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Supreme Court "Makes" Securities Fraud Recovery More Difficult

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Legislatures legislate, and courts decide what they meant. The principal federal law recourse for investors in municipal bonds and other unregistered securities for investment losses caused by fraudulent disclosure arises from a judicial reading of SEC Rule 10b-5 as creating an "implied" private cause of action. (The appellate courts in most of the federal circuits have determined that Section 17(a) of the Securities Act of 1933, the only other section of the federal securities laws that applies to municipal securities, does not create an implied private right of action.)

But what a court giveth, a court can take away. In a 5-4 ruling on June 14, 2011 in **Janus Capital Group, Inc. v. First Derivative Traders**, **http://www.supremecourt.gov/opinions/10pdf/09-525.pdf**, the U.S. Supreme Court effectively limited private investor recourse under Rule 10b-5 for fraudulent disclosure to claims against issuers, and held that other parties to bond transactions (as well as other unregistered securities offerings) generally have no Rule 10b-5 liability to investors, whatever their role in preparing the issuer's disclosure.

What this means is that bankers, consultants, advisers, lawyers and other participants in the preparation of an official statement face no federal securities law liability to investors under Rule 10b-5, with a possible but undecided exception for materials expressly attributed to such parties in the official statement (for example, a summary of a legal document attributed to its author or a legal opinion published in the official statement under the letterhead of the counsel rendering such opinion.) The decision does not affect the SEC's ability to bring regulatory enforcement actions against non-issuer participants in disclosure preparation.

Among many interesting questions raised by the *Janus* decision is the status of private 10b-5 claims against conduit borrowers, which may involve future litigation over whether the conduit borrower "controls" the disclosure made in an official statement which is, technically and legally, the official statement of the public conduit issuer. Although conduit issuers typically disclaim responsibility for portions of an official statement describing the conduit borrower and various other matters, nuances in verbiage within a particular official statement as to which party has ultimate control over the content may influence the outcome of future 10b-5 securities fraud litigation.

The *Janus* case involved a claim against Janus Capital Management LLC, the investment adviser to and management company for a Janus family mutual fund that was sued for alleged fraudulent disclosure in its mutual fund prospectus. The fund shareholders alleged that the management company participated in the preparation of the fraudulent disclosure. Rule 10b-5 makes it illegal for "any person, directly or indirectly ,... [t]o make any untrue statement of material fact" in connection with the purchase or sale of securities. Each faction on the Supreme Court pulled out its own dictionary for purposes of interpreting the verb "make."

The technical details of the decision will be of interest principally to wordophiles. The five justices in the majority relied upon the 43rd definition of "make" in the 1934 edition of Webster's New International Dictionary: "('*Make* followed by a noun with the indefinite article is often nearly equivalent to the verb intransitive corresponding to that noun'). For instance, 'to make a proclamation' is the approximate equivalent of 'to proclaim,' and 'to make a promise approximates to promise.'" Under that interpretation, the majority held, "The phrase at issue in Rule 10b–5, '[t]o make any . . . statement,' is thus the approximate equivalent of 'to state.'"

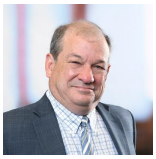
The four justices in the minority, as well as the SEC, preferred an interpretation per the *1958* edition of the same dictionary (defining "make" as "[t]o cause to exist, appear, or occur")). The majority dismissed that interpretation, opining that "[t]his definition, although perhaps appropriate when 'make' is directed at an object unassociated with a verb (*e.g.*, 'to make a chair'), fails to capture its meaning when directed at an object expressing the action of a verb."

The bottom line after this battle-of-the-dictionaries gobbledygook? Per the majority: "For 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.”

Accordingly, the Court dismissed the claim against Janus Management Company, holding that whatever responsibility the Janus fund had delegated to the management company for the preparation of the mutual fund prospectus, the mutual fund, not its management company, had the ultimate legal control over the content of the prospectus, and therefore the management company did not “make” any statement even if it drafted the disclosure on the mutual fund’s behalf.

Authors



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