Simpson Thacher

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D.C. Circuit: (1) Distributing a Statement Authored and Approved by a Superior Does Not Constitute "Making" a Statement Under *Janus*, But (2) Liability Under Rules 10b-5(a) and (c) Is Not Limited to "Makers" of Statements

On September 29, 2017, the D.C. Circuit held that a broker who distributed false statements that were authored and approved by his boss could not be liable under Rule 10b-5(b) as a "maker" of those statements within the meaning of the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011).[1] Lorenzo v. SEC, 2017 WL 4320272 (D.C. Cir. 2017) (Srinivasan, J.). However, the D.C. Circuit held that the broker could nevertheless be liable under Rules 10b-5(a) and (c) and Section 17(a)(1)[2] because those sections "do not speak in terms of an individual's 'making' a false statement."

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

2. Under Rule 10b-5(a), it is unlawful to "employ any device, scheme, or artifice to defraud … in connection with the purchase or sale of any security." Rule 10b-5(c) prohibits individuals and entities from "engag[ing] 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." Section 17(a)(1) renders it "unlawful for any person in the offer or sale of securities … to employ any device, scheme, or artifice to defraud."

Distributing a Statement Is Not Equivalent to "Making" a Statement for *Janus* Purposes

Rule 10b-5(b) renders it unlawful to "make any untrue statement of a material fact … in connection with the purchase or sale of any security." In *Janus*, 564 U.S. 135, the Supreme Court held that "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." The Court reasoned that "[w]ithout control, a person or entity can merely suggest what to say, not 'make' a statement in its own right."

In the case before the D.C. Circuit, the broker claimed that "he [had] sent the email messages at the behest of his boss" who had "supplied the content of the false statements." *Lorenzo*, 2017 WL 4320272. The broker contended that he had simply "copied and pasted [ ] the messages before distributing them." The D.C. Circuit deemed it significant that the broker's boss had "approved the messages for distribution." The court found this demonstrated the boss's "ultimate authority over the substance and distribution of the emails."

For purposes of the *Janus* analysis, the court considered it immaterial that the broker had "put his own name and direct phone number at the end of the emails" and "sent the emails from his own account." The court reasoned that this "sort of signature line … can often exist when one person sends an email that 'publishes a statement on behalf of another,' with the latter person retaining 'ultimate authority over the statement.'" *Id.* (quoting *Janus*, 564 U.S. 135).

The D.C. Circuit therefore reversed dismissal of the SEC's determination that the broker had violated Rule 10b-5(b).

Janus Does Not Limit the Scope of Liability Under Rules 10b-5(a) and (c) and Section 17(a)(1)

Although the D.C. Circuit found the broker did not violate Rule 10b-5(b), the court held that the broker could nevertheless face liability under Rules 10b-5(a) and (c) and Section 17(a)(1). The court explained that the phrase "'[t]o make any … statement' was the critical language construed in *Janus*." While this language appears in Rule 10b-5(b), the court noted that Rules 10b-5(a) and (c) and Section 17(a)(1) "do not speak in terms of an individual's 'making' a false statement."

The D.C. Circuit noted that the broker, "acting with scienter," had "produced email messages containing three false statements about a pending offering, sent the messages directly to potential investors, and encouraged them to contact him personally with any questions." Even though the broker was not himself the "maker" of those statements, the court determined that the broker's "own active role in producing and sending the emails constituted employing a deceptive 'device,' 'act,' or 'artifice to defraud' for purposes of liability under" Rules 10b-5(a) and (c) and Section 17(a)(1).

The Broker's Conduct Did Not Amount Simply to Aiding and Abetting Securities Fraud

The D.C. Circuit rejected the broker's contention that "if he could be found to have violated [these] provisions, the decision in *Janus* would effectively be rendered meaningless" because private parties could then bring suit for certain forms of aiding and abetting securities fraud.

