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The Supreme Court's Decision in Lorenzo*: Laying the Groundwork for Expansive Theories of "Scheme Liability" Under the Securities Laws*

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Recently, in *Lorenzo v. Sec. Exch. Comm'n*, 587 U.S. ___ (2019), the Supreme Court upheld a Circuit court ruling that a director of a registered broker-dealer was liable for securities fraud when he cut-and-pasted false statements prepared by his boss and, at his boss's direction, emailed those statements to potential investors. Although the Supreme Court assumed the director *was not liable* for making false statements under the antifraud provisions of the federal securities laws, the Supreme Court did find Lorenzo liable for securities fraud because his conduct in disseminating his boss's statements was deceptive and part of a scheme. This decision is certain to encourage the SEC to pursue expansive theories as to what constitutes scheme-based conduct in an effort to cast a wider net for liability. Private plaintiffs may try the same thing. Rather than simply relying on straightforward false statements claims (*i.e.*, ones that apply only to those who "make" the statement and have ultimate authority over the statement and its content), they could pursue "scheme liability" claims against not only the makers of the alleged statement but also those who acted at the maker's direction or participated in the dissemination or distribution of the statement.

Although it remains to be seen how courts will interpret *Lorenzo* and define the nature, degree and scope of conduct that could result in "scheme liability," the decision clearly has ramifications for both SEC enforcement claims and private actions.

Background

The relevant fact pattern in *Lorenzo* was straightforward and uncontested. The broker-dealer, Lorenzo's employer, was retained to sell $15 million of debentures offered by a renewable energy company, which purportedly had assets of $14 million (including intangible assets of $10 million). However, during the course of the debenture offering, the company publicly disclosed, and Lorenzo was told, that its assets were in fact valued at around $370,000 and that it had written off all of its worthless intangible assets. Shortly after the disclosure, Lorenzo sent two e-mails to potential investors falsely claiming that the debenture investment had multiple layers of protection, including $10 million in confirmed assets. The statements in the emails were not Lorenzo's statements; his boss had actually drafted the content of the statements, approved the language and directed Lorenzo to send the emails. Lorenzo's signature, however, appeared in the email block and the emails implied that the recipients should call Lorenzo with any questions.

The sole issue before the Supreme Court on appeal was whether Lorenzo, who was not the "maker" of the statements under the Supreme Court's prior decision in *Janus*,[1] could be liable for securities fraud under subsections (a) and (c) of Rule 10b-5 of the Securities Exchange Act and Section 17(a)(1) of the Securities Act, where the only conduct that Lorenzo engaged in was the dissemination of his boss's false statements. The Supreme Court made clear that its review was also limited by the fact that Lorenzo was not challenging a finding that he acted with the intent to defraud—a critical element in any securities fraud claim and one that is often hotly contested.

The Supreme Court began its analysis by evaluating the language of Rule 10b-5 which states 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,
>
> > **(a) To employ any device, scheme, or artifice to defraud**,
> >
> > (b) 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 the light of the circumstances under which they were made, not misleading, or
> >
> > **(c) 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.[2]

Subsections (a) and (c) are often referred to as the "scheme liability" provisions of the rule, and the Supreme Court noted that Section 17(a)(1) contains similar scheme liability language. Subsection (b) was not at issue because, as noted, the Supreme Court assumed for the purpose of its decision that Lorenzo did not "make" any untrue or false statement.

The Supreme Court found that the scheme liability provisions capture a wide range of conduct, and that it was "difficult to see how [Lorenzo's] actions could escape the reach of those provisions." That conclusion seemed especially swift where, as here, the Supreme Court was able to assume the fact that Lorenzo acted with the intent to defraud. Ultimately, the Court held that those "who disseminate false or misleading statements to potential investors with the intent to defraud, can be found to have violated the *other* parts of Rule 10b-5, subsections (a) and (c), as well as related provisions of the securities laws," regardless of whether they "made" the statements as defined by its prior decision in *Janus*.

