

## The Implications of *Janus* on Issuer Liability in Jurisdictions Rejecting Collective Scierter

*Browning Jeffries\**

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\* Assistant Professor of Law, Atlanta’s John Marshall Law School. The author would like to thank Benjamin Stidham for his diligent research assistance throughout this project.

## I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) pursuant to its rule-making authority granted under Section 10(b), protect investors in business enterprises from securities fraud.<sup>1</sup> These broad anti-fraud provisions allow the SEC to pursue enforcement actions against those who, in connection with the purchase or sale of a security, use “any manipulative or deceptive device,”<sup>2</sup> which includes making “any untrue statement of material fact” or omitting a material fact “necessary in order to make the statements made . . . not misleading.”<sup>3</sup> Additionally, although Rule 10b-5 is silent as to whether it allows for a private right of action, the U.S. Supreme Court has interpreted the rule to allow shareholders of corporations adversely affected by securities fraud to bring private claims against violators of the rule.<sup>4</sup>

The SEC enforcement mechanism, coupled with the private right of action available to shareholders, provides necessary protection for investors in an exceedingly complex corporate climate that is increasingly rife with securities fraud.<sup>5</sup> Indeed, under Section 10(b) and Rule 10b-5, the SEC and private litigants can pursue claims not only against issuers and corporate insiders, but also against culpable secondary actors such as underwriters, accountants, investment banks, and lawyers, thereby broadening the net of

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<sup>1</sup> Elizabeth Cosenza, *Is the Third Time the Charm? Janus and the Proper Balance Between Primary and Secondary Actor Liability Under Section 10(b)*, 33 CARDOZO L. REV. 1019, 1026–27 (2012).

<sup>2</sup> 15 U.S.C. § 78j(b) (2006).

<sup>3</sup> 17 C.F.R. § 240.10b-5(b) (2011).

<sup>4</sup> *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971).

<sup>5</sup> Speaking to corporate fraud generally, the economists Luigi Zingales and Adair Morse of the University of Chicago and Alexander Dyck of the University of Toronto, in a study pulling from frauds uncovered during the dot-com bubble, estimated that in any given year, fraud was being committed by eleven to thirteen percent of the “large companies” in the country. Eduardo Porter, *The Spreading Scourge of Corporate Corruption*, N.Y. TIMES, July 10, 2012, available at <http://www.nytimes.com/2012/07/11/business/economy/the-spreading-scurge-of-corporate-corruption.html>. The last decade has witnessed a boom of corporate malfeasance, as evidenced by the scandals involving Enron and WorldCom and, more recently, those related to the financial crisis, such as the scandals involving Bear Stearns, Lehman Brothers, Fannie Mae, and Freddie Mac. Cosenza, *supra* note 1, at 1022. And there is evidence to suggest that the latest uptick is not merely a reflection of the business cycle, but rather an indication that corporate corruption has become more prevalent over the years. Porter, *supra*.

potential liability and increasing the protection afforded to investors.<sup>6</sup> But the ability of the SEC and, especially, private litigants to pursue claims against both primary and secondary actors has been significantly curtailed in recent years.<sup>7</sup> The most recent and glaring example of this was in 2011 with the U.S. Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*.<sup>8</sup>

To be liable for a misrepresentation under 10b-5(b), the defendant must have been the “maker” of the false statement.<sup>9</sup> The *Janus* decision significantly limits the universe of individuals who can be considered a “maker” of a misstatement for purposes of 10b-5 liability. Specifically, the Supreme Court held in *Janus* that, to establish a defendant as the “maker” of the alleged misstatements, a plaintiff must show that the defendant was the person or entity with “ultimate authority” over the misstatements, including their “content and whether and how to communicate” them to the public.<sup>10</sup> Therefore, merely participating in the preparation or publication of a statement, even if that involvement is significant, is not sufficient to subject one to 10b-5 liability as a “maker.”<sup>11</sup>

In *Janus*, the defendant that escaped liability was the investment advisor to a mutual fund—a secondary actor.<sup>12</sup> But application of *Janus* has not been limited to its facts. For instance, some commentators have already noted the difficulty *Janus* creates in imposing liability on secondary actors other than investment advisors—actors such as underwriters, auditors, investment bankers, and lawyers.<sup>13</sup> Such persons may have significant influence over a corporate statement, but they rarely have “ultimate authority” over it. And lower courts that have interpreted *Janus* have routinely found that it applies not only to secondary actors, but also to corporate insiders such as directors, officers, and employees.<sup>14</sup> For lower courts

<sup>6</sup> Private plaintiffs can pursue actions against any “secondary actors . . . ‘who have some relationship with the primary wrongdoer.’” Cosenza, *supra* note 1, at 1022 (quoting Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 80 n.4 (1981)). The SEC is typically more limited in whom it can pursue in an enforcement action. *Id.* at 1022 n.1.

<sup>7</sup> See *infra* Part II for a more complete discussion of the historical development of the 10b-5 cause of action.

<sup>8</sup> 131 S. Ct. 2296 (2011).

<sup>9</sup> 17 C.F.R. § 240.10b-5(b) (2011). This section makes it unlawful “[t]o make any untrue statement of . . . material fact.” *Id.*

<sup>10</sup> *Janus*, 131 S. Ct. at 2302.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 2299.

<sup>13</sup> See, e.g., Cosenza, *supra* note 1, at 1070–83.

<sup>14</sup> See, e.g., *Red River Res., Inc. v. Mariner Sys., Inc.*, No. CV 11-02589-PHX-FJM,

analyzing whether a claimant can proceed against a particular insider, whether the misstatement was publicly attributed to the corporate insider appears determinative—courts have allowed claims to proceed where there was attribution and dismissed those where there was not.

Even though lower courts are finding that *Janus* does not bar claims against insiders where there is public attribution, many such claims still will ultimately be unsuccessful because a plaintiff may be unable to establish that the defendant acted with scienter,<sup>15</sup> a necessary element to imposition of 10b-5 liability.<sup>16</sup> In such cases, difficulty arises when the individual to whom a statement is publicly attributed—i.e., the person considered to have “ultimate authority” under *Janus*—had no knowledge of its falsity. If this individual is seen as the only potential “maker” of the misstatement, and scienter exists only in some *other* culpable insider, then there will be no corporate insider against whom a 10b-5 claim could be pursued.

After *Janus*, identifying an individual insider to hold liable is not the only problem. In many jurisdictions, this issue of scienter may make it difficult to bring claims against even the issuer to which the misrepresentation is attributed.<sup>17</sup> A plaintiff typically can establish the scienter of a corporation by imputing to the corporation the scienter of one or more culpable officers, directors, or employees. But some jurisdictions require, for imputation purposes, that the individual with the requisite scienter also be the “maker” of the statement.<sup>18</sup> Such jurisdictions have rejected the theory commonly referred to as

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2012 WL 2507517, at \*6 (D. Ariz. June 29, 2012) (“The holding in *Janus* is not explicitly limited to its facts. . . . [C]ourts have applied *Janus* to corporate insiders.”). See *infra* Part III.A for a more complete discussion of the application of *Janus* to corporate insiders.

<sup>15</sup> Scienter is defined as the defendant’s “intent to deceive, manipulate, or defraud . . . .” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 185 (1976).

<sup>16</sup> See *infra* Part II.B for a more complete discussion of the elements necessary to bring a claim under Rule 10b-5.

<sup>17</sup> See *infra* Part III.B.2 for a more complete discussion of the limitations *Janus* may impose on pursuing claims, even against corporate issuers to which misstatements are attributed.

<sup>18</sup> See, e.g., *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 745 (9th Cir. 2008) (holding that the plaintiff must plead scienter “with respect to those individuals who actually made the false statements” for such scienter to be imputed to the corporate entity); *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (rejecting the notion of “collective scienter” and instead requiring the plaintiff to establish the state of mind of the individual corporate official who made or issued the statement or ordered its making or furnished information for inclusion therein for an individual’s scienter to be imputed to the corporation).

“collective scienter,” which allows a court to impute to the corporation the scienter of some or all of its employees, even where none of the wrongdoers are necessarily the “maker” or where the wrongdoer has not yet been identified.<sup>19</sup> As such, in jurisdictions rejecting collective scienter, courts may refuse to impute the scienter of the individual to the corporation where the individual with scienter is not the person who made the misrepresentation. In the wake of *Janus*, which curtails the universe of potential “makers” of a statement, plaintiffs in such jurisdictions may have no defendant with the requisite scienter—not even the issuer itself. Consequently, plaintiffs may have no defendant against whom they can pursue a 10b-5 claim, even in the face of blatant fraud.

Take, for example, the following hypothetical. Mr. Smith is the Chief Operating Officer (COO) of Corporation X. Mr. Smith made misstatements internally to employees of Corporation X that he knew to be false at the time they were made. These misstatements were made in a number of different forms. For instance, some were made on a conference call to various employees and officers. Others were made during presentations to the management team and other employees. Some were made in written commentaries posted on Corporation X’s internal website. The written commentaries bore a written warning: “For internal use only.” Corporation X’s board of directors and other members of the management team ultimately incorporated some of Mr. Smith’s internal misstatements into public disclosures that were communicated to Corporation X’s investors. The board and management team (other than Mr. Smith) had no reason to suspect that the COO’s statements were false. Yet there is no dispute that the COO’s statements contained misrepresentations, and there is no dispute that the COO knew his statements contained misrepresentations at the time he made them.

