WILMERHALE

UPDATE: Lower Courts Interpret the Supreme Court's Decision in *Janus Capital Group, Inc. v. First Derivative Traders*

2012-04-02

Last summer, the Supreme Court held in *Janus Capital Group, Inc. v. First Derivative Traders, Inc.* that a defendant may only be held be liable for securities fraud in a private action brought under Rule 10b-5(b) of the Securities Exchange Act of 1934 if it was the "maker" of a misstatement.[1] Specifically, a defendant may be responsible for a misstatement if it is the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[2]

In the nine months since *Janus* was decided,[3] the lower courts have applied what is a seemingly simple holding in divergent ways. Market participants should take an interest in these post-*Janus* opinions for two reasons. First, they suggest potential Janus-based defenses available in ongoing or future securities-related litigation. Second, they offer a window into the strategies that the U.S. Securities and Exchange Commission ("SEC") and the plaintiffs' bar are using to avoid *Janus*'s strictures.

Among the questions dividing the courts are the following:

1. Does *Janus*'s "ultimate authority" limitation apply to actions brought under other rules or statutes prohibiting false or misleading statements?

a. Southern District of New York and SEC's Chief Administrative Law Judge: Yes.

In *SEC v. Kelly* (S.D.N.Y.), the SEC asserted causes of action against two non-officer senior managers under Rules 10b-5(a) and 10b-5(c) of the Exchange Act and Section 17(a) of the Securities Act of 1933 in connection with alleged fraudulent transactions intended to artificially inflate revenue figures reflected in publicly filed financial statements.[4] Although the SEC conceded that the defendants lacked the "ultimate authority" to make the statements at issue and thus could not be held liable under Rule 10b-5(b),[5] it argued *Janus* did not preclude it from asserting "scheme liability" under Rule 10b-5(a) and 10b-5(c) or claims alleging fraud in the sale of securities under

Section 17(a).[6] Under the SEC's logic, although Rule 10b-5(a), Rule 10b-5(b), Rule 10b-5(c), and Section 17(a) all address similar conduct constituting securities fraud, only Rule 10b-5(b) contains the word "make" on which the Court's decision in *Janus* turned.

Judge Colleen McMahon disagreed with the SEC's position, granting defendants' motions for judgment on the pleadings on all three claims.[7] She reasoned that, to hold otherwise would render *Janus* "meaningless" because it would undermine the Supreme Court's stated intention to preserve a distinction between those who are primarily liable and those who are secondarily liable under the securities laws.[8] "Where the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission," the court stated, "courts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'misstatement' liability under subsection (b) by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.'"[9]

In *In the Matter of John P. Flannery and James D. Hopkins*, the SEC's Chief Administrative Law Judge Brenda Murray reached a similar conclusion.[10] In a case involving alleged misstatements by a chief investment officer and a product engineer, she relied on *Kelly* in holding that *Janus* was appropriately applied not just to claims under Rule 10b-5(b), but also to claims under Rule 10b-5(a) and (c), as well as Section 17(a).[11] ALJ Murray held that, "with respect to allegations involving documentary evidence, the [Enforcement] Division must establish that Respondents had ultimate authority and control over such documents."[12] She proceeded to analyze whether the Respondents had "ultimate authority" over each of the alleged misstatements at issue and concluded, at least with respect to those that appeared in documents, that neither Respondent possessed sufficient authority over them to be considered the "maker" of the statement under *Janus*. (In the case of the alleged oral misstatements, the ALJ concluded that, while the Respondents had "ultimate authority" over statements that they themselves had made, the statements were not materially false or misleading).

On March 30, 2012, the SEC denied Respondents' motion for summary affirmance and granted the Enforcement Division's petition for review of the ALJ's initial decision, noting the "important and legal policy issues" raised, including that this is "a case of first impression regarding the applicability of the Supreme Court's holding in Janus to claims other than those brought pursuant to Exchange Act Rule 10b-5(b)."[13]

b. Northern District of California: Only for claims under 10b-5.

