New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 245—NO. 84

MONDAY, OCTOBER 31, 2011

Outside Counsel

Expert Analysis

Implications of 'Janus' for Securities Fraud Liability of Corporate Insiders

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To be liable under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5,[1] a defendant must have "made" a misstatement or omission of material fact.[2] This "attribution" requirement mandates that a statement (or omission) must be attributed to a particular defendant at the time of dissemination for liability to attach. In *Janus Capital Group Inc. v. First Derivative Traders*, the Supreme Court set forth a new, and seemingly categorical, rule for defining attribution: "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."[3] This rule has important implications for the liability of corporate officers and directors, as so-called "insiders," that the lower courts have only started to address.

The 'Janus' Case

Janus Capital Management LLC (JCM), a mutual fund adviser, was sued under Rule 10b-5 for alleged misrepresentations in prospectuses issued by its client, Janus Investment Fund. The fund had been created by Janus Capital Group Inc. (JCG), which owned JCM, but both JCG and JCM were legally separate from the fund.

The prospectuses stated that the Janus funds were not suitable for market timing and that policies would limit the practice. New York's Attorney General sued, asserting that JCG had secretly permitted market timing. The allegations led to a precipitous drop in JCG's stock price.

A JCG shareholder then brought a class action against JCM and JCG. The U.S. Court of Appeals for the Fourth Circuit ruled "that [Plaintiff] had sufficiently alleged that 'JCG and JCM, by participating in the writing and dissemination of the prospectuses, *made* the misleading statements.'"[4]

In a 5-4 opinion by Justice Clarence Thomas, the Supreme Court held that JCM did not make the misstatements.[5] The Court emphasized that because a §10(b) private right of action is implied, it must be given "'narrow dimensions.'" Adopting a literal view, the Court held that Rule 10b-5's language "[t]o make…any statement" is "the approximate equivalent of 'to state.'" Thus, the "maker" is whoever has "ultimate authority over the statement, including its content and whether and how to communicate it." Absent control, one can "merely suggest what to say." The Court analogized that a speechwriter drafts a speech, but the speaker controls the content. Accordingly, one who "prepares or publishes a statement on behalf of another is not its maker."

> The 'Janus' test poses further issues for insider liability. When does a particular officer or director have 'ultimate authority' over the financial disclosures of a public company?

Rejecting a "create" contention, the Court stated that one does not "make" a statement by providing information or even by participating in drafting. Still, "attribution within a statement or implicit from surrounding circumstances" is "strong evidence" that only the party to whom it was attributed is the "maker."

Applying its rule, the Court found that the fund alone made the statements since only it was obligated to file the prospectuses, and nothing indicated that statements came from JCM. That JCM "was significantly involved in preparing the prospectuses" did not change this result.

Dissent's Focus on Insiders

Justice Stephen Breyer dissented, joined by Justices Ruth Bader Ginsburg, Sonia Sotomayor and Elena Kagan. Taking a broader view of the word "make," Justice Breyer contended that "depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might 'make' statements contained in a firm's prospectus—even if a board of directors has ultimate content-related responsibility."

Justice Breyer posited that the Court's rule could immunize even "guilty management" from liability:

> What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true? Apparently under the majority's rule, in such circumstances no one could be found to have "ma[d]e" a materially false statement—even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as principals (and not as aiders and abettors).

Justice Breyer expressed concern that corporate insiders would avoid Rule 10b-5 liability for misrepresentations in their company's filings because "ultimate authority" lies with the board of directors. In his view, the relationships alleged among JCM, the fund and the prospectus statements "warrant the conclusion that [JCM] did 'make' those statements."

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Post-'Janus' Decisions

The handful of cases that have applied *Janus* are already divided as to its meaning.

SEC v. Daifotis[6] addressed a reconsideration motion based on *Janus*. The SEC alleged that two executives of Charles Schwab Corp., Randall Merk and Kimon Daifotis, violated Rule 10b-5 by making misstatements concerning management of Schwab bond funds. The defendants conceded that they "made" several of the statements under *Janus*—a registration filing signed by Merk; a website Q&A that listed Merk as the author; advertising materials that quoted Daifotis; and Daifotis' statements in conference calls. Furthermore, the allegations that Daifotis had "reviewed" an allegedly false document before it issued were sufficient under *Janus*.

However, the court held that Daifotis did not "make" alleged misstatements in advertising materials merely because his picture appeared in the materials. Moreover, the SEC conceded that other previously upheld allegations, which pled that defendants had participated in or contributed to various misstatements, were insufficient under *Janus*.[7] Importantly, the court addressed *Janus* even though defendants, unlike the legally separate entities in *Janus*, were insiders who participated in their company's statements.

By contrast, some courts have refused to apply *Janus* to corporate insiders. For instance, *In re Merck & Co. Sec., Deriv. & "ERISA" Litigation*[8] involved securities fraud claims against Merck and several of its officers, including Edward Scolnick, based on alleged misrepresentations concerning a prescription drug. Scolnick asserted that the complaint failed to allege that he had ultimate authority over the statements attributed to him. The court disagreed, reasoning that his role was "in no way analogous to [JCM's] relationship to the statements issued by [the fund]" in *Janus*.