The Court noted that borderline scheme liability cases might present challenges in the future, and that such cases could result in a narrowing of its interpretation. However, the Supreme Court found nothing borderline about the fact that Lorenzo sent false statements directly to investors and invited the investors to ask questions, all while acting in his capacity as a vice president of the broker-dealer. The Court also made clear that the three subsections of Rule 10b-5 were not mutually exclusive, and that their applications may overlap. Thus, while an individual may only be liable as a secondary actor under one subsection of the rule, she may be primarily liable under a separate section.

A strong dissent authored by Justice Thomas takes the position that the Court's holding "eviscerates" and turns into a "dead letter" the clear distinction between primary and secondary liability (*e.g.*, aiding and abetting claims) under the securities laws, which the Court's *Janus* opinion had confirmed. But in

Lorenzo, the Court rejected this argument, indicating that its holding was not an anomaly with respect to primary/secondary determinations—in fact, it noted that unlawful conduct often creates primary exposure for some violations but only secondary liability for others. As to whether minor actors might be swept up as primary actors in a securities claim alleging scheme liability, the Court simply noted that “even a bit participant in the securities market” can be primarily liable if all of the requirements for liability are met—a statement that some might consider a warning.

Takeaways

Lorenzo will have a number of potential implications in the SEC enforcement space. First and foremost, it is likely to encourage the SEC to pursue broader theories of scheme liability in an effort to identify those whom the SEC subjectively believes are responsible for a violation. Second, although “scheme liability” is not a new concept, the decision raises a number of questions: How will the term “disseminate” be defined? Will the definition include conduct where an individual simply forwards an email to another? If an email is forwarded, will all individuals on the email chain potentially face primary scheme liability? What other conduct, beyond dissemination, might be considered part of a scheme such that secondary actors will have primary exposure? And importantly, what is the scope and effect of the admission that Lorenzo acted with intent to defraud? These are among some of the critical questions to ask and consider—principally in light of the fact that the SEC will interpret this decision as sanctioning scheme-based claims against arguably bit participants.

Granted, the *Lorenzo* decision does not lift the SEC’s burden to prove all elements of a violation, including scienter and deceitful conduct. However, it does have the potential to erode the line between primary and secondary actors (*e.g.*, aiders and abettors) and encourage more aggressive pursuit of claims against a larger pool of potential defendants, including those who played no part in the preparation of the statements at issue.

Private plaintiffs will certainly attempt to expand their claims as well, although the picture there is a bit less clear. At first blush, plaintiffs’ lawyers will argue *Lorenzo* suggests that primary liability under Rule 10b-5 is now broader, with plaintiffs emboldened to bring Rule 10b-5(a) and (c) claims against a wider array of potential defendants. However, it is important to keep in mind that unlike Lorenzo’s SEC enforcement action, a private litigant would still need to show the element of reliance for Rule 10b-5 liability to attach, a point the majority opinion makes clear. Additionally, the Supreme Court did leave the door open to a “narrowing” of the reach of the scheme liability provisions, and we would expect such a narrowing to occur more quickly if aggressive civil plaintiffs attempt to apply the provisions outside their intended bounds. Otherwise, the *Lorenzo* dissent’s concern that the distinction between primary and secondary liability is being eviscerated would become a reality.

Nevertheless, the majority opinion plainly states: “Those who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c) … even if they are secondarily liable under Rule 10b-5(b).” Thus, one could imagine certain cases where plaintiffs may assert Rule 10b-5(a) or (c) primary scheme liability claims against defendants where, for example, the “maker” of the statement under *Janus* is unclear or there are defendants who acted in close concert with the maker in disseminating the alleged fraudulent statements. Defendants will need to be vigilant and strongly resist claims that expand liability beyond the statute’s intended bounds. In the meantime, litigants and lawyers alike should closely monitor securities fraud cases to see if plaintiffs pursue primary liability against additional defendants under Sections 10b-5(a) and (c) on the basis of the *Lorenzo* decision.

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If you have any questions concerning these developing issues, please do not hesitate to contact the aforementioned Paul Hastings practice groups.

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[1] *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).

[2] 17 CFR § 240.10b-5 (emphasis added).