In *SEC v. Daifotis* (N.D. Cal.), however, Judge William Alsup reached a different conclusion.[14] In light of *Janus*, the defendants moved for reconsideration of an order denying their motion to dismiss claims the SEC brought against them in a civil enforcement action under Rule 10b-5(b), Section 17(a), and Section 34(b) of the Investment Company Act.[15]

The court granted the motion to reconsider as to claims asserted under Rule 10b-5(b), holding that the defendants did not "make" a number of the statements at issue within the meaning of *Janus*.[16]

On the other hand, the court also held that *Janus* does not apply to claims asserted under Section 17(a) because the word "make" is "absent from the operative language of" the statute.[17] It reached a similar conclusion with respect to claims under Section 34(b), which prohibits the making of untrue statements of material fact in registration statements, even though that statute does include the word "make."[18] The court reasoned that *Janus*'s underlying rationale—the need to construe narrowly the scope of an implied right of private action—was inapplicable to Section 34(b) because it can be enforced only by the SEC and has not been interpreted as having an implied private right of action.[19]

c. Other courts: Limiting of Janus*'s Application to Rule 10b-5(b) claims.*

Since these two cases were decided, other lower courts have limited *Janus*'s reach to claims brought under Rule 10b-5(b). For example, in *Hawaii Ironworkers Annuity Trust Fund v. Cole*, the court reached a similar conclusion to what Judge Alsup reached in *Daifotis*, holding that *Janus* was inapplicable to claims brought under Rule 10b-5(a) and 10b-5(c).[20]

And in *SEC v. Mercury Interactive*, a different district court in the Northern District of California declined to apply *Janus* to scheme liability claims under Rule 10b-5(a) and (c) or to claims under Section 17(a) or Section 14(a) of the Exchange Act.[21] Other courts have reached similar conclusions in recent cases.[22]

2. Does Janus limit liability of corporate officers or does it apply only in situations involving legally separate entities?

a. Northern District of Ohio: Yes, Janus *applies to corporate officers.*

In the same decision rejecting *Janus*'s applicability to claims under Rule 10b-5(a) and (c), the district court in *Hawaii Ironworkers* dismissed the Rule 10b-5(b) claims that had been brought against two corporate officers by a former shareholder. The shareholder alleged that those officers internally reported false financial results that had contributed to the corporation's issuing false financial statements.[23] The officers contended that they could not be held liable under *Janus* because they had acted at the direction of other executives and therefore had not possessed "ultimate authority" over the allegedly false financial statements. In dismissing the 10b-5(b) claims against them, the court agreed, noting that "nothing in the Court's decision in *Janus* limits the key holding... to legally separate entities."[24]

b. District of New Jersey: No, Janus *only applies to separate entities.*

The ruling in *Hawaii Ironworkers* departed from the approach taken earlier by a district court in the District of New Jersey in *In re Merck & Co., Inc. Securities, Derivative & "ERISA" Litigation*.[25] In that case, the court held that *Janus* is limited to claims against "separate and independent" entities and "certainly cannot be read to restrict liability for Rule 10b-5 claims against corporate officers[.]"26

3. Can a parent company have "ultimate authority" within the meaning of *Janus* over statements made by a wholly owned subsidiary?

Even if *Janus* can fairly be read as being limited to situations involving legally separate entities, there is further disagreement about *Janus*'s scope. Specifically, can a corporate parent have "ultimate authority" over claims made by a wholly owned subsidiary?

a. Southern District of New York – Take 1: Yes.

In *City of Roseville Employees Retirement System v. EnergySolutions, Inc.* (S.D.N.Y.), Judge John Koeltl held that the holding company defendant had "ultimate authority" over and therefore was the maker of the allegedly misleading statements issued by its wholly owned subsidiary.[27] In support of this ruling, the court noted that the parent company had "direct control over all corporate transactions" of the subsidiary and, accordingly, a reasonable jury could find it had control over the content of the subsidiary's registration statement (which contained the alleged misstatement), the underlying subject matter of that statement, and the ultimate decision of whether to make that statement.[28]

b. Southern District of New York – Take 2: No, not where the subsidiary's board could make the statements without consulting shareholders.