It emphasized that at the time of the statements Scolnick signed SEC forms and was quoted in articles and reports as a Merck officer. In other words, he was acting as Merck's agent, "not as in *Janus*, on behalf of some separate and independent entity." The court stated that *Janus* did not change the established rule that a corporation can act only through its employees and agents. As the court put it, "[*Janus*] certainly cannot be read to restrict liability for Rule 10b-5 claims against corporate officers to instances in which…those officers—as opposed to the corporation itself—had 'ultimate authority' over the statement."

In *Hawaii Ironworkers Annuity Trust Fund v. Cole*,[9] shareholders alleged that corporate officers falsified financial information that contributed to other officers' misrepresentations. Defendants unsuccessfully moved to dismiss on the grounds that they did not make any statements to investors. On reconsideration, however, the court held that *Janus* had "changed the doctrine of securities liability under Rule 10b-5(b)," and partially reversed its earlier opinion.[10]

The court rejected the argument that *Janus* did not apply because defendants were corporate insiders. It stated that *Janus* had "'adopt[ed] a rule'" defining "maker" for purposes of Rule 10b-5 and had not limited this construction to disclosures involving legally separate entities. Rather, the separation between entities simply informs the analysis of where ultimate authority lies. The court explained that it disagreed with Merck's insider/separate-entity distinction, but noted that Merck's outcome was correct because the defendant there was "the speaker" since he signed SEC filings and was quoted in company materials.[11]

> In one decision, Judge John G. Koeltl applied 'Janus' to insiders based on whether they had signed their company's filings. He held that various officers and directors 'made' statements because they had signed the filings, but that two insiders were not liable for alleged misrepresentations in one filing because they had not signed it.

Nevertheless, the *Hawaii Ironworkers* court concluded that defendants did not have ultimate authority over the false statements because the information attributed to them resulted from a mandatory directive from higher management. Significantly, however, the court upheld plaintiff's "scheme liability" claims under subsections (a) and (c) of Rule 10b-5, holding that attribution under *Janus* does not apply to those provisions.[12]

In *SEC v. Das*,[13] the Nebraska district court rejected the argument of defendant CFOs that their company "made" the alleged misstatements in SEC filings and that they "merely prepared or published the materials on behalf of [the company]." The court held that defendants had ultimate authority because they had signed and certified the documents.

Judge Colleen McMahon in the Southern District recently applied *Janus* to dismiss claims against corporate officers. *SEC v. Kelly*[14] was a securities fraud enforcement action against three former corporate managers who allegedly engaged in improper transactions. After *Janus*, two of the defendants moved for judgment on the pleadings (as well as for reconsideration of a previously denied summary judgment decision). They argued that since the SEC had alleged only that they engaged in conduct that "caused," rendered them "responsible" for, or "substantially contributed" to statements by others, they did not come within *Janus*' ultimate authority rule.[15]

The SEC conceded that, given *Janus*, its misstatement claim failed under subsection (b). Nonetheless, the SEC pressed its "scheme liability" claim under subsections (a) and (c) (which do not use the language "to make") premised on defendants' alleged participation in the improper transactions. Judge McMahon acknowledged that *Janus* did not address scheme liability, but held that where the main purpose and effect of an asserted scheme is to make a misrepresentation or omission, "courts have routinely rejected the SEC's attempt to bypass" the elements for misstatement liability under subsection (b) "by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.'" To permit scheme liability based upon an alleged false statement when the defendant did not "make" the misstatement "would render the rule announced in *Janus* meaningless."

Most recently, in another Southern District decision, *City of Roseville Employees' Ret. Sys. v. EnergySolutions Inc.*,[16] Judge John G. Koeltl applied *Janus* to insiders based on whether they had signed their company's filings. He held that various officers and directors "made" statements because they had signed the filings, but that two insiders were not liable for alleged misrepresentations in one filing because they had not signed it.

Judge Koeltl also addressed the separate-entities issue. One entity defendant, while legally distinct from the issuer defendant, could be liable under *Janus* because that defendant owned the issuer's stock, retained a controlling interest in the issuer after its offering, and had control over the stock sales in issue; it therefore met *Janus*' ultimate authority test.

Implications, Uncertainties

Although *Janus'* "ultimate authority" rule seemingly is another bright-line approach in securities

law,[17] applying it might not be so easy.

Already the lower courts have differed on whether *Janus* applies to corporate insiders. The Supreme Court's language was unambiguous in defining a main term of Rule 10b-5—and the definition on its face applies to officer and directors, without differentiating among the kinds of defendants who "make" statements for purposes of a company's public disclosures and potential Rule 10b-5 liability. However, *Janus* involved legally separate entities—one, the nonparty issuer of the challenged statements, the other, the defendant and would-be "maker" of them. Will *Janus* be limited to the separate-entities context, so that insider defendants cannot invoke the ultimate authority rule? Significantly, however, the SEC has conceded application of *Janus* in enforcement cases against insiders.

