# Client Alert

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# Supreme Court Limits 10b-5 Liability to Those Who "Make" Misstatements, Rejecting "Substantial Participation" Theory

by Bruce A. Ericson, David M. Furbush, Amy L. Pierce and Ranah L. Esmaili

*On June 13, the U.S. Supreme Court, by a 5 to 4 vote, narrowed the scope of primary liability under Securities and Exchange Commission Rule 10b-5(b) by holding that someone who participates in the preparation of a misstatement – but does not utter the misstatement or control the speaker – cannot be liable.*

The U.S. Supreme Court, in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 2011 WL 2297762, surprised many who expected it to focus narrowly on the mutual fund industry, or adopt the SEC's view that the term "make" in Rule 10b-5(b) encompasses behind-the-scenes assistance in the creation of misstatements uttered by others. Instead, the Court announced a bright-line rule limiting liability in most cases to the speakers and those who control them. The Court's opinion is good news for accountants, attorneys, investment banks and other service providers who assist in but do not control the preparation of public statements to be made by others; a contrary ruling might have left them exposed to securities fraud litigation. As it is, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) and *Janus*, taken together, will deter or defeat many claims that might otherwise be filed against service providers with deep pockets. Only time will tell, but putting aside manipulation cases, all that might be left of non-speaker liability is the "innocent intermediaries" theory, discussed below.

## The Split in the Circuits

In *Central Bank*, the Court held that Rule 10b-5's private right of action does not include suits against aiders and abettors, but only against primary violators. Then, in *Stoneridge*, the Court held that Rule 10b-5's private right of action does not include suits against those who neither have a duty to speak, nor said or did anything known or relied upon by the securities markets, but nonetheless were alleged to have participated in schemes that allowed someone else to make material misrepresentations to the marketplace. Both opinions left open the question of whether one could be primarily liable under Rule 10b-5 without either uttering a falsehood to the marketplace, or controlling someone who did. After *Stoneridge* most circuits said "no," but the U.S. Court of Appeals for the Fourth Circuit in *Janus* (reported below as *In re Mutual Funds Litig.*, 566 F.3d 111 (4th Cir. 2009)), said "yes," holding that a defendant could be held liable where the reader would likely attribute a "substantial role" to the defendant in the creation of the misstatement, even if the defendant did not utter the misstatement or have it expressly attributed to him. This set up a split in the circuits. Even so, *Janus* seemed an unlikely vehicle for a broad pronouncement on this subject, arising as it did out of the highly specialized world of mutual funds.

## The *Janus* Case

The case involves three related Janus entities: petitioner Janus Capital Group, Inc. ("JCG"), a publicly traded company that created the Janus family of mutual funds; petitioner Janus Capital Management LLC ("JCM"), the investment adviser and administrator of the funds, and a wholly owned subsidiary of JCG; and nonparty Janus Investment Fund ("JIF"), a business trust that held the funds' assets and is wholly owned by investors in the funds. JCM and JIF shared employees, but JIF had a board of trustees that was almost wholly independent of JCG and JCM. At issue were prospectuses issued by non-party JIF describing the investment strategy and operations of the JIF mutual funds to investors; JCM's in-house counsel wrote the prospectuses, which were readily accessible on the website shared by JIF, JCG and JCM. The prospectuses said the funds were not suitable for "market timing" (a short-term trading strategy said to hurt long-term investors) and suggested that JCM would implement policies to curb this practice.

In September 2003, New York Attorney General Eliot Spitzer sued JCG and JCM, alleging that they had entered into secret arrangements to permit market timing in the JIF mutual funds. In response, investors withdrew $14 billion from JIF mutual funds. Because JCM's (and hence JCG's) income is a function of the size of the funds' assets, JCG's investors reacted to the news and its stock fell 12.7% in one day. JCG and JCM later settled with the Attorney General for $225 million.

Thereafter, purchasers of JCG common stock filed suit against JCG and JCM, asserting claims for violations of Sections 10(b) and 20(a) (but not 20(b)) of the Securities Exchange Act of 1934 (the "'34 Act") and Rule 10b-5. They alleged JCG and JCM had caused JIF to issue prospectuses which created the misleading impression that JCG and JCM would implement measures to curb market timing in the JIF mutual funds when in reality JCM had entered into secret deals permitting market timing.

The district court dismissed the complaint for failure to state a claim. The Fourth Circuit reversed. Noting that the plaintiff had alleged that "JCG and JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents," the Fourth Circuit held that, in the context of the mutual fund industry and given the "publicly disclosed responsibilities of JCM, interested investors would infer that JCM played a role in preparing or approving the content of the [JIF] prospectuses." (The Fourth Circuit also held the complaint stated a Section 20(a) control-person claim, but not a Rule 10b-5 claim, as to JCG.) The U.S. Supreme Court granted review to address whether JCM could be held liable under Rule 10b-5 for false statements in JIF's prospectuses.