The D.C. Circuit found the "conduct at issue in *Janus* materially differ[ed] from [the broker's] actions in this case." *Lorenzo*, 2017 WL 4320272. The court explained that "*Janus* involved an investment adviser that initially drafted false statements which an independent entity subsequently decided to disseminate to investors in its own name." The court emphasized that "[t]he investment advisor's role in originally devising the statements was unknown to the investors who ultimately received them."

Here, on the other hand, the broker's role "was not 'undisclosed' to investors," and the "dissemination of the false statements to investors [did not] result only from the separate 'decision of an independent entity.'" *Id.* (quoting *Janus*, 564 U.S. 135). The broker "transmitted misinformation directly to investors, and his involvement was transparent to them." The D.C. Circuit held that "[t]he [*Janus*] Court's concern that 'aiders and abettors would be almost nonexistent' if a private action under Rule 10b-5 reached 'an undisclosed act preceding the decision of an independent entity to make a public statement' need not obtain in the case of a person's self-attributed communications sent directly to investors (and backed by scienter)."

Rules 10b-5(a) and (c) and Section 17(a)(1) Reach Securities Fraud Actions Involving False Statements

The D.C. Circuit also rejected the argument that "actions involving false statements must fit within Rule 10b-5(b) and cannot be brought separately under Rules 10b-5(a) or (c) (or Section 17(a)(1))." The court explained that there was "no blanket reason … to treat the various provisions as occupying mutually exclusive territory, such that false-statement cases must reside exclusively within the province of Rule 10b-5(b)." Rather, the court found that "the provisions' coverage may overlap in certain respects."

The D.C. Circuit held that "Rules 10b-5(a) and (c), as well as Sections 10(b) and 17(a)(1), may encompass certain conduct involving the dissemination of false statements even if the same conduct lies beyond the reach of Rule 10b-5(b)."

The D.C. Circuit found no "incongruity in deciding both that [the broker] was not a maker of the false statements under Rule 10b-5(b) and that he nonetheless employed a fraudulent device and engaged in a fraudulent act under Rules 10b-5(a) and (c) and Section 17(a)(1)." The court explained that its ruling "follow[ed] naturally from the terms of the provisions." The broker "was not the 'maker' of the false statements because he lacked ultimate authority over them." However, the broker nevertheless "'engaged' in a fraudulent 'act' and 'employed' a fraudulent 'device' when, with knowledge of the statements' falsity and an intent to deceive, he sent the statements to potential investors carrying his stamp of approval as investment banking director." The court recognized that there may be individuals "whose ministerial acts in connection with false statements would fail to qualify either as 'making' the statements or as 'employing' any fraudulent device," but the broker here was "not such a person."

Judge Kavanaugh, Dissenting, Opines That the Majority's Decision Creates a Circuit Split

In a dissenting opinion, Judge Kavanaugh stated that "[t]he majority opinion creates a circuit split by holding that mere misstatements, standing alone, may constitute the basis for so-called scheme liability under the securities laws—that is, willful participation in a scheme to defraud—even if the defendant did not make the misstatements."[3] He found that "[o]ther courts have instead concluded that scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others." In Judge Kavanaugh's view, these courts based their decisions on "the important statutory distinction between primary liability and secondary (aiding and abetting) liability."

3. Judge Kavanaugh cited *Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner*, 655 F.3d 1039 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005); and *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2011).

S.D.N.Y.: Absent Allegations of a Ponzi Scheme, It Is "Incredibly Difficult" to Satisfy *Fifth Third*'s "Highly Exacting Standard" for Pleading a Breach of the Duty of Prudence Claim Based on Inside Information

On October 4, 2017, the Southern District of New York dismissed, in its entirety, an ERISA action brought against the fiduciaries of an employee stock ownership plan (the "Plan"). [*John Price v. Michael Strianese and Ralph D'Ambrosio*, 2017 WL 4466614 (S.D.N.Y. Oct. 4, 2017) (Caproni, J.)]. The action, which followed closely on the heels of a related securities fraud action, alleged that defendants had knowingly failed to protect Plan participants from a temporary drop in the company's stock price following the company's disclosure of alleged accounting misconduct. The court held that plaintiffs did not adequately allege that defendants knew or should have known of the alleged fraud. The court further ruled that plaintiffs did not satisfy the "highly exacting standard" established by the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014)[4] for pleading a breach of the duty of prudence claim based on inside information.