Two weeks later in *In re Optimal U.S. Litigation* (S.D.N.Y.), Judge Shira Scheindlin reached the opposite conclusion. She dismissed claims brought by a putative class of investors against the investment manager and corporate parent of the Optimal Strategic U.S. Equity Fund under Rule 10b-5 for allegedly false and misleading statements made in connection with the sale of the fund's shares. The defendants argued that they were not the makers of the allegedly false statements because they had appeared in Explanatory Memoranda (the Bahamian equivalent of a prospectus) issued by Optimal Multiadvisors, Ltd., a separate entity of which the investment manager owned 100% of the voting shares.

The court agreed, holding "it follows from *Janus* that Rule 10b-5 liability for a one-hundred percent shareholder of an entity 'making' a misleading statement is inappropriate; rather, [S]ection 20(a) [control person liability] is the appropriate source of liability."[29] The court distinguished *Roseville* on the basis that, "unlike *Roseville*," Optimal Multiadvisors' board "expressly retained the ability to amend the [prospectuses] without consulting its shareholders in numerous situations."[30]

Key Takeaways For Participants in the Securities Markets

1. *Janus* limits the universe of those who may be held liable for alleged misleading statements under Rule 10b-5(b) to those with "ultimate authority" over the statements. After *Janus*, it is evident that plaintiffs, including the SEC, must allege that entities have "ultimate authority" to make the allegedly false statements at issue or else they risk dismissal of any claims under Rule 10b-5(b).[31] Some courts have extended this rule to claims brought under Rule 10b-5(b) against an entity's individual officers[32] and controlling shareholders.[33]

2. Some courts have been reluctant to extend *Janus* to securities fraud claims other than those brought under Rule 10b-5(b). With the exception of *Kelly*,[34] several courts to consider the issue have limited *Janus*'s reach to claims under Rule 10b-5(b). Both the SEC and private plaintiffs have successfully argued that the absence of the word "make" means that *Janus* does not apply to claims alleging scheme liability brought under Rule 10b-5(a) and (c).[35] And in one case, the SEC succeeded in arguing that *Janus* does not apply to claims the Commission brings under Section 17(a) and Section 34(b) (neither of which are available to private plaintiffs).[36] The chief counsel for the SEC's Division of Enforcement recently acknowledged that *Janus* has caused the agency to shift its emphasis toward aiding-and-abetting and control person liability claims under Rules 10b-5(a) and (c) and Section 20(a), respectively.[37]

---

[1] 131 S.Ct. 2296, 2299 (2011).

[2] *Id.* at 2302.

[3] For our initial update concerning *Janus*, see Lori A. Martin, Thomas W. White, Douglas J. Davison, Christopher Davies, Michael Mugmon, and Jaclyn Moyer, *UPDATE: Supreme Court Curtails Ability of Plaintiffs to Hold Secondary Actors Liable in Private Securities Fraud Actions* (June 29, 2011). Available at: www.wilmerhale.com/publications/whPubsDetail.aspx?publication=9874.

[4] No. 08-CV-4612 (CM), 2011 WL 4431161, at *1 (S.D.N.Y. Sept. 22, 2011).

[5] *Id.* at *2.

[6] *Id.* at *2, *4. Section 17(a) applies only to the "offer and sale" of securities whereas Rule 10b-5(b) applies to either purchase or sale. *Id.* at *4.

[7] *Id.* at *6.

[8] *Id.* at *4-*5 (citing *Janus*, 131 S. Ct. at 2302 n.6).

[9] *Id.* at *3.

[10] *See Initial Decision Release* No. 438, Administrative Proceeding, File No. 3-14081 (SEC Administrative Decision, Oct. 28, 2011).

[11] *Id.* at 42-43 ("This case involves allegations of materially false or misleading statements or omissions, and I find the Janus test to be the appropriate standard to apply in evaluating the extent of Respondents' conduct.").

[12] *Id.*

[13] *See* Order Denying Motions for Summary Affirmance, Granting Petition for Review, and Scheduling Briefs, Administrative Proceeding, File No. 14081 (Securities and Exchange Commission, Mar. 30, 2012).

[14] *See* No. C 11-00137 WHA, 2011 WL 3295139, at *5 (N.D. Cal. Aug. 1, 2011). ALJ Murray cited Daifotis, but declined to follow it.

