SUPREME COURT WADES INTO CIRCUIT SPLIT, ENDORSES BROADER VIEW OF "SCHEME LIABILITY" FOR DISSEMINATING FALSE STATEMENTS

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On Wednesday, March 27, 2019, the U.S. Supreme Court ruled in favor of the Securities and Exchange Commission ("SEC") and endorsed a broad view of so-called "scheme liability" under SEC Rule 10b-5(a) and (c).

In its 6-2 decision, the Supreme Court held that an investment banker could be found liable for securities fraud under Rule 10b-5 for disseminating to clients two emails that contained false statements, even though the emails were drafted and sent on behalf of his boss and he merely "cut and pasted" the contents into an email. [1] In doing so, the Court resolved (at least partially) a split among the circuits and made clear that Rule 10b-5(b)'s prohibition against "mak[ing] any untrue statement"—which applies only to "makers" of false statements (i.e., those with "ultimate authority" over the statement's contents)—is not the only provision that can be used to punish those who disseminate false information.

The decision is significant because it will potentially make it easier for the SEC and private securities plaintiffs to bring primary securities fraud claims against actors who did not personally "make" false statements but who merely "disseminated" them—claims that formerly were available only to the SEC and only under secondary liability ("aiding and abetting" or "causing") statutory provisions.

SEC RULE 10B-5 AND "SCHEME LIABILITY"

SEC Rule 10b-5 prohibits two general types of misconduct in connection with the offer and sale of securities: making false statements and employing fraudulent schemes. [2] In 2011, the Supreme Court limited the first prohibition to "makers" of false statements, which the Court defined as those with "ultimate authority" over the statement, including its content and whether and how to communicate it. [3] After that decision, parties and courts debated whether individuals who do not fit within this definition of "maker" could nevertheless be subject to primary liability for securities fraud under the second type of prohibition, often referred to as "scheme liability." [4]

Prior to the Supreme Court's decision in *Lorenzo*, the U.S. Courts of Appeals for the Second, Eighth, and Ninth Circuits held that fraudulent misstatements, standing alone, cannot form the basis of scheme liability and therefore can only be punished when uttered by a "maker." The Eleventh and D.C. Circuits came to a different conclusion, holding that false statements, without more, can suffice to establish scheme liability. [5]

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In *Lorenzo*, the Court took up the question of whether those who do not "make" false statements but who disseminate false or misleading information with the intent to defraud can be found to have violated Rule 10b-5(a) and (c) and related provisions. The Court answered that question in the affirmative.

THE *LORENZO* DECISION

Francis Lorenzo, while the director of investment banking at an SEC-registered brokerage firm, sent two emails to prospective investors, the contents of which had been supplied and approved by his boss. The emails described a potential investment in a company with "confirmed assets" of $10 million. In reality, however, Lorenzo knew that the company had total assets of less than $400,000.

After an administrative proceeding, the SEC found that Lorenzo violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5, and Section 17(a)(1) of the Securities Act of 1933 by sending false and misleading statements with intent to defraud. He was fined $15,000, ordered to cease and desist from violating the securities laws, and barred from working in the securities industry for life. Lorenzo appealed to the D.C. Circuit, which found that Lorenzo (i) could not be held liable under Rule 10b-5(b) because he was not a "maker" of the misstatement, but (ii) could be held liable under Rule 10b-5(a) and (c) because he participated in a scheme to defraud.

Lorenzo then appealed to the Supreme Court on the issue of whether his conduct was within the scope of primary liability under Rule 10b-5. He did not challenge the lower court's finding that he acted with fraudulent intent.

Lorenzo argued that subsection (b) of Rule 10b-5 alone regulates conduct involving false or misleading statements, whereas subsections (a) and (c) of that rule can be violated only when scheme-related conduct other than misstatements is involved. The Court rejected this argument. Relying on the plain language of Rule 10b-5(a) and (c) and the dictionary definitions of "device," "scheme," "artifice," "act," and "practice," the Court held that those broadly worded provisions cover the dissemination of false or misleading information with intend to defraud. According to the Court, by sending emails he undisputedly understood to contain material and false statements, Lorenzo employed a device, scheme, or artifice to defraud and engaged in an act, practice, or course of business that operated as a fraud or deceit.

