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U.S. Supreme Court Expands Potential for Liability in Capital Market Transactions

On March 27, 2019, the Supreme Court, in *Francis V. Lorenzo v. Securities and Exchange Commission*, held (in a 6-2 decision) that a person who (i) knowingly disseminates false and misleading statements to prospective investors and (ii) acts with the intent to defraud can be held liable under subsections (a) and (c) of Securities and Exchange Commission (SEC) Rule 10b-5 (“Rule 10b-5”), and other relevant statutory provisions, even if such person was not the “maker” of such statements.

Rule 10b-5 makes it unlawful for any person, directly or indirectly, to:

- (a) employ any device, scheme or artifice to defraud,
- (b) 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) 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.

Background

In June 2009, Waste2Energy Holdings Inc. stated in a public filing that its assets were worth approximately \$14,000,000 (including intellectual property valued at more than \$10,000,000). In the summer of 2009, Waste2Energy Holdings Inc. hired Charles Vista LLC to sell \$15,000,000 of debentures to investors. In early October of 2009, Waste2Energy Holdings Inc. publicly disclosed and informed Francis Lorenzo (Petitioner), Vice President of

Investment Banking at Charles Vista LLC, that total assets of Waste2Energy Holdings Inc. were worth \$400,000, significantly less than previously disclosed to the public. After becoming aware of Waste2Energy Holdings Inc.’s overvaluation of its assets, Petitioner, at the direction of his direct superior, sent emails, the contents of which were supplied by his direct superior, to prospective investors that included false and misleading information regarding the valuation of Waste2Energy Holdings Inc.’s assets.

In 2013, the SEC charged Petitioner with, and found Petitioner liable for, violating subsection (b) of Rule 10b-5. Petitioner appealed the SEC’s ruling to the U.S. Court of Appeals for the District of Columbia (Court of Appeals). Relying on *Janus Capital Group, Inc. v. First Derivative Traders*, a Supreme Court decision holding that only the “maker” of false or misleading statements can be held liable under subsection (b) of Rule 10b-5, Petitioner argued that because his direct superior (i) directed Petitioner to send the emails and (ii) supplied the content for the emails, he was not the “maker” of any false or misleading statements, and therefore, could not be liable under subsection (b) of Rule 10b-5. The Court of Appeals agreed that Petitioner could not be held liable under subsection (b) of Rule 10b-5; however, the Court of Appeals found Petitioner liable under subsections (a) and (c) of Rule 10b-5.

Analysis

Petitioner appealed the Court of Appeals decision to the Supreme Court. In Petitioner’s argument to the Supreme Court, Petitioner claimed that each subsection of Rule 10b-5 governs “different, mutually exclusive, spheres of conduct” with subsection (b) governing the making of false or misleading statements. Petitioner went on to argue that because he did not have ultimate authority over the false or misleading statements, he could not be held liable under subsection (b) of Rule 10b-5 and that because he was not liable under subsection (b), the remaining subsections could not be applied to the acts in question.

The Supreme Court rejected Petitioner’s interpretation of Rule 10b-5, stating the Supreme Court and SEC have a history of recognizing significant overlap between the subsections of Rule 10b-5 and other securities statutes. As a result of this overlap, the Supreme Court reasoned that the making of false or misleading statements is not governed solely by subsection (b) of Rule 10b-5, but also falls within the scope of subsections (a) and (c). The Supreme Court, agreeing with the Court of Appeals, found that by sending the emails that Petitioner knew contained untrue and misleading statements, Petitioner violated subsections (a) and (c) of Rule 10b-5. The Supreme Court ultimately held that Petitioner “employ[ed] a “device,” “scheme,” or “artifice to defraud,”” violating Rule 10b-5(a) and “engage[d] in [an] act, practice, or course of business” that “operate[d]... as a fraud or deceit” in violation of Rule 10b-5(c).

What This Means to You

Given the Supreme Court's broad interpretation of Rule 10b-5, it is likely that future litigants will seek to expand the scope of activities subject to Rule 10b-5. However, as the Supreme Court noted, in cases where a person is only tangentially involved with disseminating false or misleading statements, applying subsections (a) and (c) of Rule 10b-5 may prove more difficult, and could cause the Supreme Court to more clearly define the reach of these subsections in the future. For example, as the Supreme Court noted, liability would be inappropriate for a mailroom clerk who disseminated misleading or false statements without the intent to defraud. It is clear that future cases may present factual scenarios that would fall outside the reach of subsections (a) and (c), however, in the case at hand, it was clear Petitioner was directly involved with disseminating false and misleading statements, as he sent such statements directly to investors and invited them to follow up with him directly.

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