When Corporation X eventually discovered and revealed the misrepresentations, Corporation X’s stock price was negatively affected. Shareholders of Corporation X who purchased stock after the misrepresentations were communicated to the investing public and before the statements were revealed as false, brought a 10b-5 suit against the COO and Corporation X. At first blush, in the face of obvious fraud in the form of admitted false statements by a high-

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<sup>19</sup> See, e.g., *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195–96 (2d Cir. 2008) (citation omitted) (applying collective scienter to hold that it is possible to establish scienter at the pleading stage without being able to name the individuals who devised and disseminated the fraud). See *infra* Part III.B.2, for a more complete discussion of the theory of collective scienter.

ranking officer, it would seem likely that the plaintiffs would prevail, particularly when one considers that certainly the COO in such a case would know that his internal communications would likely form the basis for public disclosures. In the wake of *Janus*, however, the private litigants may struggle to find a proper defendant.

The COO, for instance, can argue, based on *Janus*, that he did not actually “make” the misrepresentations since he did not have the “ultimate authority” over the statements, including their “content and whether and how to communicate” them to the public.<sup>20</sup> Rather, he merely made internal communications and had no say in whether or when or how such internal communications might ultimately be relayed to the public. The COO could argue it was the board and other members of the management team, or the corporation itself, that must be seen as the maker of the misstatements. After *Janus*, this argument would likely be successful and the COO would escape liability.

Moreover, while the shareholder-plaintiffs might have a good case that Corporation X, along with individual board members or other members of the management team responsible for the public disclosure, were the makers of the misstatements for purposes of *Janus*, it is possible that the plaintiffs would not be able to establish scienter as to these potential defendants. Mr. Smith is likely the only person in this scenario with the requisite scienter for 10b-5 liability. As such, the individual board members or other members of the management team responsible for the public disclosure cannot be proper defendants in a 10b-5 action. The scienter of Mr. Smith could in theory be imputed to Corporation X for purposes of establishing 10b-5 liability in a jurisdiction allowing collective scienter. But in a jurisdiction that allows the scienter of only the “maker” to be imputed to the corporation, Mr. Smith’s scienter could not be imputed to Corporation X because, under *Janus*, Mr. Smith did not have “ultimate authority” over the misstatements. Corporation X would escape liability.

After *Janus*, in this realistic scenario concerning undisputed wrongdoing,<sup>21</sup> a private litigant may be without recourse under the federal securities laws. Moreover, because, as discussed *infra*, courts

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<sup>20</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2298 (2011).

<sup>21</sup> These hypothetical facts do not present a particularly unique or unusual set of circumstances. In fact, they are adapted from a securities fraud case pending at the time of this writing in the Northern District of California, San Francisco Division. Defendant’s Motion for Summary Judgment at 2–11, SEC v. Dafoitis, No. 11-cv-00137-WHA (N.D. Cal. May 3, 2012), 2012 WL 2848995.

are applying *Janus* to actions instigated by the SEC as well as to actions brought by private litigants, even the SEC's ability to pursue such claims in enforcement actions may be hampered.

This Article explores the repercussions of the *Janus* decision. Rather than focusing on the limitations that *Janus* imposes on the liability of secondary actors such as, in the case of *Janus*, an investment advisor to a mutual fund, this Article looks instead at the implications of *Janus* on the liability of primary actors—the issuer itself and its corporate insiders. Part II of this Article, by way of background, discusses how a private suit or an SEC enforcement action proceeds under Section 10(b) and Rule 10b-5. Part II includes a brief discussion of the history of Section 10(b) and Rule 10b-5 jurisprudence and the varying avenues of liability that have been available to plaintiffs under these rules. Part II culminates with a description of the *Janus* case.

Part III of this Article addresses the gaps in liability created by *Janus*. Specifically, it addresses how lower courts are interpreting *Janus* with respect to the liability of corporate insiders. It also analyzes the potential liability gap for the issuers themselves, which is compounded in jurisdictions that have rejected notions of collective scienter and only allow scienter to be imputed to the corporation from a corporate insider if that insider in fact made the misrepresentation at issue. Additionally, Part III looks at the issue of how lower courts are applying *Janus* to claims under other federal securities laws and how such an extension would further widen the above-mentioned liability gaps. Part IV discusses some policy considerations that weigh in favor of warranting a more expansive view of liability for fraudulent misrepresentations than that permitted by *Janus*. Finally, Part V proposes some potential solutions to the liability gaps established by *Janus* and its intersection with cases rejecting collective scienter.

## II. BRIEF HISTORY OF SECTION 10(B) JURISPRUDENCE

### A. Overview of Federal Securities Laws

In response to the 1929 stock market crash and ensuing Great Depression, Congress enacted the first major pieces of federal legislation to regulate the offer and sale of securities. Two of the most important pieces of legislation enacted during this time were the Securities Act of 1933 (the “Securities Act”) and the Securities

Exchange Act of 1934 (the “Exchange Act”).<sup>22</sup> Often referred to as the “truth in securities law,” the Securities Act was aimed at disclosure—ensuring that investors receive complete and accurate information about a potential investment before purchasing securities.<sup>23</sup> To oversimplify, the Securities Act can be thought of as regulating the disclosures provided to investors in the initial distribution of securities—i.e., through the primary market—while the Exchange Act can be thought of as regulating trading between third parties on the secondary market, after the initial distribution by the issuer.<sup>24</sup> The Exchange Act was the vehicle through which Congress created the SEC, which was given broad authority to regulate the securities industry.<sup>25</sup>

*B. Section 10(b) and Rule 10b-5: Establishing a Cause of Action*

Section 10(b) of the Exchange Act is a crucial mechanism for preventing and punishing fraud in the purchase and sale of securities.<sup>26</sup> Section 10(b) makes it unlawful for anyone, directly or indirectly:

To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>27</sup>

Pursuant to its rulemaking authority under Section 10(b), the SEC promulgated Rule 10b-5, which makes it unlawful for anyone, directly or indirectly:

(a) To employ any device, scheme, or artifice to defraud,  
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . .<sup>28</sup>

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<sup>22</sup> STEPHEN M. BAINBRIDGE, CORPORATE LAW 10 (Foundation Press, 2d ed. 2009).

<sup>23</sup> *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM., <http://www.sec.gov/about/laws.shtml#secact1933> (last visited Mar. 17, 2013).

<sup>24</sup> BAINBRIDGE, *supra* note 22, at 10.

<sup>25</sup> *The Laws that Govern the Securities Industry*, *supra* note 23.

<sup>26</sup> Cosenza, *supra* note 1, at 1026 (noting that 10(b) is an essential tool for promoting information integrity).

<sup>27</sup> 15 U.S.C. § 78j(b) (2006).

<sup>28</sup> 17 C.F.R. § 240.10b-5 (2011).



As part of its broad regulatory authority, the SEC can bring enforcement actions against violators of Section 10(b) and Rule 10b-5. The rule is silent regarding whether a private right of action exists for violations of the anti-fraud provisions, but the U.S. Supreme Court settled the issue over forty years ago, determining that private litigants could pursue claims under Rule 10b-5.<sup>29</sup> To establish a 10b-5 claim, a private litigant must prove (a) a material misrepresentation or omission made by the defendant, (b) a connection between the misrepresentation or omission and the purchase or sale of a security, (c) reliance upon the misrepresentation or omission, (d) economic loss, (e) loss causation (a causal connection between the material misrepresentation and the loss), and (f) scienter.<sup>30</sup> When the SEC brings a 10b-5 claim, it is required only to show that the defendant (a) made a material misrepresentation or materially misleading omission, (b) in connection with the purchase or sale of securities, (c) with scienter.<sup>31</sup> While the SEC's elements to satisfy a 10b-5 claim are somewhat less stringent than those of a private litigant in that the SEC need not prove reliance, causation, or injury,<sup>32</sup> to be successful, it still must establish the scienter of the defendant and that the defendant "made" the material misstatement.<sup>33</sup> These two elements are the focus of this Article.

### C. *Aiding and Abetting Liability: Before and After Central Bank*

Historically, plaintiffs invoking the anti-fraud provisions of Rule 10b-5 for misstatements proceeded under Rule 10b-5(b), regardless of whether they were pursuing a primary actor, like the issuer itself, or a secondary actor, like an issuer's accounting firm.<sup>34</sup> One question

<sup>29</sup> Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971). The existence of a private cause of action is well-settled and has recently been affirmed in Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2301-02 (2011).

<sup>30</sup> Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 157 (2008) (citation omitted).

<sup>31</sup> SEC v. Merch. Capital, LLC, 483 F.3d 747, 766 (11th Cir. 2007).

<sup>32</sup> SEC v. Radius Capital Corp., No. 2:11-cv-116-FtM-29DNF, 2012 WL 695668, at \*4 n.8 (M.D. Fla. 2012).

<sup>33</sup> It should be noted that the SEC is not required to comply with the Private Securities Litigation Reform Act, which is discussed in more detail *infra* in Part III.B.1. Therefore, though the SEC and private litigants both have to establish scienter, the SEC's burden may be less onerous than the private litigant's since the Private Securities Litigation Reform Act imposes heightened pleading requirements with respect to scienter. Tellabs v. Makor Issues & Rights Ltd., 551 U.S. 308, 313 (2007). See also *infra* n.181.