Lorenzo also argued that his conduct instead fell under the aiding and abetting provisions of the securities laws, which make it unlawful to "knowingly or recklessly provid[e] substantial assistance to another person" who violates Rule 10b-5. [6] Lorenzo contended that imposing primary liability upon his conduct would "erase or at least weaken" the distinction between primary and secondary liability, which is important because only the SEC (not private plaintiffs) may bring a secondary liability claim. The Court rejected this argument and laid out a bright-line rule: "Those who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c), § 10(b), and § 17(a)(1), even if they are secondarily liable under Rule 10b-5(b)."

The Court expressed concern that, under an alternative reading of Rule 10b-5, the "plainly fraudulent" behavior exhibited by Lorenzo might fall outside the scope of the rule. If Rule 10b-5(b) were the *exclusive* regulator of conduct involving false or misleading statements, and only "makers" of such statements could be held liable, then "those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether." According to the Court, Congress could not have intended such a result.

OUTSTANDING QUESTIONS AND *LORENZO'S* IMPLICATIONS

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The Court's opinion may ultimately satisfy the majority's goal of creating an "administrable" line dividing primary and secondary violations, at least in circumstances of "[t]hose who disseminate false statements with intent to defraud." However, although the Court found "nothing borderline about this case," it acknowledged that the provisions of Rule 10b-5 "capture a wide range of conduct" and that applying them "may present difficult problems of scope in borderline cases."

The Court referenced as an example "other actors tangentially involved in dissemination—say, a mailroom clerk—for whom liability would typically be inappropriate." According to the majority, few would argue that the mailroom clerk who disseminates a misstatement should be held liable for securities fraud. But left unaddressed by the Supreme Court's decision are countless other scenarios involving actors whose conduct lies somewhere between the mailroom clerk and the "maker" or "disseminator" of information.

For example, in the wake of the *Janus* decision, lower courts reached different conclusions as to whether primary securities fraud liability covered corporate employees alleged to have been involved in conduct that later led a company to make a misstatement (e.g., business personnel whose conduct led a company's revenue or expense figures in financial statements to be materially false). The *Janus* decision foreclosed primarily liability under Rule 10b-5(b) in such circumstances because the employee lacked "ultimate authority" over the contents of the financial statements.

How the *Lorenzo* decision will affect such cases is unclear, as the Court's new line, on its face, only relates to those who "disseminate false statements." The many other non-"makers" of statements that either the SEC or private plaintiffs have tried to pursue under Rule 10b-5(a) and (c) are unaddressed in *Lorenzo*. The Court acknowledged that "[p]urpose, precedent, and circumstance" could lead to narrowing the reach of Rule 10b-5(a) and (c) in other contexts, which may well play out in the lower courts. As Justices Thomas and Gorsuch warned in dissent, though, the Court's opinion could mean that "virtually any person who assists with the making of a fraudulent misstatement will be primarily liable and thereby subject not only to SEC enforcement, but private lawsuits," provided, of course, that the other elements of a securities fraud claim, such as scienter, can be met.

Although the *Lorenzo* decision addresses a significant question in the debate between primary and secondary securities fraud liability, it is likely the decision it will continue—rather than end—the conversation over where to draw the distinction between primary and secondary violations in both SEC and private actions.

NOTES:

[1] *Lorenzo v. Securities and Exchange Commission*, No. 17-1077, at 5-6 (Mar. 27, 2019). Justice Kavanaugh was a member of the panel in the D.C. Circuit proceeding below, and therefore recused himself from the case.
[2] Specifically, Rule 10b-5 makes it unlawful "(a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact . . . , or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.
[3] *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011) (holding that an investment adviser who had merely "participate[d] in the drafting of a false statement" made by another could not be held liable in a private action under Rule 10b-5(b)).

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[4] *See* 17 C.F.R § 240.10b-5(a), (c).
[5] For additional background information on the circuit split, see our previous alert on this subject: Can a Plaintiff Re-Label and Re-File a Securities Fraud Claim?
[6] 15 U.S.C. § 78t(e).

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