a 10b-5 action may be that the statement was made by another and that there may not be two makers of the statement. The following statement by the *Janus Capital Group, Inc* Court may be cited in support of such a contention. The Court stated "... 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." *Janus,* 131 US at 2302.

The Defense That The Plaintiff Is Mischaracterizing An Aiding And Abetting Claim As A Claim For Primary Liability

Central Bank eliminated aiding and abetting liability in private actions under Rule 10b-5. The Supreme Court appears unwilling to consider reinstituting aiding and abetting as an available cause of action for private litigants under the Rule. Plaintiffs may now style their 10b-5 actions as ones for primary liability. Based on *Central Bank* and its progeny, one defense which collateral participants may raise is the contention that the claims being asserted are only secondary aiding and abetting claims dressed up and labeled as primary violations.

Consider the interrogation of plaintiff's counsel by Justices Scalia and Alito in *Janus*:

STONERIDGE INVESTMENT PARTNERS, LLC, Petitioner, v.
SCIENTIFIC-ATLANTA, INC., et al.

ORAL ARGUMENT OF STANLEY GROSSMAN ON BEHALF OF THE PETITIONER

* * *

JUSTICE ALITO: All right, just to be clear on this -- just to be clear on this -- if Charter and Arthur Andersen and Scientific-

22 King, "The Effects Of An Undefined Ultimate Authority Standard For Rule 10b-5 claims: *Janus Capital Group, Inc. v. First Derivative Traders,* 16 N.C. Banking Inst. 405 (March 2012).

Atlanta and Motorola all sat down and cooked up this scheme together and they all knew exactly what was going on, would you have a claim against the Respondents here?

MR. GROSSMAN: Yes. And the reason for that, Your Honor, is because the advertising contract was a sham, and the advertising contract was a sham ***17** because Charter was giving the Respondents money to buy the advertising.

JUSTICE ALITO: **Then I see absolutely no difference between your test and the elements of aiding and abetting.**

* * *

JUSTICE SCALIA: But don't aiders and abettors have to have that purpose as well? **What distinguishes -- what distinguishes the liability that you propose from aider and abettor liability?**

MR. GROSSMAN: You have to engage in a deceptive act under 10(b). 10(b)prohibits any deceptive act.

JUSTICE SOUTER: I thought you were telling me that in each case there may be a deceptive act but not a deceptive act in relation to somebody like the Petitioner here.

MR. GROSSMAN: Exactly.

JUSTICE SOUTER: But that's a different answer, I think, from the one you were just giving Justice Scalia.

MR. GROSSMAN: No. I -- I understood, perhaps mistakenly, from Justice Scalia that there ***22** wasn't a deceptive act in your hypothetical. If there is a deceptive act, then it's prohibited by 10(b), and we move to the next statute --

JUSTICE SCALIA: **So any aiding and abetting through a deceptive act makes you a principal? Is that it? You can't be an aider and abetter by committing or enabling a deceptive act without becoming a principal.**

MR. GROSSMAN: No. Not At all.

JUSTICE SCALIA: You cannot --

MR. GROSSMAN: You, yourself -- you, yourself, have to engage in the deceptive act.

JUSTICE SCALIA: Yes.

MR. GROSSMAN: Your own deceptive act.

JUSTICE SCALIA: Yes, but -- but if you do, or if you should have known, you are not an aider and abetter. You are automatically a principal.

MR. GROSSMAN: You may be a principal if you satisfy the other elements of our test, which are serious elements that you have to plead with particularity, with the heightened pleading standards, that they have the purpose to further a scheme to defraud. That's very different --

JUSTICE SCALIA: Is it fair to say that all aiders and abettors who commit deceptive acts are principals?

***23** MR. GROSSMAN: No.

JUSTICE SCALIA: **What's the difference? What separates the two?**

MR. GROSSMAN: You have to take it the next step further, whether or not that deceptive act had the purpose and effect for furthering a scheme of an investor.

JUSTICE SCALIA: Don't you need that to be an aider or abetter?

MR. GROSSMAN: An aider and abetter? You have to have --

JUSTICE SCALIA: What if -- if I'm entirely innocent, and I don't --

MR. GROSSMAN: An aider -- certainly -- certainly, the primary violator in the situation that we are discussing where there are deceptive acts is aiding and abetting.