<sup>34</sup> 17 C.F.R. § 240.10b-5(b) (2011). This subsection, set out in its entirety *supra* in Part II.B makes it unlawful "to make" a material false statement.

that arose fairly early in 10b-5 litigation was whether a plaintiff could succeed against a defendant who was not necessarily the primary violator, but rather was an individual or entity that engaged in some preparatory or other activity that helped the primary violator perpetrate the fraud. Prior to 1994, all of the circuits were in agreement that the answer to this question was yes: Rule 10b-5 allowed the SEC and private plaintiffs to assert claims of “aiding and abetting” violations of the federal securities laws against, for instance, corporate directors and officers or secondary actors like lawyers or accountants.<sup>35</sup> These defendants were individuals who were not responsible for the primary violation itself, but who somehow “‘participated’ in the process of issuing a misleading statement.”<sup>36</sup> Courts even allowed inaction by a corporate insider to result in aiding and abetting liability, so long as the inaction was supporting a primary violation.<sup>37</sup> Although there were variations among jurisdictions as to the elements of a claim of aiding and abetting, generally courts required that a plaintiff establish (a) the existence of an underlying primary violation of Section 10(b), (b) the defendant’s knowledge of the primary violation, and (c) substantial assistance of the violation by the defendant.<sup>38</sup>

In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,<sup>39</sup> the U.S. Supreme Court put an end to the ability of private litigants to use aiding and abetting theories of liability under Section 10(b) and Rule 10b-5. The Court held that private civil liability under Section 10(b) does not extend to those who merely aid and abet the violation rather than actually engaging in the manipulative or deceptive practice at issue.<sup>40</sup> In foreclosing plaintiffs from using theories of aiding and abetting in securities litigation, the Court went against years of unanimous precedent among the lower courts allowing for such claims.<sup>41</sup> Though the facts and holding of *Central Bank* dealt only with a private right of action under Section

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<sup>35</sup> Thomas O. Gorman, *Who Does the Catch-all Antifraud Provision Catch?* Central Bank, Stoneridge, and Scheme Liability in the Supreme Court, 1620 PLI / CORP 189, 198 (Sept.–Oct. 2007) (PLI Order No. 11072).

<sup>36</sup> Darryl P. Rains, *The Future of Control Person Liability after Janus*, 9 SEC. LITIG. REP. 10 (2012); see also Cosenza, *supra* note 1, at 1033.

<sup>37</sup> See Rains, *supra* note 36, at 10.

<sup>38</sup> Gorman, *supra* note 35, at 199.

<sup>39</sup> 511 U.S. 164 (1994).

<sup>40</sup> *Id.* at 191.

<sup>41</sup> *Id.* at 197 (Stevens, J., dissenting). In so holding, the Court focused on the text of the statute itself, noting that it does not reach those who aid and abet a Section 10(b) violation. *Id.* at 177.

10(b), it became clear that the eradication of aiding and abetting liability applied not only to private claims, but also to SEC enforcement actions.<sup>42</sup> In reaction to *Central Bank*, the Senate held hearings within one month of the decision,<sup>43</sup> and a year later, Congress added Section 20(e) to the Exchange Act, which expressly authorizes the SEC to bring 10b enforcement actions for aiding and abetting.<sup>44</sup> Congress, however, did nothing to extend such claims to the private right of action. Therefore, while the SEC can bring aiding and abetting claims under the new statutory authority, private litigants were and are still barred from using this theory of recovery.<sup>45</sup>

In the aftermath of *Central Bank*, courts struggled with how to address questions of secondary actor liability in private 10b-5 suits without running afoul of the *Central Bank* holding. Though the Court in *Central Bank* had eliminated the possibility of private actions for aiding and abetting violations of the federal securities laws, the Court had expressly not foreclosed liability against secondary actors altogether, holding that its decision “does not mean that secondary actors in the securities markets are always free from liability under the securities Acts.”<sup>46</sup> According to the Court, any secondary actor who employs a manipulative device or makes a material misstatement or omission on which a purchaser or seller of securities relies “may be liable as a primary violator . . . assuming *all* of the requirements for primary liability . . . are met.”<sup>47</sup> In attempting to walk the fine line between allowing private plaintiffs to bring claims against secondary actors for primary violations but still not allowing private plaintiffs to bring claims for aiding and abetting, courts devised various standards of liability under which to review 10b-5 claims against secondary actors.

Two of the most prominent of the standards of liability were the “bright line standard” adopted by the Second, Fifth, Eighth, Tenth, and Eleventh Circuits, and the “substantial participation test” adopted by the Ninth Circuit.<sup>48</sup> To be liable under the “bright line standard,” a secondary actor must have made the misstatement, not

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<sup>42</sup> Gorman, *supra* note 35, at 201.

<sup>43</sup> *Stoneridge Inv. Partners, LLP v. Scientific-Atlanta*, 552 U.S. 148, 173 (2008) (Stevens, J., dissenting).

<sup>44</sup> 15 U.S.C. § 78t(e) (2006); *see also* Gorman, *supra* note 35, at 201. The addition of Section 20(e) was in connection with the enactment of the Private Securities Litigation Reform Act, described in more detail *infra* in Part III.B.1.

<sup>45</sup> *Stoneridge*, 552 U.S. at 158.

<sup>46</sup> *Central Bank*, 511 U.S. at 191.

<sup>47</sup> *Id.* (emphasis in original).

<sup>48</sup> Gorman, *supra* note 35, at 202–03.

just participated in its creation. Specifically, the defendant must have either (a) been named in the document with the misrepresentation, (b) have signed the document, or (c) have been identified to investors at the time of the dissemination of the misstatement to the public.<sup>49</sup> To be deemed liable under the less stringent “substantial participation test,” the defendant merely needs to have knowingly and substantially participated in the preparation of materially false or misleading statements.<sup>50</sup> In other words, even where there was no public attribution of the misstatement to the secondary actor, such actor could still have been involved in the deception to a sufficient degree to warrant imposing primary liability.<sup>51</sup>

A third standard of liability, very similar to the substantial participation test, was adopted by the Third Circuit and dubbed the “creator standard.”<sup>52</sup> Under this test, as under the substantial participation test, the defendant need not have been the person who made the misrepresentation, nor must the misstatement have been publicly attributed to the defendant to create liability. Rather, the plaintiff only had to prove that the secondary actor (a) was aware of the misrepresentation, (b) could be considered the author or co-author of the statement by having participated in the creation of the statement, (c) knew the misrepresentation would be relied upon by investors, and (d) met the other requirements for 10b-5 liability.<sup>53</sup>

The substantial participation and the creator standards gave way to a theory of liability referred to by some courts in the post-*Central Bank* era as “scheme liability.”<sup>54</sup> Under a theory of scheme liability, plaintiffs would proceed not under Rule 10b-5(b), requiring the defendant to have *made* a material misrepresentation or material omission, but instead under Rule 10b-5(a) and (c), which allows for the imposition of liability on one who *employed* any “device, scheme, or artifice” to defraud and on one who has *engaged in* “any act, practice, or course of business which . . . would operate as a fraud or deceit.”<sup>55</sup> By using 10b-5(a) and (c) instead of (b), plaintiffs hoped to

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<sup>49</sup> Cosenza, *supra* note 1, at 1037.

<sup>50</sup> *Id.* at 1043–44.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 1047.

<sup>53</sup> *Id.*

<sup>54</sup> Gorman, *supra* note 35, at 214–17.

<sup>55</sup> 17 C.F.R. § 240.10b-5(a), (c) (2011). Because theories of “aiding and abetting” had been available to plaintiffs under Rule 10b-5(b) prior to *Central Bank*, courts had previously had little experience applying Rules 10b-5(a) and (c) in the context of misrepresentations where the defendant had assisted in the preparation of the misstatement but not necessarily been its maker. ROBERT J. HAFT & MICHELE H.

do an “end-run” around the requirement that the defendant be the actual maker of the misrepresentation in instances where the defendant participated in the fraud, but could not be identified as the maker.<sup>56</sup> Courts permitting claims of scheme liability generally found that the alleged misrepresentations or omissions that formed the basis of a Rule 10b-5(b) claim were insufficient evidence of scheme liability under Rule 10b-5(a) and (c).<sup>57</sup> A defendant typically still could be found liable as part of a fraudulent scheme, however, so long as the scheme also encompassed conduct beyond those misrepresentations or omissions.<sup>58</sup>

Just as some courts began to read scheme liability very broadly to incorporate a wide range of secondary actors and counterparties within reach as defendants,<sup>59</sup> the Supreme Court stepped in to end the expansion in its 2008 decision *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*<sup>60</sup>

#### D. Limiting Scheme Liability: Stoneridge

The Supreme Court granted certiorari in *Stoneridge* to address whether a plaintiff can pursue claims against a defendant who did not make a misrepresentation but did participate in a scheme to violate the antifraud provisions of the federal securities laws.<sup>61</sup>

In *Stoneridge*, the plaintiffs sued Charter Communications, Inc. (Charter), a cable operator, for engaging in various practices to fraudulently improve its quarterly reports.<sup>62</sup> Scientific-Atlanta, Inc. (Scientific) and Motorola, Inc. (Motorola), each suppliers and later customers of Charter, were also named as defendants for

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HUDSON, DUE DILIGENCE § 8:25, DUE DILIGENCE § 8:25 (Sep. 2011).

<sup>56</sup> See HAFT & HUDSON, *supra* note 55.

<sup>57</sup> See, e.g., *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011) (holding that a 10b-5(a) or (c) “claim cannot be premised on the alleged misrepresentations or omissions that form the basis of a Rule 10b-5(b) claim”) (citation omitted); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) (same).

<sup>58</sup> *WPP Luxembourg Gamma Three Sarl*, 655 F.3d at 1057–58; *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 359 (D.N.J. 2009); *S.E.C. v. Patel*, No. 07-cv-39-SM, 2009 WL 3151143, at \*6–7 (D.N.H. Sept. 30, 2009); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 475 (S.D.N.Y. 2005).

<sup>59</sup> These expansive readings of scheme liability seemed in some cases indistinguishable from claims asserting theories of aiding and abetting, which of course were extinguished by the Supreme Court’s 1994 *Central Bank* decision. See HAFT & HUDSON, *supra* note 55.

<sup>60</sup> 552 U.S. 148 (2008).

<sup>61</sup> *Id.* at 156.