If *Janus* is applied to officers and directors, they will have an additional, strong defense to Section 10(b) liability. The Supreme Court made clear that supplying information for a company's public disclosures or participating in drafting are not enough to satisfy the ultimate authority test. More must now be shown for an insider to be liable.

Also importantly, the "group pleading" doctrine might be a dead letter. That doctrine is an exception to the requirement that fraudulent acts be attributed to each defendant separately, affording a pleading presumption that a company's group-published information is the collective work of those individuals who have direct involvement in the everyday business of the company.[18] *Janus*' ultimate authority test likely means that group pleading no longer suffices to attribute a misstatement to an insider defendant.

The *Janus* test poses further issues for insider liability. When does a particular officer or director have "ultimate authority" over the financial disclosures of a public company? As Justice Breyer noted in his dissent, final authority typically lies with the board. After all, a public company's SEC filings, which often contain the statements underlying a securities fraud claim, are filings of the company. Those documents are generally the product of a multi-level, multi-person drafting, vetting and review process, both internally and with outside counsel. Does any one person actually have "ultimate authority" over particular statements contained in the filings?

The signing of an SEC filing or a SOX certification by a senior officer is meaningful conduct—but does signing alone mean that one has "ultimate authority" over all of the contents of a document, when many others perform significant roles for the corporate-reporting function? Oral statements made during an investor conference call could be a clearer example of an individual officer being a "maker." But even there, conference calls are often carefully scripted by investor relations and other company personnel, again suggesting diffused responsibility. The complex realities of corporate public disclosures may present uncertainty whether a given insider actually has final authority over supposed misstatements.

Further complicating matters, *Janus* said that there could be attribution "implicit from surrounding circumstances."[19] This also creates uncertainty by opening the door to fact-specific arguments that ultimate authority over a statement can be linked to a defendant "implicitly" due to the "surrounding circumstances."

Janus poses other nettlesome questions. Will it be applied to scheme liability claims under subsections (a) and (c) of Rule 10b-5? If not, will private plaintiffs and the SEC more aggressively plead securities fraud through scheme liability cases rather than misstatement cases? Will the SEC assert more aiding and abetting claims against corporate insiders to avoid *Janus*' rule limiting primary liability? Will *Janus*' literal approach and narrow construction be applied to other provisions of Rule 10b-5, perhaps significantly limiting criminal prosecutions for securities fraud, SEC enforcement actions and private actions alike?

In short, *Janus* has numerous and important implications for corporate officer and director Rule 10b-5 liability that will assuredly be addressed in future cases.

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1. 15 U.S.C. §78j(b) ("Section 10(b)"); 17 C.F.R. §240.10b-5 ("Rule 10b-5").

2. See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *ATSI Commc'ns Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 105 (2d Cir. 2007).

3. 131 S. Ct. 2296, 2302 (2011).

4. Id. at 2301(emphasis in Ct. of Appeals' opinion).

5. In the Supreme Court, plaintiff dropped its claim that JCG also had violated Rule 10b-5, instead seeking to hold JCG liable only as a "controlling person" of JCM under Section 20(a) of the Exchange Act.

6. 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011), modifying on reconsideration, 2011 WL 2183314 (N.D. Cal. June 6, 2011).

7. See also *Daifotis*, 2011 WL 2183314, at *5-*6 (prior Order, describing allegations upheld).

8. 2011 WL 3444199 (D.N.J. Aug. 8, 2011).

9. 2011 WL 3862206 (N.D. Ohio Sept. 1, 2011).

10. Other cases similarly recognize that *Janus* changed the law. E.g., *SEC v. Big Apple Consulting USA Inc.*, 2011 WL 3759916, at *1 (M.D. Fla. Aug. 25, 2011); *Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681, 694 n.8 (9th Cir. 2011).

11. *Hawaii Ironworkers* also cited *Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Fin. Corp.*, 2011 U.S. Dist. LEXIS 93873 (N.D. Ala. Aug. 23, 2011), and *Curry v. Hansen Med. Inc.*, 2011 WL 3741238 (N.D. Cal. Aug. 25, 2011), for the proposition that *Janus* applies to corporate insiders; see also *In re Coinstar Inc. Sec. Litig.*, 2011 WL 4712206, at *10 (W.D. Wash. Oct. 6, 2011).

12. Accord, *SEC v. Geswein*, 2011 WL 4565861, at *2 (N.D. Ohio Sept. 29, 2011).

13. 2011 WL 4375787 (D. Neb. Sept. 20, 2011).

14. 2011 WL 4431161 (S.D.N.Y. Sept. 22, 2011).

15. See Mem. of Law of Defendant Wovsaniker at 7-8; Defendant Rindner's Mem. of Law at 8-9, *SEC v. Kelly*, 2011 WL 4431161 (S.D.N.Y. July 11, 2011) (No.1:08-cv-04612-CM).

16. 2011 WL 4527328 (S.D.N.Y. Sept. 30, 2011).

17. See *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010) (adopting bright-line "transactional test" for determining extraterritorial application of Section 10(b)).

18. See *Adelphia Recovery Trust v. Bank of Am., N.A.*, 624 F.Supp.2d 292, 316 (S.D.N.Y. 2009).

19. 131 S. Ct. at 2302.