[15] *Id.* at *1.

[16] *Id.* at *3.

[17] *Id.* at *5-6.

[18] *Id.* at *6.

[19] *Id.*

[20] *See* No. 3:10CV371, 2011 WL 3862206, at *5-6 (N.D. Ohio Sept. 1, 2011).

[21] *See* 5:07-cv-02822, 2011 WL 5871020, at *2-3 (N.D. Cal. Nov. 22, 2011).

[22] *See, e.g., SEC v. Pentagon Capital Mgmt. PLC,* 08 CIV. 3324, 2012 WL 479576, at *41-42 (S.D.N.Y.

Feb. 14, 2012) (declining to apply *Janus* to claims brought by the SEC under Rule 10b-5(a) and (c) and Section 17(a)).

[23] 2011 WL 3862206, at *3.

[24] *Id.*

[25] MDL No. 1658 (SRC), 2011 WL 3444199 (D. N.J. Aug. 8, 2011).

[26] *Id.* at 26. Other courts have also held individual officers to be "makers" under *Janus*. *See, e.g., SEC v. Carter*, No. 10 C 6145, 2011 WL 5980966, at *2-3 (N.D. Ill. Nov. 28, 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787, at *6 (D. Neb. Sep. 20, 2011); *SEC v. Landberg*, No. 11 Civ. 0404, 2011 WL 5116512, at *4 (S.D.N.Y. Oct. 26, 2011).

[27] *See City of Roseville Employees' Ret. Sys. v. EnergySolutions, Inc.*, 814 F. Supp. 2d 395, 418 (S.D.N.Y. 2011).

[28] *Id.*

[29] No. 10 Civ. 4095(SAS), 2011 WL 4908745, at *5-*6 (S.D.N.Y. Oct. 14, 2011).

[30] *Id.* at *6 n.50.

[31] *See, e.g., Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681, 694 (9th Cir. 2011) ("The insufficiency of Reese's pleadings are reinforced by the Supreme Court's recent opinion in Janus ... which sets the pleading bar even higher in private securities fraud actions seeking to hold defendants primarily liable for the misstatements of others."); *S.E.C. v. Radius Capital Corp.*, 2:11-CV-116-FTM-29, 2012 WL 695668, at *7 (M.D. Fla. Mar. 1, 2012) (dismissing complaint for failure to state a claim where the SEC failed to allege facts demonstrating that the defendant exercised "ultimate authority" over alleged misstatements).

[32] See, e.g., *Hawaii Ironworkers*, 2011 WL 3862206, at *3. *But see Merck*, 2011 WL 3444199.

[33] *See, e.g., Optimal*, 2011 WL 4908745, at *5. *But see City of Roseville*, 2011 WL 4527328, at *17-18.

[34] 2011 WL 4431161.

[35] *See Mercury Interactive, LLC,* 2011 WL 5871020 (holding *Janus* does not apply to scheme liability claims brought by SEC); Hawaii Ironworkers, 2011 WL 3862206 (holding *Janus* does not apply to scheme liability claims brought by private plaintiffs).

[36] See *Daifotis*, 2011 WL 3295139, at *5-6.

[37] *See* Yin Wilczek, *SEC Looking to Aiding/Abetting Claims In Wake of* Janus *Decision, Official Says*, Securities Law Daily (Feb. 27, 2012).

Authors

Lori A. Martin

PARTNER

lori.martin@wilmerhale.com

+1 212 295 6412

Thomas W. White

RETIRED PARTNER

+1 202 663 6000

Christopher Davies

PARTNER

Vice Chair, Securities & Financial Services Department

christopher.davies@wilmerhale.com

+1 202 663 6187

Michael Mugmon

PARTNER

Partner-in-Charge, San Francisco Office

michael.mugmon@wilmerhale.com

+1 628 235 1006

Jaclyn Moyer

PARTNER

jaclyn.moyer@wilmerhale.com

+1 202 663 6309

Lesley Fredin McColl

SPECIAL COUNSEL

lesley.mccoll@wilmerhale.com

+1 202 663 6411