Plaintiffs Did Not Allege Defendants Knew Or Should Have Known of the Alleged Fraud

Plaintiffs contended that defendants "knew or should have known that [the Plan] had become an imprudent investment during the [c]lass period" because of alleged accounting improprieties involving a contract at one of the company's operating divisions. In a parallel securities fraud class action litigation, the Southern District of New York found plaintiffs failed to allege scienter as to the individual defendants based on substantially similar allegations.[5]

4. Simpson Thacher represents certain members of the Benefit Plan Committee of L3 Technologies (previously known as L-3 Communications) in this matter.

5. *Patel v. L-3 Commc'ns Holdings Inc.*, 2016 WL 1629325 (S.D.N.Y. Apr. 21, 2016) (Caproni, J.). Simpson Thacher represented L3 Technologies' CEO and CFO in this matter.

Plaintiffs attempted to rely on *Jander v. International Business Machines Corp.*, 205 F. Supp. 3d 538 (S.D.N.Y. 2016), a case in which the court held that the Rule 8 pleading standard was satisfied in an ERISA action even though the court found plaintiffs had not adequately alleged scienter in a parallel securities fraud action. However, the *Price* court found *Jander* "distinguishable" because that case involved materially different facts: "a $2.4 billion write down associated with the sale of an entire business segment." Here, by contrast, plaintiffs alleged a "material misstatement aris[ing] out of [allegedly] improper recognition of $17.9 million in revenue associated with a single contract in a subdivision of one of [the company's] four business segments." The *Price* court reasoned that *Jander* was inapposite for purposes of assessing what defendants "knew or should have known" because "a significant write down associated with the sale of a business segment necessarily requires the involvement of the company's senior most executives, whereas the revenue recognition associated with a single contract typically does not."

Plaintiffs Failed to Meet *Fifth Third*'s "More Harm Than Good" Standard for Pleading a Breach of the Duty of Prudence Claim Based on Inside Information

The court found that even if plaintiffs had satisfied the "knew or should have known" standard, they "failed to allege an ERISA breach of duty of prudence claim" based on inside information. The court explained that, to survive a motion to dismiss under *Fifth Third*, plaintiffs "must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." The *Price* court emphasized that *Fifth Third* established a "highly exacting standard that is incredibly difficult to satisfy" and noted that "the vast majority of ERISA duty of prudence claims brought against [the fiduciaries of employee stock ownership plans] since *Fifth Third* have foundered on the pleading requirements."

In the case before it, the court found plaintiffs' proposed "alternative courses of action [did] not satisfy *Fifth Third* because [plaintiffs] … failed to plead facts plausibly showing that any of these alternatives was legally viable or that [d]efendants could not have concluded that they would do more harm than good."

First, plaintiffs alleged that defendants "could have closed the [Plan] to new purchases or otherwise prevented Plan participants from purchasing [company] stock until the stock price corrected to a non-inflated value." The court explained that "[t]his alternative … has been consistently rejected" because freezing purchases could have such "dire consequences" as "sending the stock into a significant price decline and weakening investor confidence in the company—particularly if the freeze is not accompanied by a disclosure explaining the reason for the freeze."

Second, plaintiffs argued that defendants could have made an "earlier public corrective disclosure." The *Price* court found that post-*Fifth Third* courts "have [also] consistently … rejected earlier public disclosure" as a viable alternative course of action. Courts have reasoned that a prudent fiduciary "could very easily conclude that such an action *would* do more harm than good," especially if "the disclosure would have been made before the company had an opportunity to investigate the issue that would have been disclosed."

