Supreme Court Limits Investors' Right to Sue in Securities Fraud Lawsuits

By Kristen Friend, staff SEO | Law Firm News Center U.S. Supreme Court and Congress writer – June 14, 2011

The Supreme Court issued an opinion on Monday barring a group of investors from proceeding with a lawsuit against Janus Capital Group for allegedly making misleading statements in Janus mutual fund prospectuses.

The ruling overturned a decision by the Fourth Circuit Court of Appeals that had allowed the lawsuit to move forward.

At issue was whether Janus Capital Management (JCM), in its role as adviser to the Janus Investment Fund, could be held primarily liable for false or misleading statements made in the fund's prospectus. In its appeal, Janus argued that because the mutual funds were a separate legal entity, owned by investors, neither the adviser nor its subsidiaries could be held liable in a private securities fraud action. The Supreme Court agreed.

In the decision, the Justices addressed the question of how to assign liability to legally independent companies that nonetheless conduct business as a seemingly singular entity with mutual actors and interests.

In 2003, the New York State Attorney General announced that an ongoing investigation had uncovered evidence of secret deals between JCM and several hedge finds. According to the discreet arrangements, the hedge funds were allowed to engage in market-timing trades using assets from Janus Investment Funds. [1] While a few large investors were allowed to privately make risky day trades, the Janus funds were advertised publicly as safe for long-term investors. The prospectus indicated that market-timing was discouraged and that steps were taken to curb the practice.

As a result of the attorney general's complaint against JCM, investors left en masse, quickly removing $14 billion from the funds. Reacting to the rapid loss of capital, shares of Janus Capital Group, Inc. (JCG), owner of JCM, suffered a 12.7 percent loss between September 2 and September 4 of 2003. [2]

Investors engaged in market-timing take advantage of differences in the opening and closing times of foreign markets to make short-term purchases or sales of foreign securities. Since markets on the other side of the world close before markets in New York, investors can make speculative trades based on news that is released after the foreign markets have closed. Janus's favored investors could, for example, buy a foreign security at an artificially low price with the knowledge that the security was likely to open higher due to post-closing developments. [3] This was done without the knowledge and at the expense of the long-term investors.

Craig Wiggins filed the original complaint against JCG in a Colorado district court in November of 2003. In 2004, the case was transferred to the District of Maryland so that it could be integrated with other similar actions. The district court appointed First Derivative Traders as the lead plaintiff. Shareholders of JCG, led by First Derivative, added JCM to the class action suit against JCG, (collectively Janus), alleging both had violated federal securities laws by misleading long-term investors. [4]

First Derivative's amended complaint observed that JCG used JCM, a wholly owned subsidiary, as its primary operating company. The boards of both JCG and JCM have common members, and JCG derives the majority of its revenue through JCM. The complaint charged that as an investment adviser, JCM was "responsible for the day-to-day management of [the] investment portfolio and other business affairs of the funds." [5] Furthermore, the prospectuses were published publicly on a joint Janus funds-JCG-JCM website.

Janus, First Derivative asserted, violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission. Section 10(b) and Rule 10b-5 in prohibit fraud in connection with the purchase or sale of any security. Companies that perpetrate fraud or deception can be held privately civilly liable. Rule 10b-5 makes it "unlawful for any person, directly or indirectly" [6] to manipulate or mislead investors in the sale or purchase of a security.

The district court dismissed the case, saying that the shareholders had failed to meet the requirements of a claim under Section 10(b) because the complaint, "contain[ed] no allegations that JCG actually made or prepared the prospectuses." [7]

The Fourth Circuit reversed upon appeal, saying both JCG and JCM had "helped" draft the incorrect documents. The court stated that Janus, "by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents." [8] Because of the close relationship between the Janus companies, investors could reasonably assume Janus had directed or at least approved of the false claims.

In accepting the case, the Supreme Court addressed two questions: whether an adviser can be held legally responsible for participating in false statements made by another company and whether an adviser can be held liable in securities fraud actions for statements it did not make directly.