<sup>62</sup> *Id.* at 153.

participating in Charter's scheme to defraud.<sup>63</sup> Scientific and Motorola provided Charter with cable boxes that Charter then supplied to its customers.<sup>64</sup> Charter entered into agreements with Scientific and Motorola pursuant to which Charter would overpay them for each cable box it purchased for a particular period of time, with an agreement that Scientific and Motorola would reimburse "the overpayment by purchasing advertising from Charter."<sup>65</sup> The transactions had no business purpose. Rather, the transactions allowed Charter to record the advertising purchases as revenue, in violation of generally accepted accounting principles, and allowed Charter to convince its auditor to approve a false financial statement showing it met projected revenue and operating cash flow numbers, even though it did not.<sup>66</sup> As part of the scheme, the companies deceived Charter's auditor by drafting documents to make the transactions look unrelated.<sup>67</sup>

Charter then filed false financial statements with the SEC, which were thereby reported to the public,<sup>68</sup> reflecting revenue and operating cash flow inflated by approximately \$17 million.<sup>69</sup> Motorola and Scientific had no role in preparing or disseminating Charter's financial statements and, in their own financial statements, reflected the transactions appropriately according to generally accepted accounting principles.<sup>70</sup> Because Motorola and Scientific allegedly knew or recklessly disregarded Charter's intention to use the transactions to inflate its revenues, and knew investors would rely on Charter's false financial statements, plaintiffs sued Motorola and Scientific under Rule 10b-5(a) and (c) under a theory of scheme liability.<sup>71</sup>

In affirming the Eighth Circuit's dismissal of the plaintiffs' suit against Motorola and Scientific, the Supreme Court held that Charter's investors could not show they relied on any misrepresentations or other acts by Motorola or Scientific, a necessary element of a 10b claim.<sup>72</sup> The Court held that the plaintiff

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<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 154.

<sup>65</sup> *Id.*

<sup>66</sup> *Stoneridge*, 552 U.S. at 154.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 155.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 155, 159–60.

<sup>72</sup> *Stoneridge*, 552 U.S. at 159 ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action.").

could not show reliance on the actions of Motorola or Scientific except in an “indirect chain” that the Court found “too remote for liability.”<sup>73</sup> The Court noted that the defendants did not do anything that made it “necessary or inevitable for Charter to record the transactions as it did” in its financial statements.<sup>74</sup> In the Court’s view, if it allowed plaintiffs to proceed with their claim, it would revive the implied cause of action against any aider and abettor “if he or she committed a deceptive act in the process of providing assistance,”<sup>75</sup> contrary to Congress’s determination that such claims should only be available to the SEC.<sup>76</sup>

But the Court’s holding in *Stoneridge* did not entirely quell expansive interpretations of 10b-5 to allow for imposition of liability against secondary actors. Because the Court cabined its holding to the issue of reliance, it did not speak to the larger issue of whether or not a defendant must have actually “made” a public misstatement to be held liable.<sup>77</sup> In fact, the Court specifically stated that it is not necessarily the case that “[a]ll secondary actors . . . are immune from private suit.”<sup>78</sup> Instead, the Court reiterated what it had stated in *Central Bank*—“the implied right of action in § 10(b) continues to cover secondary actors who commit primary violations.”<sup>79</sup> So, after *Stoneridge*, the question remained open of when a defendant who assisted in the preparation of a fraudulent statement, but to whom that statement was not actually attributed, could be liable.

#### E. The Meaning of “Make” in Rule 10b-5: Janus

In 2011, in *Janus Capital Group, Inc. v. First Derivative Traders*,<sup>80</sup> the Supreme Court finally addressed this issue head-on and provided a more definitive statement of when liability can be imposed on a secondary actor that participated in a fraudulent misrepresentation.

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<sup>73</sup> *Id.* The “indirect chain” to which the Court referred was the plaintiff’s contention that, had the defendants not assisted Charter, Charter’s auditor would not have been blind to the fraud, and the financial statement would have more accurately reflected Charter’s financial position. *Id.* at 160. The plaintiffs asserted the causal link was sufficient since the financial statement Charter released was the foreseeable result of the defendants’ actions. *Id.* But, the Court did not think reliance was established, particularly given the fact that the defendants’ actions were never disclosed to the public. *Id.* at 161.

<sup>74</sup> *Stoneridge*, 552 U.S. at 161.

<sup>75</sup> *Id.* at 162–63.

<sup>76</sup> *Id.* at 163.

<sup>77</sup> HAFT & HUDSON, *supra* note 55.

<sup>78</sup> *Stoneridge*, 552 U.S. at 166.

<sup>79</sup> *Id.*

<sup>80</sup> 131 S. Ct. 2296 (2011).

The plaintiffs in *Janus* were shareholders of Janus Capital Group, Inc. (JCG), who filed a private 10b-5 action against JCG and its wholly owned subsidiary, Janus Capital Management, LLC (JCM), for making false statements in mutual fund prospectuses filed by Janus Investment Fund (JIF).<sup>81</sup> JCM was the investment advisor and administrator for JIF.<sup>82</sup> JIF was created by JCG, but was a separate legal entity owned entirely by mutual fund investors.<sup>83</sup> JCM was involved in preparing prospectuses issued by JIF and made those available to investors on its own website.<sup>84</sup> The Fourth Circuit had held that the plaintiffs had sufficiently alleged that JCM made the misleading statements in the prospectuses, for the purpose of 10b-5 liability, by having participated in the writing and dissemination of the documents.<sup>85</sup>

In a ground-breaking—and much-criticized<sup>86</sup>—5-4 opinion, the Supreme Court reversed the Fourth Circuit, holding that JCM could not be liable because it did not make the statements in question.<sup>87</sup> The Court articulated the rule that, for purposes of 10b claims, 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.”<sup>88</sup> The Court went on to say that one who merely prepares a statement on behalf of someone else is not its maker.<sup>89</sup>

The Court likened the facts of the case to the relationship between a speechwriter and the speech giver, stating that, though a speechwriter might draft a speech, the person giving the speech is the one with ultimate control over the content and thus should take the credit or blame.<sup>90</sup> The Court also mentioned the relevance of

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<sup>81</sup> *Id.* at 2299–300.

<sup>82</sup> *Id.* at 2299.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.* at 2305 n.12.

<sup>85</sup> Cosenza, *supra* note 1, at 1065.

<sup>86</sup> See, e.g., Diana B. Henriques, *A Mutual Fund Ruling Remains a Head-Scratcher*, N.Y. TIMES, July 7, 2012, available at <http://www.nytimes.com/2012/07/08/business/mutfund/effects-of-janus-case-remain-a-mystery-for-mutual-funds.html?pagewanted=all>; Jeffrey N. Gordon, *Janus Capital Group v. First Derivative Traders: Only the Supreme Court Can “Make” a Tree*, HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REG. (June 29, 2011, 9:27 A.M.), <http://blogs.law.harvard.edu/corpgov/2011/06/29/janus-capital-group-v-first-derivative-traders-only-the-supreme-court-can-make-a-tree/>; Editorial, *So No One’s Responsible*, N.Y. TIMES, June 14, 2011, available at <http://www.nytimes.com/2011/06/15/opinion/15wed2.html>.

<sup>87</sup> *Janus*, 131 S. Ct. at 2299.

<sup>88</sup> *Id.* at 2302.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*



publicly attributing the contents of a disclosure to a particular individual or entity. Specifically, the Court stated that “attribution within a statement or implicit from surrounding circumstances is strong evidence that the statement was made by—and only by—the party to whom it is attributed.”<sup>91</sup> In so holding, the Court rejected the argument, proposed by the United States in its amicus brief, that one can “make” a statement by “creating” it or taking part in the creation of it, even if the creator is not actually publicly identified.<sup>92</sup> The United States argued that this interpretation was consistent with the ordinary meaning of the word “make,” but the Court found that such an interpretation would be inconsistent with the precedent of *Central Bank* and *Stoneridge*.<sup>93</sup>

The Court held that, based on the facts presented, JCM did not make the misstatements, but rather only JIF could be seen as the maker because only JIF bore “the statutory obligation to file the prospectuses with the SEC.”<sup>94</sup> Since there was no allegation that JCM filed the prospectuses and there was nothing in the filings that attributed the statements to JCM rather than JIF, there could be no liability against JCM.<sup>95</sup> The Court’s decision in *Janus*, like that in *Stoneridge*, seemed largely motivated by its concern with the expansion of the judicially created private cause of action for 10b-5 violations.<sup>96</sup>

The *Janus* decision has been criticized for, among other things, the Court’s refusal to recognize the close relationship between a mutual fund (e.g., JIF) and its advisor (e.g., JCM). The Janus funds were organized in accordance with industry practice, such that “while each mutual fund [was] in fact its own company, as a practical matter the management company [ran] it.”<sup>97</sup> Therefore, the relationship was less like the relationship between a company and its outside advisors (such as its lawyers and accountants), and more akin to the relationship between a corporation and its corporate insiders.<sup>98</sup> For

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<sup>91</sup> *Id.* (emphasis added).

<sup>92</sup> Brief for the United States as Amicus Curiae Supporting Respondent at 14, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 4339892.

<sup>93</sup> *Janus*, 131 S. Ct. at 2303–04.

<sup>94</sup> *Id.* at 2304.

<sup>95</sup> *Id.* at 2305.

<sup>96</sup> *Id.* at 2302 (“[W]e are mindful that we must give ‘narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.’”) (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 167 (2008)).

<sup>97</sup> Brief for the United States as Amici Curiae Supporting Respondent, *supra* note 92, at 9 (citation omitted).