If an accountant comes in and deliberately falsifies a financial statement, he is giving substantial assistance to the company's statement through the company who is issuing those false statements. He would be an aider and abetter in that sense. He is also a primary --

JUSTICE SCALIA: You see, I really thought the difference was that the principal is the one who ***24** makes the deceptive representation and obtains money from it. The aider and abetter is the person who facilitates or enables that deceptive representation, which is what we have here.

And you say if you facilitate knowingly and intentionally or even grossly negligently, you are not an aider and abetter, but you're a principal. I really don't understand what's the line between the two.

2007 WL 2932905 (emphasis supplied).

Justices Alito and Scalia were expressive. They articulated their impression that the essence of the plaintiff's claim was a secondary aiding and abetting claim incorrectly labeled as a primary violation. With

aiding and abetting liability in private 10b-5 actions definitively eliminated by *Central Bank*, a viable defense to 10b-5 lawsuits is the contention that the claims are essentially aiding and abetting claims labeled as primary violations claims in an effort to "plead around" *Central Bank*. Authority for such a defense includes cases such as *S.E.C. v. Tambone*.

The court in *S.E.C. v. Tambone*, rejected the claims of a plaintiff based on its finding that the plaintiff was merely calling the defendant a primary violator when it was actually nothing more than an alleged aider and abettor. 597 F.3d 436 (1st Cir. 2010). The court rejected the S.E.C.'s argument to "impose primary liability … for conduct that constitutes, at most, aiding and abetting (a secondary violation)." *Id.* [23]

Is There A Middle Ground For Liability Between Primary And Secondary Liability?

After *Central Bank* it seemed that there was no 10b-5 liability unless the defendant met all attributes of a primary violator. However, certain Justices, in particular Justice Ginsburg, have made comments at oral argument indicating that there may be 10b-5 liability for actors who do not qualify as primary violators. Dialogue at oral argument in the *Stoneridge Investment Partners LLC* matter was as follows:

STONERIDGE INVESTMENT PARTNERS, LLC, Petitioner,
v.
SCIENTIFIC-ATLANTA, INC., et al.

ORAL ARGUMENT OF STANLEY GROSSMAN ON BEHALF OF THE PETITIONER

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JUSTICE GINSBURG: That's if they are -- that's if they are aiders and if there are only two categories and everyone who is not Charter is an aider and abettor, then you're right. But if there's a middle category of people who, while not the benefited company -- the company that's trying to achieve the deception -- but made it possible for that -- for that deception to happen. . . .

* * *

MR. SHAPIRO: But Congress's policy judgment here is that the SEC, an expert agency that is impartial, should evaluate a claim of that sort and decide whether to proceed.

JUSTICE GINSBURG: That's if they are aiders and abettors, which is what Congress covered. And I again go back to, is there another category or is everyone -- either Charter, the person whose stock is at stake, the company whose stock is at stake and everyone else is an aider? I take it that that's your position.

MR. SHAPIRO: Well --

JUSTICE GINSBURG: It's either the company whose stock is in question or you're an aider and abettor.

MR. SHAPIRO: You are only a primary violator under -- under Central Bank if each and every element of 10b-5 liability is satisfied, including reliance on your statement, including the ***36** ""in-connection-with'' test, and including loss causation. None of those tests are satisfied here, but what is satisfied is Section 20(e), which says, did they knowingly give substantial assistance to somebody who is committing a fraud? And that -- that fits this case like a glove . . . .

* * *

JUSTICE KENNEDY: Do you know, Mr. Shapiro, if in the law of torts and the restatement of torts or in other areas of the law there is some third classification that's between aider and abettor in principle?

MR. SHAPIRO: I don't know the answer. ***42** Although in these statutes themselves there are such provisions not included in Section 10(b). For example in Section 18(a), if you cause some other person to make a false statement in a financial statement, you can be held liable, but they are not invoking it in Section 18. Same thing under Section 17. If you engage in a scheme to cause some falsehood, you can be prosecuted by the government.

But nowhere has Congress said that an individual litigant can bring a claim like that without regard for reliance and in connection with in the loss causation test.