## The Court's Ruling (Justice Thomas, Joined by the Chief Justice and Justices Scalia, Kennedy and Alito)

The Court first reiterates that a private action under Rule 10b-5 should be given a narrow reading because it is a judge-created claim that Congress did not authorize when enacting or revising the '34 Act.

The Court then turns to the meaning of the verb "make" in Rule 10b-5(b).[1] Citing several dictionaries from the era in which the rule was written, the Court says that to make a statement means to state it, and not simply to participate in its creation. It then holds that, "[f]or purposes of Rule 10b-5, 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." "Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker." It also concludes that, "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed." The Court sees this reading as essential to harmonizing the outcome in *Janus* with the rules in *Central Bank* and *Stoneridge*.

Applying its definition, the Court holds that JCM did not "make" the statements in JIF's prospectuses. Only JIF had a statutory obligation to file the prospectuses with the SEC, and the SEC's records indicated that JIF, not JCM, had made such filings. The Court rejects the argument that both JCM and JIF might have "made" the misleading statements because JCM was "significantly involved in preparing the prospectuses," holding that this assistance, being subject to the ultimate control of JIF's trustees, did not mean JCM "made" the statements in the prospectuses. Picking up on an analogy that Justice Scalia offered during the oral argument, the Court reasons: "This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame—for what is ultimately said." Slip op. at 6-7. "Although JCM, like a speechwriter, may have assisted [JIF] with crafting what [JIF] said in the prospectuses, JCM itself did not 'make' those statements for purposes of Rule 10b-5." Slip op. at 12. Accordingly, the Court reverses the Fourth Circuit, concluding that JIF made the state-ments in its prospectuses, not JCM.

## The Dissent (Justice Breyer, Joined by Justices Ginsburg, Sotomayor and Kagan)

The dissent starts by saying that the dictionary definition of "make" is by no means as narrow as the Court says, but also may encompass those who participate in the creation of a statement to be made by others. The Court then distinguishes *Central Bank* and *Stoneridge*, saying that *Stoneridge* is about reliance, not who made the statement, and *Central Bank* contains language expressly leaving open the possibility of primary liability on the part of service providers such as accountants, attorneys and banks. But most of the dissent is devoted to decrying what the dissenters see as the giant loophole created by the Court's ruling. Focusing on the "innocent intermediate" hypothetical – where a fraudster utters misstatements through an innocent dupe, misstatements never attributed to the fraudster – the dissent reasons that the fraudster can no longer be held primarily liable, or secondarily liable as a control person under Section 20(a) of the '34 Act, because the dupe lacks the mental state (scienter) needed to be liable himself. Or, as Justice Breyer put it, "The possibility of guilty management and innocent board is the 13th stroke of the new rule's clock." Slip op. of dissent at 9.

## Liability for Misstatements Made Through "Innocent Intermediaries" is Left on the Table

The interesting part of the debate between the Court and the dissent is over what should happen to entities that make misstatements through "innocent intermediaries." The Court leaves this for another day, suggesting that Section 20(b) of the '34 Act might cover that situation. Slip op. at 10 n.10. That Section im-

[1] Rule 10b-5(b) makes it unlawful for a person "[t]o 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...."

poses liability on those doing acts that would be unlawful under the '34 Act "through or by means of another person." The dissent, however, suggests that the culpable-but-behind-the-scenes puppeteer escapes all liability under the Court's rule, so long as the statement is attributed only to the puppet and not to the puppeteer, adding that if the Court really believes that Section 20(b) is applicable, the Court should have remanded to let the plaintiff add a Section 20(b) claim – something the plaintiff had not done in the lower courts.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors of this alert.

Bruce A. Ericson (bio)
San Francisco
+1.415.983.1560
bruce.ericson@pillsburylaw.com

Charles J. Landy (bio)
Washington, DC
+1.202.663.8358
charles.landy@pillsburylaw.com

Richard M. Segal (bio)
San Diego
+1.619.544.3203
richard.segal@pillsburylaw.com

Ranah L. Esmaili (bio)
New York
+1.212.858.1526
ranah.esmaili@pillsburylaw.com

David M. Furbush (bio)
Palo Alto
+1.650.233.4623
david.furbush@pillsburylaw.com

Mark Hellerer (bio)
New York
+1.212.858.1787
mark.hellerer@pillsburylaw.com

Amy L. Pierce (bio)
Sacramento
+1.916.329.4765
amy.pierce@pillsburylaw.com