Simpson Thacher

Securities Law Alert

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–Benchmark Litigation 2019

Supreme Court: Considers Applicability of Rules 10b-5(a) and (c) to an Individual Who Was Not the "Maker" of a Fraudulent Statement

On December 3, 2018, the Supreme Court heard oral arguments in *Lorenzo v. SEC* (No. 17-1077), a case in which the Court will decide whether an individual who merely distributed a material misstatement or omission, and was not the "maker" of the statement under the test set forth in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011), can nonetheless be held liable under the "fraudulent scheme" provisions of Rule 10b-5(a) and (c).[1] The circuit courts are split on this issue: The Second, Eighth, and Ninth Circuits have held that a misstatement cannot be the sole basis for a fraudulent scheme claim, while the D.C. Circuit and the Eleventh Circuit have held that a misstatement, standing alone, can be the basis for such a claim.[2]

Background

SEC Rule 10b-5 enables the SEC—or private plaintiffs—to bring civil actions to enforce three types of securities fraud violations: those committed by (a) employing any "device, scheme or artifice to defraud;" (b) making a false statement or omitting

1. Please click here to read our discussion of the Supreme Court's decision in *Janus*.

2. *Compare Lentell v. Merrill Lynch*, 396 F.3d 161 (2d Cir. 2005) (holding that plaintiffs cannot successfully assert "a market manipulation claim under Rule 10b-5(a) and (c)" if "the sole basis for such claims is alleged misrepresentations or omissions"), *Public Pension Fund Grp. v. KV Pharm.*, 679 F.3d 972 (8th Cir. 2012) ("[A] scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b)."), *and WPP Luxembourg Gamma Three Sarl v. Spot Runner*, 655 F.3d 1039 (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) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions.") *with Lorenzo v. SEC,* 872 F.3d 578 (D.C. Cir. 2017) (holding defendant liable under Rules 10b-5(a) and (c) for disseminating a statement he did not make), *and SEC v. Big Apple Consulting USA*, 783 F.3d 786 (11th Cir. 2015) ("[E]ven a person . . . who is not the 'maker' of an untrue statement of a material fact, nonetheless could be liable as a primary violator of Rule 10b-5(a) and (c).").

information that would be misleading to an investor; or (c) engaging in fraudulent or deceitful conduct.

Francis Lorenzo, a registered representative of a broker-dealer, sent two emails to potential investors containing material misstatements. The emails indicated they were sent "at the request" of Lorenzo's boss, and Lorenzo testified that he copied and pasted content that was supplied by his boss. The SEC initiated an administrative enforcement action against Lorenzo, charging violations of, *inter alia*, all three Rule 10b-5 provisions. An SEC Administrative Law Judge found that Lorenzo's conduct amounted to offenses under all three provisions of Rule 10b-5. The Commission affirmed this ruling, issuing a lifetime bar on Lorenzo working in the securities industry, as well as imposing a $15,000 monetary penalty.

A divided panel of the D.C. Circuit reversed the Commission in part, finding that Lorenzo's tenuous connection to the statements was insufficient to find that Lorenzo was the "maker" of the statements under *Janus*, as required to impose fraudulent misstatement liability under Rule 10b-5(b). *Lorenzo v. SEC*, 872 F.3d 578 (D.C. Cir. 2017). In reaching this conclusion, the D.C. Circuit emphasized that under *Janus*, Lorenzo's boss was the one with control and the "ultimate authority" over when and how to communicate the information.

However, the D.C. Circuit affirmed the SEC's decision to impose fraudulent scheme liability on Lorenzo under Rules 10b-5(a) and (c) due to his role in disseminating the misstatements to potential investors. The Court reasoned that although Lorenzo was not the "maker" of the misstatement, he "conveyed materially false information to prospective investors about a pending securities offering backed by the weight of his office as director of investment banking," thereby using the statements to defraud investors. The Court took an expansive view of the securities laws and found that Rules 10b-5(a) and (c) could be employed to find liability in connection with false statements even where the defendant's conduct was outside the scope of Rule 10b-5(b). In a dissenting opinion, then-Judge Kavanaugh—who is not participating in the decision at the Supreme Court—argued that "scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others."

Lorenzo petitioned the Supreme Court for a writ of certiorari, which was granted on June 18, 2018.

Oral Argument Highlights

The oral argument focused heavily on whether permitting liability under Rule 10b-5(a) and (c) would allow for an end run around the Court's ruling in *Janus*. In addressing this issue, the Justices also explored whether the provisions of Rule 10b-5 were intended to be mutually exclusive, or whether the provisions were in fact intended to operate together to broadly prohibit fraudulent conduct in the securities industry.