JUSTICE SOUTER: Let's assume there is reliance and loss causation. Let me ask a question very similar to what Justice Ginsburg has posed a couple of times. She has said is there

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23 In ***S.E.C. v. Tambone***, 597 F.3d 436 (1st Cir. 2010), the SEC brought a 10(b)(5) securities fraud action against officers of a primary underwriter for a group of mutual funds.

The United States District Court for the District of Massachusetts granted defendants' motion to dismiss. The U.S. Court of Appeals for the First Circuit reversed and remanded. This ruling was made following a granting of *en banc* review.

The First Circuit rejected the SEC's theory that dissemination of a statement constitutes "making" that statement under Rule 10b-5. The court followed *Central Bank* and concluded that courts should not confuse primary violators with secondary violators. Although the court recognized that SEC actions are different from private actions, it refused to expand liability under 10(b)(5) to the facts of this case. The court rejected the SEC's argument to "impose primary liability … for conduct that constitutes, at most, aiding and abetting (a secondary violation)."

a third category. My question is, is there an overlap? Can there be an overlap?

MR. SHAPIRO: No, I don't there can be. . . .

The issue whether there may be liability short of primary liability is unresolved, but at least one Justice, Justice Ginsburg, is keenly interested in such a middle ground.

Conclusion - The 10b-5 Remedy Contracts

Commentators have labeled decisions of the United States Supreme Court from *Central Bank* through *Janus Capital Group* as "contracting" the scope of Rule 10b-5. At oral argument in *Janus Capital Group, Inc.* Chief Justice Roberts gave an indication of his reserved approach regarding the proper role of the Court in cases involving implied rights of action:

STONERIDGE INVESTMENT PARTNERS, LLC, Petitioner,
v.
SCIENTIFIC-ATLANTA, INC., et al.

ORAL ARGUMENT OF STANLEY GROSSMAN ON BEHALF OF THE PETITIONER

* * *

CHIEF JUSTICE ROBERTS: But it's not like under the Sherman Act, where we have reason to think Congress intended the Court to go about the business of construing and developing antitrust law. In fact, they are kind of taken over for us. They are imposing certain limits on when actions can be brought, proposing specific elements. In one of the provision, 20(e), specifying SEC can bring an action but private investors can't.

I mean, we don't get in this business of implying private rights of action any more. And isn't the effort by Congress to legislate a good signal that they have kind of picked up the ball and they are running with it and we shouldn't?

MR. GROSSMAN: Well, this Court, Your Honor, as recently as 2002 in Wharf (Holdings) said there is a private right of action for violation of any of the subdivisions of Rule 10b-5: A, B, or C. That would have to be reversed.

Going back to the Superintendent of Insurance case in, in -- that would be in 1971, Your ***7** Honor, the Court held there was a private right of action for violation of --

CHIEF JUSTICE ROBERTS: **Well, that's kind of my point. We did that sort of thing in 1971. We haven't done it for quite sometime.**

MR. GROSSMAN: Well, when Congress enacted the Private Security Law Reform Act, everything it did in connection with that statute was directed to the private right of action that this Court had previously implied under 10(b). Nothing that Congress did was intended in any way --

CHIEF JUSTICE ROBERTS: **I'm not -- my suggestion is not that we should go back and say that there is no private right of action. My suggestion is that we should get out of the business of expanding it,** because Congress has taken over and is legislating in the area in the way they weren't back when we implied the right of action under 10(b). . . .

* * *

CHIEF JUSTICE ROBERTS: Why shouldn't we be guided by what Congress did in the action to the Central ***12** Bank case? There we said there's no aiding and abetting liability, Congress amended the statute in 20(e) to say yes, there is, but private plaintiffs can't sue on that basis. Why shouldn't that inform how we further develop the private action under 10b-5?

MR. GROSSMAN: Well, I think if Congress intended under 20(e) -- certainly the private action is similar to this -- it would have said that only the SEC has the authority to bring a claim for substantial assistance whether or not it involves deceptive conduct. They could have very easily said any deceptive conduct, and that would have barred these claims. They chose not to do that.