<sup>98</sup> *Id.* at 9. As one critic of the Court’s decision pondered in disbelief: “Perhaps

instance, it is typical in such relationships that the advisor creates the mutual fund, selects the fund's directors, manages its investments, and provides other services.<sup>99</sup> And since a mutual fund is "little more than a paper shell containing its investors' money,"<sup>100</sup> any recovery from JIF would be satisfied only from the investors' own assets.<sup>101</sup> Therefore, ignoring the close relationship between JCM and JIF and, consequently, not allowing plaintiffs to pursue a claim against JCM left plaintiffs effectively without a remedy.<sup>102</sup>

In some ways, the *Janus* holding is fairly limited.<sup>103</sup> On its facts, it only applies to a claim brought by private litigants, not the SEC. And it applied only to a 10b-5 claim, not claims brought under a myriad of other federal securities or states' laws. Moreover, it only applied to the relationship between a mutual fund and its investment advisor. But in the aftermath of *Janus*, as the lower courts scramble to interpret the ruling, they will be called upon to determine whether it applies more broadly.<sup>104</sup> Thus far, most courts agree that the *Janus* holding is not limited to private rights of action, but also applies to SEC enforcement actions.<sup>105</sup> But lower courts seem to be diverging in

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the five prevailing justices actually believe that a Janus fund's board could fire Janus and hire T. Rowe Price to manage the fund as easily as it might replace its law firm, transfer agent or any other 'service provider.'" Henriques, *supra* note 86.

<sup>99</sup> Brief for the United States as Amicus Curiae, *supra* note 92, at 9.

<sup>100</sup> Henriques, *supra* note 86.

<sup>101</sup> Darryl P. Rains, Eugene Illovsky & Jay G. Baris, *Investment Management: Janus and its Impact on Mutual Funds*, 25 INSIGHTS: THE CORP. & SEC. L. ADVISOR 3 (2011) ("A fund's only assets, of course, are investor assets. Funds typically have no assets apart from assets contributed by investors in exchange for shares issued by the fund. As a result, any liability under Rule 10b-5 could be satisfied only from investors' own assets—which is probably not what plaintiffs would have in mind.").

<sup>102</sup> Editorial, *So No One's Responsible*, *supra* note 86 ("Only the business trust set up to hold the funds can be held liable, though it has no assets of its own to compensate plaintiffs in the lawsuit. Which means that there is no one to sue for the misleading prospectuses.").

<sup>103</sup> Rains et al., *supra* note 101, at 2.

<sup>104</sup> As stated by one federal district court, the *Janus* holding "is not explicitly limited to its facts." *Red River Res. Inc. v. Mariner Sys. Inc.*, No. CV 11-02589-PHX-FJM, 2012 WL 2507517, at \*6 (D. Ariz. June 29, 2012).

<sup>105</sup> See *SEC v. Radius Capital Corp.*, No. 2:11-cv-116-FtM-29DNF, 2012 WL 695668, at \*4 (M.D. Fla. Mar. 1, 2012); *SEC v. Carter*, No. 10 C 6145, 2011 WL 5980966, at \*2 (N.D. Ill. Nov. 28, 2011); *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139, at \*2 (N.D. Cal. Aug. 1, 2011); *In re Textron, Inc. S'holders Derivative Litig.*, 811 F. Supp. 2d 564, 574 (D.R.I. 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787, at \*6 (D. Neb. 2011). See also *SEC v. Landberg*, 836 F. Supp. 2d 148, 154 (S.D.N.Y. 2011) ("assuming *arguendo* that *Janus's* holding applies to SEC enforcement actions" and finding it satisfied); *SEC v. Kelly*, 817 F. Supp. 2d 340, 343 (S.D.N.Y. 2011) (SEC conceding "that *Janus* foreclosed its ability to assert a misstatement claim" since the defendants did not have ultimate authority over the statement); *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*42 (ALJ Oct. 28, 2011); Bryan

their interpretations of other aspects of the *Janus* holding, much as they did in the wake of *Central Bank* and *Stoneridge*. And the fact that courts are applying *Janus* both to private suits and SEC actions makes the answers to these developing questions all the more pertinent.

### III. IMPLICATIONS OF JANUS: LIABILITY GAPS

One question courts have had to grapple with is whether *Janus* should be extended beyond the mutual fund/investment advisor relationship to other secondary actors or, even more broadly, to corporate insiders. And if the ruling *should* be so extended, courts must determine to what extent. Since the Court in *Janus* did not define what it means to have “ultimate authority” over a misstatement, applying the *Janus* holding to corporate insiders is a complicated question and one to which the Supreme Court did not provide obvious answers.<sup>106</sup> Additionally, courts will have to determine what effect *Janus* has on plaintiffs’ ability to establish scienter in 10b-5 claims. This will be as true in jurisdictions that have historically accepted theories of collective scienter as it is in those that reject such theories. Finally, courts must decide whether *Janus* should be limited to 10b-5 actions or should also apply to claims brought under other similar federal securities laws, such as Section 17(a) of the Securities Act. Again, the *Janus* opinion provides little guidance in this regard. In Part III *infra*, this Article analyzes some of the responses of the lower courts to these questions and the implications of *Janus* as it is applied in cases that will begin to work their way through the appellate process.

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P. King, *The Effects of an Undefined “Ultimate Authority” Standard for Rule 10B-5 Claims: Janus Capital Group, Inc. v. First Derivative Traders*, 16 N.C. BANKING INST. 405, 430 (2012) (“[T]he Court did not provide one definition of the word ‘make’ for private actions, and a separate definition for SEC actions.”). But see SEC v. Pentagon Capital Mgmt. PLC, 844 F. Supp. 2d 377, 421–22 (S.D.N.Y. 2012) (“*Janus* was a private suit, not an enforcement action brought by the SEC. . . . There is no indication that the Court or Congress intended for actions brought by the SEC to be so limited.”); Henriques, *supra* note 86 (“Federal district judges in Manhattan have come down on opposite sides of the question of whether the *Janus* decision applies at all in regulatory cases filed by the S.E.C. . . .”). The application of *Janus* to SEC enforcement actions is not unlike what was seen in the aftermath of the *Central Bank* decision. Though that case applied on its facts only to the private 10b-5 right of action, it became generally accepted in the wake of the Court’s holding that it would apply equally to SEC enforcement actions brought under Rule 10b-5. Gorman, *supra* note 35, at 201.

<sup>106</sup> Rains et al., *supra* note 101, at 2 (“*Janus* . . . establishes ‘ultimate authority’ as the standard without ever identifying the source of that authority.”).

A. *Limitations of Liability on Corporate Insiders: The Importance of Attribution*

Critics of *Janus* have focused on the ways in which *Janus*, when applied outside the mutual fund context, will limit the liability of other secondary actors like auditors, underwriters, and lawyers—a seemingly natural extension of the *Janus* ruling.<sup>107</sup> In addition to limiting the liability of secondary actors, however, it does not take a particularly broad reading of *Janus* to see how it will also potentially limit the liability of corporate insiders.<sup>108</sup> In fact, this was one of the concerns expressed by Justice Breyer in his dissent in *Janus*. The dissent pointed out that, under the majority’s rule, in the situation where “guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true,” no one would be liable because no one on the management team was the “maker” of the misstatements under *Janus*.<sup>109</sup> That is because it is the unknowing board in this scenario that has ultimate authority over the issuance of the statement, and not the members of management who actively engaged in the fraud.

Corporate executives facing 10b-5 claims have begun to invoke *Janus* “to argue that they are merely hired hands at their companies—like the management company hired by a mutual fund” and, as such,

<sup>107</sup> Cosenza, *supra* note 1, at 1078 (“Outside advisers are the traditional gatekeepers of the securities markets, on whom investors rely to ensure complete and accurate disclosure. Under the *Janus* standard, outside advisers do not face the prospect of liability for their conduct under Section 10(b) and will remain undeterred under the current legal regime.”); SULLIVAN & CROMWELL, LLP, PRIVATE SECURITIES FRAUD CLAIMS UNDER SECTION 10(B) BASED ON FRAUD OR MISLEADING STATEMENTS 1, 4 (2011), available at [http://www.sullcrom.com/files/Publication/b3ae77c9-1dc3-4bf4-a0c4-a5580c78376c/Presentation/PublicationAttachment/048148f3-258c-43dc-9fb7-a5f31912ecb3/SC\\_Publication\\_Private\\_Securities\\_Fraud\\_Claims\\_Under\\_Section\\_10b.pdf](http://www.sullcrom.com/files/Publication/b3ae77c9-1dc3-4bf4-a0c4-a5580c78376c/Presentation/PublicationAttachment/048148f3-258c-43dc-9fb7-a5f31912ecb3/SC_Publication_Private_Securities_Fraud_Claims_Under_Section_10b.pdf) (“The Supreme Court’s opinion in *Janus* could have significant implications for (i) those, such as accountants, consultants, and attorneys, who help securities issuers prepare and publish public disclosures, and (ii) those, such as advisers and corporate parents, that may be alleged to have significant influence over an issuer’s business affairs and public disclosures.”); King, *supra* note 105, at 426 (“The initial effect is a major victory for outside advisers in that there is now precedent and authority granting them de facto immunity from 10b-5 suits.”) (citation omitted).

<sup>108</sup> Rains, *supra* note 36, at 11 (“*Janus* may well have ended primary Rule 10b-5 liability for corporate officers and directors in most contexts. Usually, a corporation will be the ‘maker’ of a statement. No individual will be exposed to primary liability under Rule 10b-5, because no individual will have had ultimate authority over its content or mode of communication.”).

<sup>109</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2310 (2011) (Breyer, J., dissenting).

are not liable for any fraudulent information disseminated by their corporate employers.<sup>110</sup> Though there seems to be little doubt that *Janus* applies to corporate insiders,<sup>111</sup> courts are not at all uniform in determining *how* it should apply.

For instance, some courts have found that there is no 10b-5 liability for insiders who merely participated in the preparation of the false statements that ultimately appeared in public filings—these insiders simply were not “makers” of the statements under *Janus*.<sup>112</sup> *Hawaii Ironworkers Annuity Trust Fund v. Cole*<sup>113</sup> is a good illustration of this line of cases. In that case, the defendants were corporate officers who had allegedly falsified financial information that was incorporated into “overly optimistic public statements” made by other officials of the corporation.<sup>114</sup> The court held that *Janus* applied to corporate insiders as well as secondary actors,<sup>115</sup> and found that the plaintiffs had not satisfied the *Janus* requirement of showing

<sup>110</sup> Henriques, *supra* note 86. Such arguments gain more traction in light of post-*Janus* cases that have held there is no duty of one who assists in the preparation of materials to correct any errors in the public transmission of such materials by the person or entity with “ultimate authority” over that transmission. *Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp.*, 675 F.3d 1047, 1051–52 (7th Cir. 2012).

