The Duality of the U.S. Supreme Court's *Janus* Decision

By Dayrel S. Sewell and Amulya Appalaraju – December 9, 2015

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder prohibit, among other things, the making of untrue and misleading statements of fact in connection with the purchase and sale of a security.

In light of this prohibition, a seminal question arises with respect to who is the "maker" of the untrue or misleading statement? The United States Supreme Court addressed this question in its decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). The *Janus* decision made an impact on the securities fraud landscape. It initially appeared to be a well-constructed guiding principle, yet different courts have come to disparate conclusions with respect to its application, thus creating the "duality" that exists—ironically—in the aftermath of the *Janus* decision.

The Supreme Court's 2011 *Janus* Decision

In *Janus*, the Court held that only a person who has the "ultimate authority" over a statement, including its content and whether and how to communicate it, can be the "maker" of the statement for purposes of section 10(b) and Rule 10b-5(b).

The *Janus* Court held that an investment advisor to a mutual fund cannot be primarily liable under section 10(b) for statements made in the fund's prospectus because the investment advisor did not have the ultimate authority for making the statements. The Court held that to "make" statements for purposes of Rule 10b-5(b), the alleged maker must have "ultimate authority over the statement, including its content and whether and how to communicate it." *Janus*, 131 S. Ct. at 2302. The Court concluded that it is the entity that has control over the content of the statements, and the authority of how and when to make them, that will have the primary liability. *Id.* at 2301.

In reaching this decision, the Court rejected the argument interpreting the word "make" as "create" and thereby extending the primary liability to all parties who had a significant role in the creation of the misinterpretations. The Court also rejected the dissent's broader view of interpreting the "maker" based on the facts and circumstances of the particular case. *Id.* at 2311 (Breyer, J., dissenting). Justice Breyer's dissent argues that several different individuals or entities can "make a statement that each has a hand in producing." He added that the "special relationships" alleged between the fund, its investment advisor, and the prospectus statements "warrant the conclusion that [the investment advisor] did 'make' those statements." *Id.*

Who Is the "Maker" When More Than One Entity Is Involved?

A recent case from the federal district court of Oregon, *In re Galena Biopharma, Inc. Securities Litigation*, 2015 WL 4643474 (D. Or. Aug. 5, 2015), addressed the issue of "ultimate authority" where there were a few separate entities accused of being involved with the alleged misrepresentations. The defendant company, Galena Biopharma, Inc., was alleged to have "entered into an unlawful promotional scheme," including having a stock promotion company write misleading articles, blogs, comments, and email blasts without including the required disclosure that it was being paid by the defendants. The plaintiffs argued that, in addition to Galena, the stock promotion company should also be held primarily liable for the alleged misstatements contained in the web articles. *In re Galena*, 2015 WL 4643474, at *3.

The *Galena* court began its analysis of this issue by noting how *Janus* examined two business entities where the first entity had a statutory obligation to file these statements with the Securities and Exchange Commission (SEC), while the second entity contributed content that the first entity could choose to include in the filing. The *Galena* court then noted that the stock promotion company and its individual authors were more similar to the second entity, which made the contribution, rather than the first entity, which made the required SEC filing, because the stock promotion company did not have "ultimate authority" over the published statements.

Accordingly, the court rejected the idea that the individual authors and the stock promotion company could be held liable for the statements when Galena and its officers had the final say in approving and publishing the statements. Noting that it is not possible for both business entities to have ultimate authority, the court asserted that the lesson of *Janus* is that where legally distinct entities are involved, only one entity has the final say in a publication.

A similar result occurred in *City of Roseville Employees Retirement System v. EnergySolutions, Inc.*, 814 F. Supp. 2d 395 (S.D.N.Y. 2011), a securities class action against EnergySolutions (ES) and its sole stockholder ENV holdings, Inc., for making materially false and misleading statements about its business. The court stated that being the sole stockholder and the parent company, ENV had "direct control over all the corporate transactions" of the subsidiary and therefore was the maker of the alleged misleading statements released by ES. *Roseville*, 814 F. Supp. 2d at 418 (quoting *Janus*, 131 S. Ct. at 2302).

But the court in *In Re Optimal U.S. Litigation*, No. 10 CIV 4095 SAS, 2011 WL 4908745 (S.D.N.Y. Oct. 14 2011), took a different approach. In this case, a claim was brought against the investment manager and parent company Optimal Strategic U.S. Equity Fund for false and misleading statements made in connection with the sale of the fund's shares. The court distinguished *Roseville* on the basis that the subsidiary entity's board "manages and has the authority to alter the prospectus statements without consulting the shareholders." *In Re Optimal U.S. Litig.*, 2011WL 4809745, at *22.