2007 WL 2932905(emphasis supplied).

Chief Justice Roberts' comments during oral argument make evident the role he sees for the Court. The *Janus Capital Group Inc.* majority saw a narrow role for the Court in interpreting Rule 10b-5. The *Janus Capital Group* majority stated "we must give the implied private right of action" a "narrow scope." *Janus,* 131 US at 2302. It added that "we will not expand liability beyond the person or entity that ultimately has authority over a false statement." *Id.*

The role envisioned by Justice Roberts and the *Janus Capital Group* majority is different from the role many commentators desire the Court to play. One such commentator, Seitz, states "since the Supreme Court is charged with ...taking any action it feels is in the best interest of the public welfare, we may see an era in which the Court broadens the current confines of judicial interpretation some day."[24] Based on comments of the various Justices during oral argument and the language of recent opinions, it

24 Securities Law--The Implied Right Of Action Under Rule 10B-5 Does Not Extend Liability To Aiders And Abettors. *Janus Capital Group v. First Derivative Traders,* 131 S. Ct. 2296(2011)

seems unlikely that such a broadening will occur.

ENDNOTES

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About Judy Burnthorn

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Ms. Burnthorn is a partner in the firm. For over 25 years she has focused on trying all types of commercial matters before juries, judges and arbitration panels.

Ms. Burnthorn handles litigation in the areas of professional liability, employment law, securities and commodities fraud, financial transactions, negotiable instruments, tax, business valuation, non-competition agreements, unfair trade practices, insurance (life, health, disability, directors & officers, and errors & omissions), and malpractice (CPA, attorney, surveyor, appraiser and insurance agent). Ms. Burnthorn has extensive experience representing excess insurance carriers and insurance guaranty associations. She has also successfully handled multi-district litigation and class action matters.

Ms. Burnthorn set precedent eliminating vicarious liability under provisions of the RICO statute, enforcing contractually shortened fidelity bond statutes of limitations against claims of waiver and invalidity, enjoining the prosecution of state litigation through injunctions issued in federal court, and enforcing coverage provisions of insurance guaranty association statutes. Prior to joining the firm, Ms. Burnthorn completed an externship with the Honorable Martin L.C. Feldman, USDC, E.D.La.

Securities

Ms. Burnthorn has tried numerous securities and commodities fraud lawsuits. Her primary practice is on behalf of defendants. She has tried securities cases brought against brokers and sellers of securities alleging misrepresentations and omissions of material facts, failure to supervise, churning, unauthorized trading, selling away, and unsuitability. She has handled matters under the Securities Act and the Securities Exchange Act, including issues for reporting companies and lawsuits arising out of broker/dealer registration provisions.

She has handled a limited number of securities cases on behalf of plaintiffs. For example, when a meritorious securities fraud case against a national broker dealer presented itself from the plaintiff's perspective, Ms. Burnthorn accepted the case. She alleged "selling away" and unauthorized trading, tried the case to conclusion, and obtained a judgment in favor of the plaintiff. In the self-service action, Ms. Burnthorn successfully represented a group of plaintiff investors seeking rescission of securities purchases and damages under Securities Act registration provisions, Securities Act fraud provisions, Securities Exchange Act fraud provisions, and the Louisiana Blue Sky Law. She has additionally presented programs instructing claims handlers on FINRA litigation.

Financial and Banking Cases

Ms. Burnthorn has obtained outstanding results defending financial institutions in matters brought by investors, borrowers, depositors, employees, and the federal government. She has also prevailed prosecuting actions on behalf of financial institutions, including fidelity bond actions and contested foreclosures. Ms. Burnthorn successfully handled multiple letter of credit cases, including those involving the following financial institution beneficiaries involved in the action:

- First National Bank of Columbus ($1.55 Million) First National Bank of Columbus v. Pelican Homestead, 869 F.2d 896 (5th Cir 1989).
- Sun Bank of Ocala ($550,000)
- Exxon Corporation ($2.74 Million)
- Hibernia National Bank ($200,000)
- Capital Bank ($300,000)
- Joseph E. Juban and George P. Bevan, Baton Rouge attorneys ($250,000)

Education

- J.D., magna cum laude, Tulane University School of Law, 1986 (Tulane Law Review; Order of the Coif)
- B.A., summa cum laude, Political Philosophy, Louisiana State University, 1982