The *Price* court observed in passing that it could "imagine a scenario in which a proposed corrective disclosure could potentially survive *Fifth Third*'s standard" if a complaint included "particularized allegations" that "earlier disclosure of the 'bad fact' would necessarily cause less damage than a later disclosure." The court offered as an example a case in which a plan fiduciary was "aware that the company [was] a Ponzi scheme that [was] built on sand and virtually worthless." The court noted that in such a situation, it would "seem[ ] likely that the fiduciary could not conclude that it would cause more harm than good to disclose as soon as possible." "Unlike [this] hypothetical Ponzi scheme," however, the court found that "a prudent fiduciary [in the case before it] could have concluded that early disclosure would do more harm than good." The court stated that "only an extremely narrow category of … fiduciary duty claims based on failure to disclose nonpublic information may survive" a motion to dismiss under the framework articulated by *Fifth Third*. The court opined that this is due in part to the fact that "'ERISA and the securities laws ultimately have differing objectives pursued under entirely separate statutory schemes'" and that, as such, "alleged securities law violations do not necessarily trigger a valid ERISA claim."

Finally, the plaintiffs suggested that defendants could have invested in a "low-cost hedging product that would behave in a countercyclical fashion vis-à-vis [company] stock." The court found that this "third alternative [was] also not adequately pled pursuant to *Fifth Third* because the description of the hedging product [was] simply too vague for the [c]ourt to conclude that it reflect[ed] a viable option." The court further observed that that it was not clear from plaintiffs' allegations "whether the purchase of such a product would qualify as the purchase of a security that might implicate insider trading laws."

S.D.N.Y.: Statements Concerning User Metrics Do Not Include Implied Representations Concerning the Quality of the Users

On September 22, 2017, the Southern District of New York dismissed securities fraud claims alleging that a media technology company had misleadingly touted the number of its "registered users" to "fan investor enthusiasm" without disclosing that many of these "users" were unable to access the company's streaming services because of technological limitations. [*In re Eros Int'l Sec. Litig.*, No. 15-CV-8596 (S.D.N.Y. Sept. 22, 2017) (Nathan, J.)]. The court rejected plaintiffs' contention "that a person cannot be a 'registered user' if he or she cannot meaningfully make 'use' of the product."

Plaintiffs acknowledged that the company "did not define the term 'registered user,'" but alleged that "the term refers in the internet technology field to persons who not only register to access a website, but who also interact with the website to extract some benefit." The court held that plaintiffs could not "import the word 'meaningful' before 'use' absent some representation on the part of the [company] about the quality of registrants' use."

The court also rejected plaintiffs' contention that the company "'failed to warn' investors that 'registered users' could not make 'meaningful use'" of the company's streaming services. The court emphasized that "an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts." The court explained that "[d]isclosure is not required simply because an investor might find the information relevant or of interest."

The court found that the company "*could have* defined and reported 'users' in an alternate way that took into account the specifics of their use, but that does not amount to misrepresentation."

S.D.N.Y.: (1) Companies Have No Duty to Update Statements of Existing Fact That Do Not Include Forward-Looking Representations, and (2) Item 303 of Regulation S-K Does Not Mandate Disclosure of Speculative Quantitative Information

On September 30, 2017, the Southern District of New York held that there is no duty to update statements of existing fact that cannot be "characterized as 'hype' or 'forward-looking projections.'" *Plumbers and Steamfitters Local 137 Pension Fund v. American Express Co.*, 2017 WL 4403314 (Sept. 30, 2017) (Gardephe, J.). The court further held that Item 303 of Regulation S-K does not mandate disclosure of speculative quantitative information concerning known trends or uncertainties.

There Is No Duty to Update Statements That Do Not "Hype" an Aspect of the Company's Business

The court explained that "[t]he duty to correct applies when 'a company makes a historical statement that at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not.'" *Id.* (quoting *In re Int'l Bus. Machines Corp. Sec. Litig.*, 163 F.3d 102 (2d Cir. 1998)). "Alternatively, 'a duty to update may exist when a statement, reasonable at the time it is made, becomes misleading because of a subsequent event.'" The court emphasized that "[t]he duty to update is not without limits." The court stated that the duty to update "does not extend to (1) 'vague statements of optimism or expressions of opinion'; (2) statements that are 'not forward looking and do not contain some factual representation that remains alive in the minds of investors as a continuing representation'; or (3) statements that are not material."