Lorenzo's counsel argued that imposing fraudulent scheme liability in this case, where an individual only distributed someone else's false statement, would essentially reduce *Janus* to a case of incorrect pleading. After receiving some pushback from Justice Kagan on the idea that Rules 10b-5(a) and (c) are meant to operate separately from Rule 10b-5(b), Lorenzo's counsel did admit that there could be a situation where additional deceptive conduct could take a misstatement into fraudulent scheme territory; however, Lorenzo's counsel reiterated that the act of sending an email, as was the case here, would be insufficient to do so because such an act is not "inherently deceptive."

Justice Alito asked: "Why doesn't his conduct fall squarely within the language of (c)?" He questioned how an individual could violate Rule 10b-5(c) without a misstatement of some type: "I don't quite know how you're going to engage in a fraud . . . without saying some words." Lorenzo's counsel argued that liability under Rule 10b-5(c) is "a type of fraud that's categorically different than merely misstatements or omissions."

Justice Gorsuch seemed to be convinced by Lorenzo's arguments, as he challenged the government's insistence that sending the email itself was an act of fraud. Instead, Justice Gorsuch appeared to be of the opinion that the misstatement was the sole act of fraud, and Lorenzo could not be held liable as he did not "make" the statement. The government continued to rely on the fact that *Janus* was decided exclusively within the context of fraudulent misstatement allegations under Rule 10b-5(b) and argued that the "maker" standard was not relevant to an interpretation of Rule 10b-5(a) or (c).

Argument also focused on the Supreme Court's decision in *Central Bank of Denver, v. First Interstate Bank of Denver,* 511 U.S. 165 (1994), which drew a distinction between primary and secondary liability. Lorenzo's counsel argued that if the Court were to affirm the D.C. Circuit's decision, essentially holding Lorenzo liable for conduct amounting to aiding and abetting his boss's misstatement, such a holding would blur the lines between primary and secondary liability, opening a new avenue of lawsuits to private plaintiffs. Lorenzo's counsel acknowledged that Section 17(a)(2), which makes it unlawful to obtain money or property by means of any untrue statement of material fact, would have been a better mechanism through which the SEC could have sought liability for Lorenzo's conduct that would not jeopardize the distinction made in *Central Bank*, as enforcement under Section 17(a)(2) is only available to the government.

A decision in *Lorenzo* is expected before next summer.

Delaware Supreme Court: Affirms Chancery Court Decision Finding a "Material Adverse Effect" for the First Time

On December 7, 2018, the Delaware Supreme Court affirmed the Delaware Chancery Court's decision in *Akorn v. Fresenius Kabi*, 2018 WL 4719347 (Del. Ch. 2018) (Laster, V.C.), which held that a buyer was justified in terminating a public company merger agreement on the basis that a Material Adverse Effect ("MAE") had occurred. *Akorn v. Fresenius Kabi*, 2018 WL 6427137 (Del. 2018) (Strine, Jr., C.J.). An MAE, one of the key terms in an acquisition agreement, essentially defines when a buyer does not have to complete an agreed-upon acquisition as a result of an adverse change to a target's business during the period between signing and closing.

Delaware courts to consider this issue have found that an MAE requires that "unknown events" threaten earnings potential in a "durationally-significant manner." *IBP v. Tyson Foods*, 789 A.2d 14 (Del. Ch. 2001). In *Akorn*, the buyer terminated the merger agreement on the grounds that (1) significant declines in the target's performance amounted to an MAE (and therefore, a failure of the standalone MAE condition), and (2) serious FDA compliance failures breached the target's regulatory compliance representations in a manner that constituted an MAE (and therefore, a failure of the target's ability to "bring-down" its representations and warranties at closing).[3]

In a brief decision, the Delaware Supreme Court held that "[t]he factual record adequately supports the Court of Chancery's determination, based on its application of precedent such as [*IBP*] . . . that [the target] had suffered a material adverse effect . . . that excused any obligation on [the buyer's] part to close." The Delaware Chancery Court further held that "[t]he record adequately supports the Court of Chancery's declaration that [the buyer] properly terminated the merger . . . because [the target's] breach of its regulatory representations and warranties gave rise to an MAE and [the buyer] had not itself engaged in a prior, material breach

3. Please click here to read our discussion of the Delaware Chancery Court's decision in *Akorn*.

of a covenant that would have prevented [the buyer] from exercising its immediate termination rights under the Merger Agreement."

