September 2011: Securities Litigation Update

Supreme Court Redefines "Makers" of Untrue Statements as Those With Ultimate Authority: The Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 at 2302 (2011), in the final weeks of the 2010-2011 term, turned on the meaning of a single word. Securities and Exchange Commission (SEC) Rule 10b-5 states that it shall be unlawful for "any person . . . [t]o **make** any untrue statement of material fact . . . in connection with the purchase or sale of any security." Securities Exchange Act, 15 U.S.C. § 78j(b) (1994). At issue was the scope of potential primary liability for actors involved in "mak[ing]" misleading statements under Rule 10b-5. The Court held 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 the content and whether and how to communicate it." *Id.* This narrow definition of "make" has significance well beyond *Janus* because it impacts the extent to which a public company's affiliates, officers, directors and outside professionals, including accountants, lawyers and investment advisers, may face liability under the federal securities laws for false or misleading statements issued by the company. After *Janus*, only the company itself faces primary liability under Rule 10b-5.

Background and Posture

Janus' corporate structure was consequential to the outcome of the litigation. Janus Capital Group, Inc. (JCG), is a publicly traded asset management company and the sixteenth largest mutual fund complex in the United States, with more than four million mutual fund investors. *Company Profile*, Janus Capital Group, http://press.janus.com/company-profile.cfm (last visited July 26, 2011). Janus Capital Management LLC (JCM), JCG's wholly owned subsidiary, serves as an investment adviser and administrator for the Janus mutual fund family. In this capacity, officers and employees of JCG and JCM participated in the preparation and dissemination of prospectuses issued by Janus Investment Fund (JIF), a separate legal entity with a separate board of trustees, and owned entirely by mutual fund investors. Although JIF was legally separate from JCM, the entities were closely related. For instance, each of JIF's officers was also a JCM employee. *Janus*, 131 S. Ct. at 2302 (Breyer, J., dissenting).

The alleged misstatements giving rise to the litigation were exposed in September 2003 following an investigation by the New York Attorney General's Office into "market timing," which refers to the short-term, "in and out" trading in mutual-fund shares to, *inter alia*, exploit stale prices for stocks listed on foreign exchanges. *New York v. Canary Capital Partners*, (N.Y. Sup. Ct. Sept. 3, 2003). In prospectuses issued between 2001 and 2003, JIF represented that its policy was to discourage or prohibit market timing.

As a result of its investigation, however, the New York Attorney General filed a complaint against the Canary Capital Partners, LLC hedge fund, alleging that it had colluded in a market-timing scheme with JIF. See id. Ultimately Janus paid $225 million in 2004 to settle claims by regulators that it had failed to disclose the trading arrangements to long-term investors. *See* James Vicini & Ross Kerber, Top Court Rules for Janus in Securities Case, Reuters (June 13, 2011, 11:38 AM), http://www.reuters.com/article/2011/06/13/us-janus-lawsuit-court-idUSTRE75C3CC20110613. This disclosure caused investors to withdraw nearly $14 billion from various Janus funds. As a result, JCG's stock price fell substantially.

First Derivative Traders, representing a class of stockholders in JCG, subsequently filed a private Rule 10b-5 securities class action in the District of Maryland. The district court dismissed the action, but the Court of Appeals for the Fourth Circuit reversed, holding that First Derivative had adequately pled its complaint. JCG and JCM then filed a petition for certiorari, which the Court granted.

Supreme Court Decision

In a 5-4 decision, the Supreme Court reversed the Fourth Circuit holding that the plaintiffs had failed to state a claim. Justice Thomas, joined by Chief Justice Roberts and Justices Scalia, Kennedy, and Alito, held that the "maker" of a misstatement under Rule 10b-5 is the person or entity with ultimate authority over the statement. According to the majority, this narrow view of primary liability followed directly from the Court's holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* 511 U.S. 164 (1994), which held that Rule 10b-5's private right of action excludes suits against aiders and abettors who contribute "substantial assistance" to the making of a statement but do not actually make it. An "expanded" right of action would undermine the distinction between "primary violators" and "aiders and abettors" by rendering the potential class of aiders and abettors practically non-existent.