In the case before it, the court found defendants had no duty to update statements concerning a business agreement. The court distinguished the company's statements from those at issue in *In re Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993) and *In re Quintel Entertainment Securities Litigation*, 72 F. Supp. 2d 283 (S.D.N.Y. 1999). In both cases, "defendants 'hyped' a part of their business plan as a solution to a problem or to justify a claim that the value of the company was increasing." Here, however, there were no allegations that the company "hyped" the agreement at issue.

Item 303 of Regulation S-K Does Not Mandate Disclosure of Speculative Quantitative Business Information

Plaintiffs contended that defendants "failed to quantify and disclose the expected impact" of a "known trend of increased competition with respect to co-brand agreements" as required under Item 303 of Regulation S-K, which sets forth the disclosure requirements for the Management's Discussion and Analysis (MD&A) section of a public company's SEC filings. Item 303 states that a public company must "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[6]

The court noted that the SEC has "cautioned that [Item 303] requires quantitative information only when it is reasonably available and will provide material information for investors." The court also observed that in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015), the Second Circuit did not interpret Item 303 to "require companies to 'give competitors notice of proprietary strategies and information.'" *Id.* (quoting *Stratte-McClure*, 776 F.3d 94). The court explained that "*Stratte-McClure* evinces a concern for the disclosure of sensitive business information."

The court held the company was not required under Item 303 to "precisely quantify potential effects on its business" because the company "did not know (1) which agreements might not be renewed; (2) which agreements might be renewed on less favorable terms; or (3) for agreements that were renewed on less favorable terms, what the new terms and their financial impact might be."

6. On March 27, 2017, the Supreme Court granted certiorari to address whether Item 303 of Regulation S-K creates a duty to disclose for purposes of Section 10(b) and Rule 10b-5. However, on October 17, 2017, the Court granted a request to cancel arguments in light of a settlement between the parties. Please click here to read our discussion of the Court's grant of certiorari in *Leidos v. Indiana Public Ret. Sys.* (No. 16-581).

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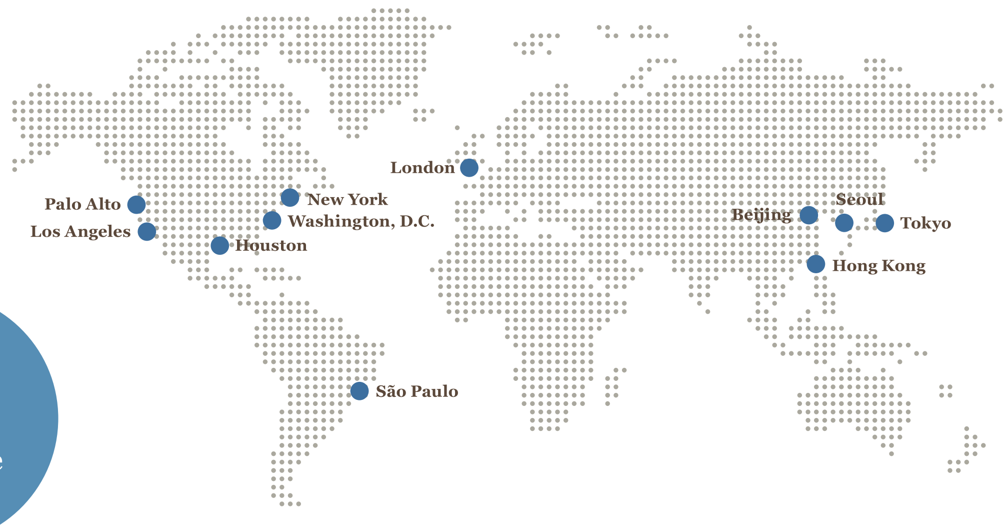

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