<sup>111</sup> Most courts addressing the issue of whether *Janus* applies to situations involving corporate insiders have assumed without discussion that it does. *See, e.g., In re Stillwater Capital Partners, Inc. Litig.*, 853 F. Supp. 2d 441, 461 (S.D.N.Y. 2012); *Allstate Life Ins. Co. Litig.*, No. CV-09-8162-PCT-GMS, 2012 WL 1900560, at \*5 (D. Ariz. May 24, 2012); *City of St. Clair Shores Gen. Emps. Ret. Sys. v. Lender Processing Servs., Inc.*, No. 3:10-cv-1073-J-32JBT, 2012 WL 1080953, at \*3 (M.D. Fla. Mar. 30, 2012); *City of Roseville Emps. Retirement Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395, 417 (S.D.N.Y. 2011); *SEC v. Landberg*, 836 F. Supp. 2d 148, 154 (S.D.N.Y. 2011); *SEC v. Carter*, No. 10 C 6145, 2011 WL 5980966, at \*2–3 (N.D. Ill. Nov. 28, 2011); *SEC v. Mercury Interactive, LLC*, No. 5:07-cv-02822-WHA, 2011 WL 5871020, at \*2 (N.D. Cal. Nov. 22, 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787, at \*6 (D. Neb. 2011); *In re Merck & Co., Sec. Derivative & “ERISA” Litig.*, No. 2:05-cv-02367-SRC-MAS, 2011 WL 3444199, at \*25 (D.N.J. Aug. 8, 2011); *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139, at \*2 (N.D. Cal. Aug. 1, 2011). Only a few courts have specifically addressed the issue and expressly held that *Janus* applies. *See, e.g., Red River Res., Inc. v. Mariner Sys., Inc.*, No. CV 11-02589-PHX-FJM, 2012 WL 2507517, at \*6 (D. Ariz. June 29, 2012) (“The holding in *Janus* is not explicitly limited to its facts. . . . courts have applied *Janus* to corporate insiders.”); *Haw. Ironworkers*, No. 3:10CV371, 2011 WL 3862206, at \*3 (N.D. Oh. Sep. 1, 2011) (“Plaintiff asserts that, ‘[i]n essence, *Janus* involves a secondary actor’ and thus ‘*Janus* does not analyze whether corporate executives can be liable.’ . . . [But] nothing in the Court’s decision in *Janus* limits the key holding . . . to legally separate entities.”).

<sup>112</sup> *Kerr v. Exobox Techs.*, CV No. H-10-4221, 2012 WL 201872, at \*12 (S.D. Tex. Jan. 23, 2012); *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*41 (ALJ Oct. 28, 2011); *Haw. Ironworkers*, 2011 WL 3862206, at \*5; *Mercury Interactive*, 2011 WL 5871020, at \*2.

<sup>113</sup> *Haw. Ironworkers*, 2011 WL 3862206.

<sup>114</sup> *Id.* at \*1.

<sup>115</sup> *Id.* at \*3.

that the defendants—corporate insiders—had “ultimate authority” over the misstatements.<sup>116</sup> The court pointed out that the defendants were required to meet a mandatory six percent profit-margin increase for the division for which they were in charge of financial reporting to senior officers.<sup>117</sup> They had “no choice” but to increase forecasts to meet the new six percent benchmark.<sup>118</sup> The defendants’ superiors, who ultimately incorporated the false forecasts into public statements, knew that the six percent requirement was “unobtainable” and therefore the underlying data would have to have been manipulated to show compliance.<sup>119</sup> Essentially, the defendants had merely sent the results “they were commanded to send” and had no real authority over their issuance.<sup>120</sup> In other words, notwithstanding their fraudulent conduct, because they were not “makers” under *Janus*, they were not liable.

In an administrative proceeding addressing the liability of insiders, the SEC’s Chief Administrative Law Judge (ALJ) went even further in her refusal to impose 10b-5 liability on a corporate insider. In *In re Flannery*, the ALJ determined that an insider would not be liable for making five presentations to clients using a chart that he knew included misrepresentations.<sup>121</sup> The insider did not prepare the presentation but he was asked to review and correct material in the presentation, and he was responsible for giving the presentation.<sup>122</sup> The ALJ found that, though he was asked to make corrections in the presentation, this did not give him ultimate authority over its contents or distribution.<sup>123</sup> Additionally, the insider prepared a draft of a “client-friendly letter” which he sent to other management professionals within the company.<sup>124</sup> When he circulated the letter,

<sup>116</sup> *Id.* at \*5.

<sup>117</sup> *Id.* at \*4.

<sup>118</sup> *Id.*

<sup>119</sup> *Haw. Ironworkers*, 2011 WL 3862206, at \*4.

<sup>120</sup> *Id.* at \*5.

<sup>121</sup> *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*38 (ALJ Oct. 28, 2011) (initial decision).

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* It should be noted that this outcome seems inconsistent with the use of the speechwriter versus speech giver analogy used by the majority in *Janus* to justify the “ultimate authority” test. Here, the insider was in fact the equivalent of the “speech giver”—he gave the presentation in which the misrepresentations were made. Yet the court found he was not the one with ultimate authority since he did not prepare it—i.e., he was not the speechwriter. The result here seems directly contrary to the *Janus* Court’s determination that it is the speech giver, not the writer, who has ultimate authority. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

<sup>124</sup> *In re Flannery*, 2011 WL 5130058, at \*41.

he stated that recipients could send it out or suggest improvements.<sup>125</sup> It was undisputed that the insider defendant did not have authority to send the letter out, beyond circulating it internally.<sup>126</sup> A senior officer ultimately sent out the letter.<sup>127</sup> Because the defendant did not send the letter out to clients, did not sign the letter, and was not mentioned in the letter, the ALJ found that he did not have ultimate authority over the letter, and therefore could not be subject to 10b-5 liability.<sup>128</sup>

Other courts, however, have imposed 10b-5 liability on corporate insiders, finding their level of involvement in the preparation of the public statement to be sufficient to consider them the individuals with “ultimate authority” over the making of the misstatement, thereby satisfying *Janus*.<sup>129</sup> For instance, in *In re Merck & Co. Securities, Derivative & “ERISA” Litigation*, one of the defendants was an officer of Merck, holding the positions of “Executive Vice President for Science and Technology and President of Merck Research Laboratories.”<sup>130</sup> He had signed some of Merck’s public filings with the SEC and these filings contained misrepresentations.<sup>131</sup> Additionally, he had been quoted in articles and reports, conveying additional misrepresentations to the public.<sup>132</sup> The court held that the 10b-5 claim could proceed against this officer based on the misrepresentations publicly attributed to him.<sup>133</sup>

The distinguishing factor between most post-*Janus* cases dealing

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> *In re Stillwater*, 853 F. Supp. 2d 441, 453 (S.D.N.Y. 2012); *Red River Res., Inc. v. Mariner Sys., Inc.*, No. CV 11-02589-PHX-FJM, 2012 WL 2507517, at \*6 (D. Ariz. June 29, 2012); *City of St. Clair Shores Gen. Emps. Ret. Sys. v. Lender Processing Servs., Inc.*, No. 3:10-cv-1073-J-32JBT, 2012 WL 1080953, at \*3 (M.D. Fla. Mar. 30, 2012); *In re Pfizer Inc., Sec. Litig.*, 2012 WL 983548, at \*4 (S.D.N.Y. Mar. 22, 2012); *SEC v. Mercury Interactive, LLC*, No. 5:07-cv-02822-WHA, 2011 WL 5871020, at \*2 (N.D. Cal. Nov. 22, 2011); *City of Roseville Emps. Retirement Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395, 417 (S.D.N.Y. 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787, at \*6 (D. Neb. 2011); *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139, at \*3 (N.D. Cal. Aug. 1, 2011); *In re Merck & Co., Sec. Derivative & “ERISA” Litig.*, No. 2:05-cv-02367-SRC-MAS, 2011 WL 3444199, at \*25–26 (D.N.J. Aug. 8, 2011); *SEC v. Carter*, No. 10 C 6145, 2011 WL 5980966, at \*3 (N.D. Ill. Nov. 28, 2011); *SEC v. Landberg*, 836 F. Supp. 2d 148, 154 (S.D.N.Y. 2011); *Local 703 I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, 2011 US Dist. LEXIS 93873, at \*2 (N.D. Ala. Aug. 23, 2011).

<sup>130</sup> *In re Merck*, 2011 WL 3444199, at \*25.

<sup>131</sup> *Id.* at \*24–25.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.* at \*25.

with corporate insiders—those finding potential liability and those finding no liability—appears to be this issue of attribution. In other words, the majority of cases that have found potential liability of corporate insiders involve public statements that have in some way been attributed to the corporate insider, such that the investing public knows that person played a large role in the preparation of the misstatements and is ultimately responsible for them.<sup>134</sup> Courts have justified these results by looking to the language of *Janus* itself, which, at least in dicta, discusses the issue of attribution. Specifically, the Supreme Court stated that “attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by . . . the party to whom it is attributed.”<sup>135</sup> Therefore, the interpretation by lower courts that an express attribution of a statement to someone in a public filing identifies that person as the “maker” of the statement seems reasonable.