The majority rejected the definition of "make" proposed by the United States, appearing as amicus. The government contended that "make" should properly be defined as "create," allowing primary liability to extend to any person who provides misleading or false information that is later issued as a public statement. *Janus*, 131 S. Ct. at 2303 - 2304. The majority argued that this meaning was inconsistent with *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), which rejected a private 10b-5 suit against companies involved in deceptive transactions, even when information about those transactions was subsequently incorporated into false public statements. In relying on *Stoneridge*, the majority refused to distinguish *Janus* on the basis of the "uniquely close relationship between a mutual fund and its investment advisor." (Justice Thomas noted that he would "decline this invitation to disregard the corporate form." *Janus*, 131 S. Ct. at *2304 - 2305.) *Janus* thus sets a bright-line rule limiting primary liability *exclusively* to the company or individual with "ultimate authority over the statement." *Id.* at *13.

Applying its narrow definition of "make" to JCM, the majority held that JIF was the exclusive "maker" of the alleged misstatements in the prospectuses. Only JIF had the statutory obligation to file the prospectuses with the SEC, and notwithstanding that JCM may have been "substantially involved" in drafting the impugned sections of the prospectuses, their issuance remained "subject to the ultimate control" of JIF. *Id.* at *23. JCM acted only as a "speechwriter," but, "[e]ven when a speechwriter drafts a speech, . . . it is the speaker who takes credit—or blame—for what is ultimately said." *Id.* at *13-14.

Justice Breyer, in a dissent joined by Justices Ginsburg, Sotomayor, and Kagan, argued that "[n]either common English usage nor this Court's earlier cases limit the scope of [the word 'make'] to those with 'ultimate authority' over a statement's content." *Id.* at *26 (Breyer, J., dissenting). In the minority's view, the bright-line rule articulated by the majority is willfully blind to the practical exercise of agency in the making of public statements. "Every day," the minority noted, "hosts of corporate officials make statements with content that more senior officials or the board of directors have 'ultimate authority' to control. So do cabinet officials make statements about matters that the Constitution places within the ultimate authority of the President." *Id.* at *27-28 (Breyer, J., dissenting). Accordingly, the minority suggested that the determination of a statement's "maker"—and susceptibility to primary liability—ought to "depend[] upon the circumstances." *Id.* at *26 (Breyer, J., dissenting). On the facts presented, the minority concluded that the facts alleged brought JCM within the scope of Rule 10b-5 because its "involvement in preparing and writing the relevant statements could hardly have been greater." *Id.* at *44 (Breyer, J., dissenting).

Reflections and Impact
The decision has already been criticized by certain commentators, which ascribe it to the Court's hostility to the implied private right of action under Rule 10b-5. In dissent, Justice Breyer envisioned that "guilty management" might make materially false statements, that "fools both board and public into believing they are true." *Janus*, 131 S. Ct. at *2310 – 2311. Under the *Janus* bright-line rule, the manager would not be liable as a Rule 10b-5 primary violator because he did not "make" the statement. Neither could he be pursued by the SEC as an "aider and abettor" because there would be "no other primary violator [he] might have tried to 'aid' or 'abet.'" (Under the Private Securities Litigation Reform Act of 1995, the SEC is authorized to prosecute "aiders and abettors" pursuant to section 10(b), but Congress did not provide a private cause of action against aiders and abettors). Professor Jeffrey Gordon has commented that "the decision exacerbates the problem of 'agency capitalism'—the tendency of the managing agents to pursue their own objectives at the expense of the ultimate beneficiaries." Gordon, *supra* note 23. In his view, the majority's reasoning ignores one of the principal lessons of the financial crisis, which is that the "purported gatekeepers to the financial system—accountants, lawyers, credit rating agencies, underwriters—often pursued their immediate economic interests at the expense of their critical gate-keeping function." *Id.*

Janus appears to foreclose the potential for primary 10b-5 liability for false statements on the part of outside professionals, such as accountants, attorneys and investment advisers, who assist companies in issuing SEC filings and public statements. *Janus* also seems to shield from primary liability officers of a company who are not themselves vested with "ultimate authority" to issue a public statement. The decision will likely encourage litigants to seek recourse through other avenues of liability for actors who participated in, but did not actually utter, false public statements. One avenue may be found in section 20(b) of the Securities Exchange Act of 1934, which provides for "control person" liability for a company, even when its board had no knowledge of the underlying fraud, if any of its agents had such knowledge. Another lies in state common law claims, such as fraud and aiding and abetting fraud, which remain unaffected by the Court's restrictive statutory interpretation of Rule 10b-5.