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An Opportunity To Slow The Rise Of Securities Class Actions

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Plaintiffs are filing more securities fraud class actions than ever before. To date, 328 cases have been filed in 2018, surpassing the 271 filed in 2016, and on pace to match (if not exceed) 2017's 412.[1] Further, average settlement amounts in the first half of 2018 raised fivefold to $124 million from $25 million in 2017. This rise in filings is concerning because the Private Securities Litigation Reform Act was designed to protect issuers and deter plaintiffs from filing low-quality complaints. The U.S. Supreme Court has the opportunity to slow this rise when addressing securities cases in this term and beyond.

Esteban Morales

Since Chief Justice John Roberts was appointed to the Supreme Court in 2005, the court has heard an average of two securities cases per term, more than any previous court. As this trend continues into 2018, the conservative majority on the bench has the opportunity to roll back expansive interpretations of the PSLRA, Rule 10b-5, and other provisions of the Securities Exchange Act of 1934.

Matthew Novian

One tell for future potentially defendant-friendly rulings is Justice Brett Kavanaugh's history of arguing for tighter U.S. Securities and Exchange Commission standards, an opinion shared by the other four conservative justices on the court. As a judge on the D.C. Circuit, Justice Kavanaugh dissented in Lorenzo v. SEC, a major securities fraud case now before the Supreme Court.[2] In his dissent, Kavanaugh remarked that "the SEC should vacate the order in its entirety and either end this case altogether or (if appropriate and permissible) fairly start the process anew before the administrative law judge." Justice Kavanaugh recused himself from Lorenzo on Oct. 19, making it more likely a 4-4 split could affirm the D.C. circuit's holding. Nevertheless, in future SCOTUS terms, Kavanaugh's restrictive jurisprudence will likely narrow the interpretive scope of securities law.

In Lorenzo, the court will interpret one of the most hotly contested securities issues: Rule 10b-5, which prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.[3] The case involves a prior decision, Janus Capital Group Inc. v. First Derivative Traders, where the court concluded that only a "maker" of a misrepresentation can be held liable.[4] In defining the contours of a "maker" the Janus court explained 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 ... one who prepares or publishes a statement on behalf of another is not its maker."[5] In other words, a party that merely assists in the dissemination of a misleading statement cannot be primarily liable under Rule 10b-5(b) if he or she lacks "ultimate control" over the content of the statement.[6]

In Lorenzo, the SEC accused brokerage firm director Francis Lorenzo of violating Rule 10b-5 when forwarding emails from his boss to prospective investors. Lorenzo claimed he did not intentionally convey any false information and that he had merely copied and pasted information from an email he received from his boss without checking to see if it was accurate. The majority held that Lorenzo did not "make" the false statements at issue for purposes of Rule 10b-5(b) because Lorenzo's boss, and not Lorenzo himself, retained "ultimate authority" over the statements.[7] Nevertheless, the majority also held that Lorenzo violated the scheme liability provisions of 10b-5(a) and (c) by sending the email.[7] Under Rule 10(b)-5(a) and (c), scheme liability hinges on the performance of an inherently deceptive act that is distinct from an alleged misstatement. Therefore, the D.C Circuit found Lorenzo's use of the statement sufficient to invoke the scheme liability provisions of Rule 10b-5(a) and (c), even though Lorenzo was not himself the maker of the statement and even though the court identified no additional deceptive conduct apart from the use of the misstatement itself.

The Lorenzo dissent advocated for a position that would impose a tighter standard and "vacate the SEC's conclusions as to both sanctions and liability."[9] It accused the majority opinion of "creating a circuit split by holding that mere misstatements, standing alone, may constitute the basis for so-called scheme liability under the securities laws — that is, willful participation in a scheme to defraud — even if the defendant did not make the misstatements. ... Other courts have instead concluded that scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others."[10]

Lorenzo will likely affect private plaintiffs who bring 10b-5 claims. In the unlikely event that a 5-3 decision affirms the D.C. Circuit's ruling, it would expand the scope of liability in securities class action suits and broaden the range of targets to encompass more actors within companies. Under primary liability, a plaintiff may bring an action against any person who employs a manipulative scheme, while secondary liability only attaches to actors whose statements are attributable to them. The SEC would like to abolish the distinction between primary and secondary liability to target more actors. However, as explained in Lorenzo's brief, the D.C. Circuit's ruling was inconsistent with past Supreme Court cases, such as Stoneridge Investment Partners v. Scientific-Atlanta Inc., where the Supreme Court had "rejected a broad test for primary liability" and "drew a sharp distinction between the person who made the misstatements and the vendors who played some role in facilitating the false statements."[11] Lorenzo asks the court to follow Stoneridge by drawing a sharp line between the primary actor, Lorenzo's boss, and the secondary actor, Lorenzo.

If the court adopts Kavanaugh's views regarding scheme liability, which is in accordance with the Second, Eighth and Ninth Circuits, there will be a clear standard demarcating the line between primary and secondary liability, making it harder for plaintiffs and the SEC to target specific actors within a company.[12] Lorenzo marks the first of many opportunities the court will have to roll back interpretations of securities law. The court will hear Lorenzo on Dec. 3, 2018.

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[1] Stanford Law School, Securities Class Action
Clearinghouse: http://securities.stanford.edu/filings.html?page=6.0.

[2] See Lorenzo v. Securities and Exchange Commission, 872 F.3d 578, 596 (D.C Cir. 2017).

[3] 17 C.F.R. § 240.10b5

[4] Janus Capital Grp. Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011)

[5] Id.

[6] Id. at 147-48

[7] Lorenzo, 872 F.3d at 587.

[8] Id. at 591.

[8] Id. at 579.

[10] Id. at 600.

[11] Brief of Petitioner at 39, Lorenzo v. SEC, No. 17-1077, 2018 WL 4035397 (U.S. Aug. 20, 2018)

[12] Pub. Pension Fund Grp. v. KV Pharma. Co., 679 F.3d 972, 987 (8th Cir. 2012); WPP Luxembourg Gamma Three Sarl v. Spot Runner Inc., 655 F.3d 1039, 1057-58 (9th Cir. 2011); Lentell v. Merrill Lynch & Co., 396 F.3d 161, 177 (2d Cir. 2005).