But in addition to express attribution, the language from *Janus* allowing for “implicit” attribution “from surrounding circumstances” leaves open the possibility that courts may impose liability on corporate insiders even in the absence of an express attribution in a public statement to the individual insider defendant. At least two post-*Janus* cases, each out of the U.S. District Court for the Southern

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<sup>134</sup> Compare *Kerr v. Exobox Techs.*, CV No. H-10-4221, 2012 WL 201872, at \*12 (S.D. Tex. Jan. 23, 2012) (holding that there was no information suggesting the officer defendant contributed to the statement issued by another officer of the corporation and therefore plaintiffs failed to properly plead a 10b-5 cause of action), and *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*41 (ALJ Oct. 28, 2011) (holding that, though the defendant insider had drafted the letter that was ultimately sent to investors, since the insider had no authority to send the letter, did not sign the letter, and his name did not appear on it, he could not be considered its maker), and *City of Roseville*, 814 F. Supp. 2d at 417 (holding that certain corporate insider defendants could not be liable partly because neither signed the registration statement at issue), with *Das*, 2011 WL 4375787, at \*6 (“As the CFOs who signed and certified the statements, [the defendant officers] were the persons with ultimate authority and control over the content of the statements and whether and how they were communicated.”), and *In re Stillwater*, 858 F. Supp. 2d at 287–88 (“*Janus* . . . cannot be used to shield [the officer], who signed the documents at issue and thereby ‘made’ the alleged misstatements.”), and *In re Flannery*, 2011 WL 5130058, at \*46 (holding that defendant could be considered the maker of misstatements in a letter when “he initiated it, wrote the first draft, approved the edits, signed it, and directed that it be sent out.”), and *City of Roseville*, 814 F. Supp. 2d at 417 (“Because all of the [officer defendants] signed the July 2008 Registration Statement, all are proper defendants on the claims regarding alleged misstatements in that document.”).

<sup>135</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). The Court went on to state that, when a statement is being “made” indirectly, rather than directly, attribution is necessary to find that the defendant was the maker. *Id.* at 2305 n.11.



District of New York, have imposed liability in such scenarios.<sup>136</sup> It is likely that these two cases will be reversed on appeal because they seem to adopt a meaning of “maker” that is the equivalent of someone who is considered one of the “creators” of a statement—an interpretation that was expressly rejected by the Supreme Court in *Janus*.<sup>137</sup> In fact, it seems likely that appellate courts will find that these factual scenarios—involving an officer who participated in the creation of a misstatement but to whom the misstatement was not publicly attributed—are difficult to distinguish from claims of aiding and abetting, which are limited to SEC enforcement actions and are not available to private litigants.<sup>138</sup> Regardless of outcome on appeal, the question will likely remain as to what constitutes “implicit” attribution capable of satisfying *Janus*.

It is not just the cases involving implicit attribution that are at risk on appeal. Even the cases described above that allow explicit attribution to satisfy *Janus* might ultimately be reversed. Litigants have argued, for example, that under *Janus*, even express attribution is not sufficient, but rather the test is one of control.<sup>139</sup> Therefore, for

<sup>136</sup> *In re Pfizer Inc., Sec. Litig.*, 2012 WL 983548, at \*4 (S.D.N.Y. Mar. 22, 2012) (holding that, even though the statements in the company’s press releases were not explicitly attributed to the insider defendants, the case could proceed against the defendants since *Janus* recognized attribution could be “implicit from surrounding circumstances”); *SEC v. Landberg*, 836 F. Supp. 2d 148, 155 (S.D.N.Y. 2011) (holding that the plaintiffs’ claim could proceed against an insider executive who had generated fraudulent materials that misrepresented the company’s financial performance but who had not been identified in any of the public misrepresentations as their author since there were adequate surrounding circumstances to conclude the misstatements were implicitly attributable to the defendant).

<sup>137</sup> *Janus*, 131 S. Ct. at 2303–04 (“The Government contends that ‘make’ should be defined as ‘create.’ . . . Adopting the Government’s definition of ‘make’ would . . . lead to results inconsistent with our precedent. The Government’s definition would permit private plaintiffs to sue a person who ‘provides the false or misleading information that another person then puts into the statement.’”).

<sup>138</sup> See *supra* notes 39–47 and accompanying text.

<sup>139</sup> Defendant’s Motion for Summary Judgment at 5, *SEC v. Daifotis*, No. 11-cv-00137-WHA, 2012 WL 2848995 (N.D. Cal. May 3, 2012). While control may in fact be relevant to the inquiry, control alone as we think of it in the corporate context—e.g., a parent controls its one-hundred percent owned subsidiary—is not enough to satisfy the “ultimate authority” test of *Janus*. For instance, in *In re Optimal U.S. Litigation*, Optimal Management Services (“OIS”) owned one-hundred percent of Optimal Multiadvisors, Ltd. (“Multiadvisors”). No. 10-cv-4095-SAS, 2011 WL 4908745, at \*4 (S.D.N.Y. Oct. 14, 2011). The plaintiffs asserted OIS participated in the preparation of certain explanatory memoranda made available to investors by Multiadvisors. *Id.* Since these explanatory memoranda contained material misrepresentations, the plaintiffs brought a 10b-5 claim against OIS. *Id.* at \*1. The court held that, just because OIS owned one-hundred percent of Multiadvisors and was able to appoint and remove Multiadvisors’ directors at will, this was not sufficient

instance, where a defendant insider is quoted in marketing materials, but claims not to have made the quoted statement, the only potential defendants would be the individuals who actually drafted and issued the marketing materials, despite the public attribution of the statement to the defendant insider.<sup>140</sup> This argument seems to go against the majority of the lower court decisions analyzing the effect of express attribution as described above. The argument may gain traction, however, as attribution alone certainly does not seem to be the equivalent of the “ultimate authority” the *Janus* holding demands before an individual will be deemed the maker of a statement. While the *Janus* language refers to attribution as being “strong evidence” that a person was the maker of a statement,<sup>141</sup> it may not be sufficient standing alone as the only evidence to satisfy the “ultimate authority” test.

This argument that attribution alone is insufficient to satisfy *Janus* is not the only potential cause for reversal of the lower court decisions that have allowed 10b-5 claims to proceed against corporate insiders. Litigants may also argue that *Janus* stands for the proposition that there can be only one “maker” of a misstatement, further limiting the liability of the team of corporate insiders often involved in public disclosures. The language in *Janus* regarding attribution states that attribution is strong evidence that a statement “was made by—and only by—the party to whom it is attributed.”<sup>142</sup> Some have interpreted this to mean that there can be only one person or entity liable for a particular misstatement in a misrepresentation disclosed to investors.<sup>143</sup> Though lower courts do not appear to be adopting this interpretation,<sup>144</sup> most courts have

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to satisfy the *Janus* test. *Id.* at \*5. The court found that plaintiffs were “conflating shareholder control with ‘ultimate authority’” and found such argument to be unavailing. *Id.* at \*5. While such “control” through one-hundred percent ownership of an issuer could be sufficient to establish control person liability under Section 20(a) of the Exchange Act, a claim for control person liability is considered a secondary action that requires an underlying primary violation by the controlled person or entity in order to be actionable. *Id.* at \*4, \*8.

<sup>140</sup> Defendant’s Motion for Summary Judgment, *supra* note 139 at 5.

<sup>141</sup> *Janus*, 131 S. Ct. at 2302.

<sup>142</sup> *Id.*

<sup>143</sup> James D. Redwood, *To Make or to Mar: The Supreme Court Turns Away Another Securities Law Plaintiff*, 14 U. PA. J. BUS. L. 463, 495–96 (2012) (“[N]othing in logic or linguistics compels the conclusion that a statement, or indeed anything else, has to have one and only one ‘maker.’ The Court’s ‘either-or’ approach is thus ill-founded.”); Cosenza, *supra* note 1, at 1074 (“*Janus* . . . limit[s] liability under section 10(b) to the person or entity with ‘ultimate authority’ over the statement.”) (emphasis added).

<sup>144</sup> *In re Nat’l Century Fin. Enter. Inc.*, 846 F. Supp. 2d 828, 861 (S.D. Ohio 2012)

ignored the issue and seem simply to assume without deciding that there can be more than one maker. If, as these cases work their way through the appeals process, the circuit courts determine there can be only one “maker” of a statement under *Janus*, either the corporate entity or the corporate insider could be liable, but not both. Moreover, presumably only one corporate insider could be liable for a given misrepresentation, ignoring the realities of the marketplace—that public disclosures “reflect a combined work product” of potentially numerous individual wrongdoers.<sup>145</sup>

As indicated by the above discussion, many questions still remain for courts addressing the issue of individual liability in the post-*Janus* world. Notably, even if circuit courts agree that express attribution is sufficient to establish an insider as a maker of a statement, courts will need to decide what kinds of actions constitute express attribution.<sup>146</sup> For instance, in *In re Flannery*, described in more detail above, the ALJ seemed to indicate attribution was important when she refused to impose liability on a defendant who drafted a letter, but was not the one who signed it or sent it out.<sup>147</sup> Yet, in that same case, the ALJ found no liability for the defendant who gave a presentation but was not the one who created it.<sup>148</sup> It would seem as though, by giving a presentation, one would be publicly identifying himself as the maker

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(rejecting the defendant’s “either-or” contention that the document containing the misstatement could only belong to the issuer *or* its placement agent and finding that it was appropriate to find that the misstatements could be attributed to both parties); *City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359, 374 (S.D.N.Y. 2012) (“It is not inconsistent with *Janus Capital* to presume that multiple people in a single corporation have the joint authority to ‘make’ an SEC filing, such that a misstatement has more than one ‘maker.’”); *City of Roseville Emps. Retirement Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395, 417 n.9 (S.D.N.Y. 2011) (“The Supreme Court’s statement does not imply that there can be only one ‘maker’ of a statement in the case of express or implicit attribution.”).