Delaware Chancery Court: Forum Selection Provisions Requiring Federal Securities Act Claims to Be Brought in Federal Court Are "Ineffective and Invalid"

On December 19, 2018, the Delaware Chancery Court held that provisions in certificates of incorporation requiring claims under the Securities Act of 1933 (the "Securities Act") to be brought in federal court are "ineffective and invalid." [*Sciabacucchi v. Salzberg*, No. 2017-0931-JTL (Del. Ch. 2018) (Laster, V.C.)]. The court found that its earlier opinion in *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013), authored by then-Chancellor Strine, "answers whether a forum-selection provision can govern claims under" the Securities Act.[4] The *Boilermakers* court held that Section 109(b) of the Delaware General Corporation Law ("DGCL") permits a Delaware corporation to "adopt a forum-selection bylaw for internal-affairs claims" but "does *not* authorize a Delaware corporation to regulate external relationships."[5] *Sciabacucchi*, No. 2017-0931-JTL. Relying on "[t]he *Boilermakers* distinction between internal and external claims," the *Sciabacucchi* court held that a forum-selection provision cannot govern Securities Act claims because such claims are "external to the corporation."

The forum selection bylaws at issue in *Boilermakers* concerned derivative suits, fiduciary duty suits, suits asserting claims under the DGCL, and internal affairs suits. The *Boilermakers* court found that "[t]hese are the kind of claims most central to the relationship between those who manage the corporation and the corporation's stockholders." The court emphasized that these types of claims are "brought by stockholders *qua* stockholders." The court contrasted the forum selection laws at issue with hypothetical forum selection bylaws governing tort or contract claims, which would be "beyond the statutory language" of Section 109(b) because such claims concern "external matters" rather than "the rights and powers of the plaintiff stockholder *as a stockholder*." Following the *Boilermakers* decision, the Delaware General Assembly adopted Section 115 of the DGCL, which specifically authorizes corporations to adopt forum-selection provisions in their certificates of incorporation or bylaws providing "that any or all internal corporate claims shall be brought solely and exclusively in" Delaware courts. 8 *Del. C.* § 115.

In *Sciabacucchi*, the court found that "the reasoning in *Boilermakers* applies equally to a charter-based [forum selection] provision" because "the language of Section 109(b) dealing with the subject matter of bylaws parallels in large measure the language of Section 102(b)(1) dealing with what may be included in a certificate of incorporation."[6]

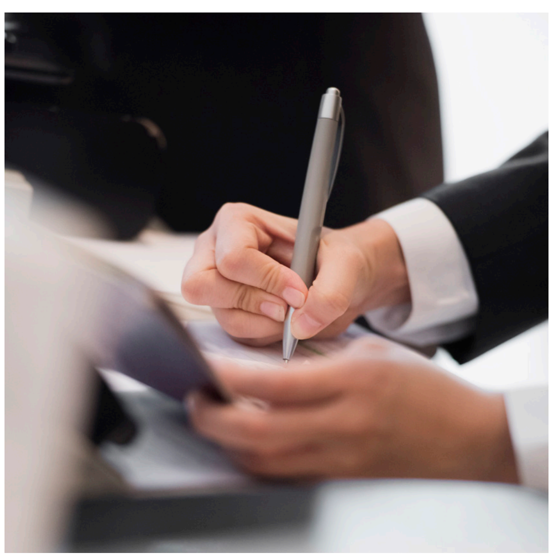
4. Please click here to read our discussion of the Delaware Chancery Court's decision in *Boilermakers*.

5. At the time *Boilermakers* was decided, Section 109(b) provided in relevant part as follows: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." 8 *Del. C.* § 109(b) (2014).

6. Section 109(b) provides that a corporation's "bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." 8 *Del. C.* § 109(b). Section 102(b)(1) similarly provides that a certification of incorporation may include "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders or any class of the stockholders . . . if such provisions are not contrary to the laws of this State." 8 *Del. C.* § 102(b)(1).

The court determined that under *Boilermakers*, “a Delaware corporation does not have the power to adopt in its charter or bylaws a forum-selection provision that governs external claims.”

The *Sciabacucchi* court found that “a federal claim under the [Securities Act] is a clear example of an external claim.” Such a claim “does not turn on the rights, powers, or preferences of the shares, language in the corporation’s charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation.” The court noted that a plaintiff may assert a Securities Act claim against a broad range of defendants regardless of whether those defendants have “internal role[s] with the corporation.” Moreover, “shares of a Delaware corporation are only one subset” of one type of security governed by the Securities Act. Finally, the court underscored that a Securities Act claim “does not arise out of or relate to the ownership of the share, but rather from the purchase of the share.” The court explained that “[a]t the moment the predicate act of purchasing occurs, the purchaser is not yet a stockholder and does not yet have any relationship with the corporation that is governed by Delaware corporate law.” The court found it significant that the purchaser does not have to “continue to own the security to be able to assert a [Securities Act] claim.” The court concluded that a Securities Act “claim resembles a tort or contract claim brought by a third-party plaintiff who was not a stockholder at the time the claim arose,” and is therefore “an external claim that falls outside the scope of the corporate contract.”