The Supreme Court addressed the issue of indirect liability for aiding and abetting deceptive practices in the 1994 case *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* The case involved manipulative practices that ultimately led to a bond default. First Interstate Bank and other bondholders sued several entities, including Central Bank, who they claimed was "secondarily liable" for adding and abetting in the fraud. [9]

The Court found that Section 10(b) and Rule 10b-5 do not allow a private plaintiff to bring an aiding and abetting suit. The case marked a turning point in the interpretation of securities fraud rules. Prior to the ruling, secondary actors like trustees, attorneys, and banks were often found guilty of misconduct under Rule 10b-5. [10]

In its brief to the Court, Janus argued that according to *Central Bank*, no aiding and abetting liability exists in private 10(b) claims. Janus, as an adviser and service provider, merely assisted another company and could not be held legally responsible for statements made by that company. Janus also claimed that reinterpreting the aiding and abetting standard would create an overly litigious climate in which investors would rush to sue other service providers. [11]

First Derivative countered that should the Court adopt Janus's position, it "would provide a roadmap for unscrupulous companies to commit securities fraud." [12] A firm would simply have to create a shell company that could be used to distribute misleading or manipulative information, insulating itself from charges of fraud.

During oral arguments, much of the questioning centered on the interpretation of the word "make." Justice Sotomayor seemed skeptical of Janus's claim that they could not be held liable for information they wrote simply because the false statements were attributed to the mutual funds. During questioning, Sotomayor asked Mark Perry, attorney for Janus, "Do you mean to tell me that puppets become a legal defense for someone who intentionally manipulates the market information?" [13]

Justices Kennedy and Sotomayor also questioned Perry about who controlled the day-to-day activities of the mutual funds. Perry argued that control was irrelevant. The fact that the funds were a separate legal entity automatically precluded JCG and JCM from any civil liability. [14] To make and to cause to be made, Perry argued, are two legally distinct actions. Janus simply could not make a statement that was attributed to an independently governed company.

David Frederick, arguing for First Derivative, attempted to narrow the focus of the case from all service providers to the specific actions of JCM. At the same time, Frederick argued for a broader interpretation of the word make. In response to questions from Justice Scalia, Frederick said, "We address the definition of 'make' under the SEC's interpretation, which is entitled to deference, as being to create or to compose or to accept as one's own." [15]

Assistant to the Solicitor General Curtis Gannon, representing the United States, also argued on behalf of First Derivative. Gannon stated that to make a statement and to create a statement are the same thing. [16] In an amicus brief, the U.S. argued that, "the Court can resolve this case by holding that a defendant 'makes' a false statement actionable under § 10(b) and Rule 10b-5 when the defendant creates or causes a misstatement to exist, falsely describes its own conduct, and disseminates that statement." [17] Since Janus, as a manager, developed the language for the mutual fund prospectuses, they could be said to have created the false statements.

The 5-4 decision was split along ideological lines, with Justice Thomas issuing the opinion and Justices Kagan, Breyer, Sotomayor and Ginsburg dissenting. The Court said that Janus could not be held liable since they did not actually make the false statements. In the opinion, Thomas wrote, "One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed." [18]

Chicago-Kent College of Law associate professor William Birdthistle, who wrote an amicus brief in support of First Derivative, called the ruling simplistic. Birdthistle said, "What this ruling says is that as long as there are separate legal entities, even if management totally dominates all aspects, there's no liability." [19]

The decision is regarded as important because it further defines the limitations of private liability under Rule 10b-5. More mutual fund companies may choose to adopt a split management structure in order to shield owners and subsidiaries from liability. According to Robert Skinner, a partner at Ropes & Gray LLP, "This is a very big decision for the industry. With this decision, the Supreme Court is saying that just being significantly involved in making prospectus statements isn't enough." [20]

The case is *Janus Capital Group, Inc. v. First Derivative Traders* No. 09-525.

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