The plaintiffs attempted to get around this application of *Janus* by arguing that the court should pierce the corporate veil to find the parent corporation liable. The court rejected this argument but did note that there "will soon be a case where a court must decide whether a corporate veil-piercing theory can be used to avoid the legal strictures that would otherwise bar a Rule 10b-5 claim under *Janus*."

Another similar route to liability against a non-maker parent corporation lies in section 20(a) of the Exchange Act, which the justices in Janus considered as part of their "maker" analysis. Section 20(a) establishes liability for any person who, directly or indirectly, controls another person who violates, inter alia, section 10(b). Proof of liability under section 20(a) therefore requires two basic things: (1) a primary violation of a federal securities law by a "controlled" person and (2) a separate person who had "control" over the "controlled" person.

However, secondary liability under section 20(a) cannot exist unless primary liability under section 10(b) is first established against the "maker" of the statements. *See Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (putting an end to aiding and abetting as a viable theory under Rule 10b(5) in private suits). Thus, a plaintiff would have to prove primary violations by the maker of the statements and "control person" liability against the non-maker of the statement to attach liability against the non-maker. *Janus*,131 S. Ct. at 2302.

"Ultimate Authority" of Corporate Officials or the Corporation?
Another unsettled area in the aftermath of *Janus* concerns whether corporate officers or the corporation (or its board) have "ultimate authority" for any given representation. The potential divide appears along the fault line of whether the *Janus* Court intended its decision to cover only corporate entities or to also be inclusive of those within a corporation said to have made a misinterpretation. The dissent appears to suggest that it covers both situations: "Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have 'ultimate authority' to control." *Janus*, 131 S. Ct. at 2307 (Breyer, J., dissenting).

In *In re Merck & Co., Inc. Securities, Derivative & ERISA Litigation*, 2011 WL 3444199, at *25 (D.N.J. Aug. 8, 2011), a New Jersey district court stated that *Janus* "did not alter the well-established rule that a corporation can act only through its employees and agents." An executive vice president and president of the corporation was arguing that he could not be held primarily liable for alleged misstatements made by the corporation in light of *Janus* because he did not have the "ultimate authority" over the statements. The court rejected this argument stating that the executive "made the statements pursuant to his responsibility and authority to act as an agent of Merck, not on behalf of some separate and independent entity." *In re Merck & Co.*, 2011WL3444199, at *25.

Applicability to Other Antifraud Provisions and SEC Enforcement
Another instance in which the lower courts have divided opinions is with respect to the applicability of *Janus* to other antifraud provisions and the SEC's enforcement authority. In *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2011), the court applied *Janus* to Rule 10b-5(b) and also to section17(a) of the Securities Act. The court stated that "since subsection 2 of §17(a) and subsection (b) of Rule 10b-5 are treated similarly, it would be inconsistent to require a defendant to have made the statement under Rule 10b-5(b) but not under subsection 17(a)."

On the other hand, in *SEC v. Pentagon Capital Management PLC*, 844 F. Supp. 2d 377 (S.D.N.Y. 2012), the court refused to apply *Janus*, stating that "there is no persuasive reason why the decision should read to reach enforcement actions brought by the SEC." In addition, the court also did not believe that *Janus* could be applied to section 17(a), primarily because the word "make," which is the focus of the *Janus* decision, is absent from that section. Most of the lower courts prefer this path instead of siding with *Kelly*. *SEC v. Garber*, 959 F. Supp. 2d 374 (S.D.N.Y. 2013); *SEC v. Big Apple Consulting USA, Inc.*, No. 6:09-cv-1963-Orl-28GJK, 2012 WL 3264512, at *3 (M.D. Fla. Aug. 9, 2012) (refusing to apply *Janus* to section 17(a) and noting that "the analysis in Janus closely focused on the 'to make' language in Rule 10b-5(b)"); *see also SEC v. Sells*, No. C 11-4941 CW, 2012 WL 3242551, at *7 (N.D. Cal. Aug. 10, 2012) (holding that *Janus* did not apply to sections (a) and (c) of Rule 10b-5).

Conclusion
Until higher courts have ruled on the scope of *Janus*, the *Janus* ruling might confound similarly situated class action plaintiffs and persuade them to look for alternatives to avoid dismissal. The *Janus* decision will continue to have an impact on securities fraud claims. Investment advisors, corporate entities, boards of directors, management, and investors will

do well to be mindful of the securities litigation landscape in the post-*Janus* environment.

Keywords: litigation, securities, SEC, ultimate authority, Rule 10b-5

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