The *Sciabacucchi* court further found that “[t]he constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware’s corporate law.” The court stated that Delaware law cannot govern claims brought under the Securities Act because “[f]ederal law creates the claim, defines the elements of the claim, and specifies who can be a plaintiff or a defendant.” Consequently, the court held that forum selection laws governing Securities Act claims are “ineffective and invalid.”

Delaware Chancery Court: A *Brophy* Insider Trading Claim May, Depending on the Circumstances, Be Premised on Trades by an Entity Affiliated With and Controlled by a Director

On December 14, 2018, the Delaware Chancery Court held that plaintiffs adequately alleged demand futility by pleading that a majority of the company’s directors faced a substantial likelihood of liability for insider trading under *Brophy v. Cities Service Co.*, 31 Del. Ch. 241 (Del. Ch. 1949).[7] [*In re Fitbit Stockholder Derivative Litig.*, 2018 WL 6587159 (Del. Ch. 2018) (Slights, V.C.)]. In a case of first impression, the court considered whether “a fiduciary may be held liable on a *Brophy* claim for trades that an entity or fund associated with that fiduciary executed in its name.” The court declined “to state a hard and fast rule,” but found that plaintiffs adequately alleged that trades by entities affiliated with two of the directors could be attributed to those directors.

Plaintiffs alleged that one of the directors was a founder and managing member of a venture capital firm, while another director was a partner at a different venture capital firm. Both firms sold millions of the company’s shares during the relevant time period. The court noted that the directors were “not simply board designees

7. A *Brophy* claim “permits a corporation to recover from its fiduciaries for harm caused by insider trading.” *In re Fitbit Stockholder Derivative Litig.*, 2018 WL 6587159 (Del. Ch. 2018).

for their funds." Rather, plaintiffs alleged that "[b]oth directors share voting and dispositive power over the [company] stock owned by their respective funds." The court found plaintiffs adequately alleged that the directors "personally and materially profited from the challenged stock sales through their ownership and control of their affiliated funds."

Given these allegations, the court determined that "finding *ipso jure* that the [venture capital firms'] trades cannot be attributed to [the directors affiliated with those firms] would frustrate the policy that animates *Brophy*." The court reasoned that such a ruling "would permit a director to trade on inside material information without consequence just because the director did not trade personally but rather passed the information to an entity with which he is affiliated (and over which he exercised control) to do the trading." The court found that this "is not and cannot be our law." The court stated that "to allow these directors, through their controlled funds, to profit from inside information without recourse would be inconsistent with the policy of extinguishing all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation that undergirds Delaware's insider trading law."

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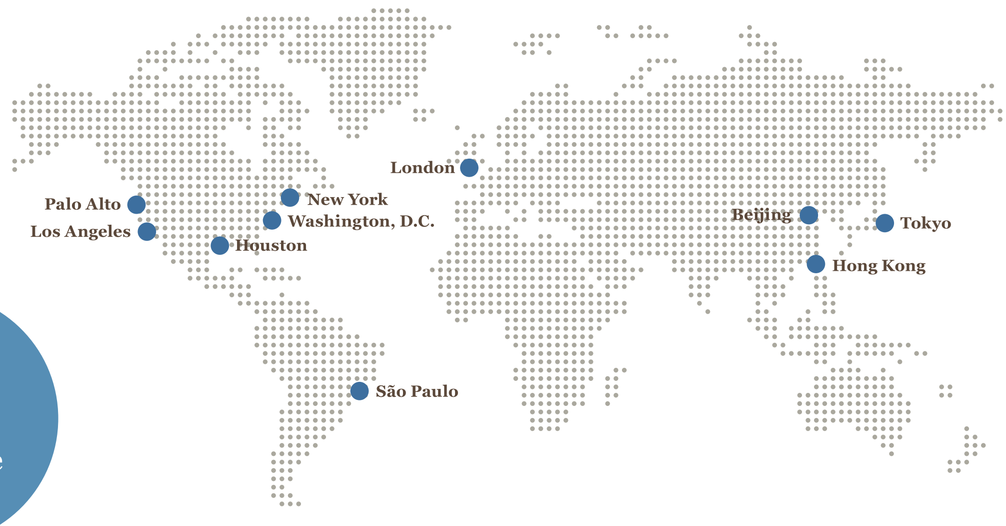

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