<sup>145</sup> Cosenza, *supra* note 1, at 1050. One critic of this potential implication of *Janus* that there may be only one “maker” has analogized this issue to other areas of law. Redwood, *supra* note 143, at 496. For instance, in the case of tort liability arising from an injury incurred from faulty construction, courts allow for plaintiffs to pursue anyone who was responsible for the injury. *Id.* In other words, courts do not engage in the fictional assumption that there can be only one maker of a building. *Id.* If the injury is caused by something defective in both design and construction, for example, a plaintiff could pursue both the architect and the contractor. *Id.* The dissent in *Janus* similarly analogized to other areas of law, focusing specifically on criminal law. *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting). The dissent pointed out that pursuant to criminal law principals, one is guilty as a principal “when one uses an innocent third party to commit a crime.” *Id.*

<sup>146</sup> Rains et al., *supra* note 101, at 7.

<sup>147</sup> *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*41 (ALJ Oct. 28, 2011).

<sup>148</sup> *Id.* at \*38.

of the statements contained therein, but this was not the case according to the ALJ.<sup>149</sup> If making a presentation (or giving a speech, to use the analogy asserted by the majority in *Janus*) is not enough to satisfy attribution, courts will have to identify what additional facts are required.

Similarly, courts will have to determine whether a Sarbanes-Oxley (SOX) Section 302 certification constitutes express attribution for purposes of determining ultimate authority.<sup>150</sup> In a large organization, the realities of the process of preparing corporate disclosure filings are such that, though one person may sign the disclosure documents, the responsibility for the language and content of such filings may lie with a team of individuals.<sup>151</sup> As such, courts will have to determine whether liability can be imposed on a CFO, for instance, solely because of his signature on a filing pursuant to SOX requirements.

At least one court has addressed this issue since *Janus*. In *City of St. Clair Shores General Employees' Retirement System v. Lender Processing Services, Inc.*, the court viewed the signing of SOX certifications as direct attribution sufficient to satisfy *Janus*, at least when combined with the other facts that some of the individual defendants had made statements quoted in press releases in their official capacities.<sup>152</sup>

But this approach is not without critics, who note that SOX certifications do not always indicate ultimate authority.<sup>153</sup>

<sup>149</sup> *Id.*

<sup>150</sup> Rains et al., *supra* note 101, at 7. Under SOX, senior executives of public companies must certify the accuracy of quarterly and annual financial reports. 15 U.S.C. § 7241(a) (2006). Each officer must certify that he and other officers are “responsible for establishing and maintaining internal controls[,]” which they have designed “to ensure that material information” of the issuer will be reported “to such officers by others within” the entity. 15 U.S.C. § 7241(a)(4)(A). Moreover, the officers must certify that they have “evaluated the effectiveness of the issuer’s internal controls” within the previous ninety days and have “presented in the report their conclusions about the effectiveness of their internal controls.” 15 U.S.C. § 7241(a)(4)(C)–(D).

<sup>151</sup> Scott M. Himes, *Implications of “Janus” for Securities Fraud Liability of Corporate Insiders*, N.Y. L.J. (Oct. 31, 2011), <http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202520766667&slreturn=20130217160926>; King, *supra* note 105, at 426.

<sup>152</sup> *City of St. Clair Shores Gen. Emps. Ret. Sys. v. Lender Processing Servs., Inc.*, No. 3:10-cv-1073-J-32JBT, 2012 WL 1080953, at \*3 (M.D. Fla. Mar. 30, 2012).

<sup>153</sup> Rains, *supra* note 36, at 11 (“It could be argued that some corporate statements are attributable . . . to corporate directors or executives. For example, chief executives and chief financial officers sign Sarbanes-Oxley certifications, chief executives and chief accounting officers sign periodic reports, directors sign registration statements, and executives make oral statements to investors or the public. But a signature on a disclosure document rarely means the signer had ultimate control over the document or the power to change its contents, and

Additionally, even if public attribution—such as the signing of a SOX certification—is enough to satisfy the “ultimate authority” test, it is not at all clear that such claims could be successful at trial based on an inability to establish the scienter necessary for a 10b-5 claim.<sup>154</sup> For instance, if a CFO signs a SOX certification for filings prepared by other corporate officers or employees, where those preparers knew of the misstatements in the materials but the CFO did not, a plaintiff will have a difficult time establishing the scienter of the CFO. Prior to *Janus*, some circuits held that a SOX certification is “only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements.”<sup>155</sup> According to such courts, if a SOX certification alone, with nothing more, was enough to provide the requisite inference of scienter, scienter would automatically be adequately pled any time “it is alleged that an accounting error . . . made by a publicly traded company was later uncovered.”<sup>156</sup> Even if the plaintiff can establish that the defendant *should* have known of the violations, according to these courts it is insufficient to meet the heightened pleading requirements for scienter in 10b-5 cases.<sup>157</sup> Thus, it follows that if the CFO in this scenario is the “maker” of the statement for purposes of *Janus*, but only the employee who prepared the materials to give to the CFO has the requisite state of mind, plaintiffs will be unable to identify a proper 10b-5 defendant. Though courts are willing to impute scienter of an individual wrongdoer to the issuer itself,<sup>158</sup> as discussed

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suggestions that any one signer might have veto power are often overblown.”).

<sup>154</sup> See *supra* note 30 and accompanying text for the elements of a 10b-5 claim.

<sup>155</sup> *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006). See also *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 747 (9th Cir. 2008) (quoting *Garfield* in holding that SOX certification is only relevant to scienter if the person signing was severely reckless); *Ind. Elec. Workers’ Pension Trust Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 544–45 (5th Cir. 2008) (same).

<sup>156</sup> *Stevens v. InPhonic, Inc.*, 662 F. Supp. 2d 105, 119 (D.C. Cir. 2009). While a plaintiff may be able to use the fact that defendants failed to check information they had a duty to monitor in order to support a showing of scienter, scienter cannot be established by the “bare inference [alone that the] defendant ‘must have had knowledge of the facts.’” *Id.* at 120 (citation omitted). Therefore, filing a SOX certification alone is insufficient to adequately plead scienter and to hold otherwise would “eviscerate the heightened pleading requirement[s]” of the Private Securities Litigation Reform Act of 1995. *Id.* (citation omitted). The requirements of the Private Securities Litigation Reform Act are described in more detail *infra* Part III.B.1.

<sup>157</sup> *Glazer*, 549 F.3d at 748. Heightened pleading requirements for scienter were instituted by the Private Securities Litigation Reform Act, described in more detail *infra* Part III.B.1.

<sup>158</sup> There is precedent for imputing the scienter of an individual, and in some jurisdictions a group of individuals, to the corporate entity by which the individual is

in more detail in Part III.B.1 *infra*, scienter of one corporate insider cannot be imputed to a different insider.<sup>159</sup>

Factual scenarios such as this can already be seen in the cases currently working their way through the lower courts and SEC administrative proceedings. For instance, in *In re Flannery*, described above, the defendant did not have ultimate authority over a letter because he did not send it out or sign it, nor was he identified as its author.<sup>160</sup> Yet he was the individual who prepared the contents of the draft letter and circulated it to more senior managers.<sup>161</sup> In such scenarios, if the person who signed and sent the letter—and thus had “ultimate authority”—did not know of the falsity of the letter’s contents, such individual would not likely be found liable for a 10b-5 violation due to a lack of scienter.

In sum, it is possible that on appeal, circuit courts will determine one or more of the following: (a) express attribution, on its own, is not enough to satisfy the *Janus* “ultimate authority” test or, if it is, what constitutes “express attribution” is very limited; (b) there can only be one “maker” of a misstatement after *Janus*; or (c) an unknowing officer who signs a public filing, while the “maker” of the statement, does not have scienter sufficient to establish a 10b-5 claim. One or more of these findings—particularly in combination—could be devastating to the 10b-5 cause of action. Such limitations could make it nearly impossible for private litigants or the SEC to assert claims against corporate insiders. Combined with the challenges *Janus* poses for bringing suits against secondary actors, potential plaintiffs are left with only the remedy of pursuing the issuer itself. And, as discussed in Part III.B. *infra*, even the ability to pursue the issuer may be significantly limited by *Janus*.

*B. Limitations of Liability on Corporate Issuers: Inability to Impute Scienter*

*Janus* not only potentially limits the 10b-5 liability of corporate insiders and secondary actors, but, when combined with previously existing precedent, may also limit the liability of even the corporate

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employed in 10b-5 suits against the corporate issuer. See *infra* note 182 and accompanying text.

<sup>159</sup> Therefore, in this scenario where the CFO is the maker but another employee has the scienter, if courts were to impute the employee’s scienter to the CFO, rather than to the corporation itself, this would have to involve an expansion of the concept of imputed scienter.

<sup>160</sup> *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*41 (ALJ Oct. 28, 2011).

<sup>161</sup> *Id.*

issuers in whose name the misrepresentation was made. This is because, as discussed in more detail in this Part, many courts will only impute the scienter of an individual agent within the corporation to the corporation itself if that individual with the requisite state of mind is also the individual who was the maker of the misstatement. In such jurisdictions—i.e., those that reject the theory of “collective scienter”—it may be only in the most limited of circumstances that a plaintiff will be able to successfully plead that the corporation had the required state of mind for a 10b-5 claim. In these jurisdictions, cases in which the lower courts have allowed the plaintiffs to proceed against the issuer based on express attribution of a public statement to a particular individual may be reversed on appeal for failure to establish the scienter of the identified individual insiders.<sup>162</sup> If this is the case, not only will plaintiffs be barred from pursuing culpable individuals, but they also would be barred from pursuing the corporation itself. In other words, plaintiffs will be left with no remedy at all.

#### 1. Pleading an Issuer’s Scienter in 10b-5 Cases

As discussed in Part II.B. *supra*, scienter is a necessary element in both private causes of action and SEC enforcement actions asserting 10b-5 liability.<sup>163</sup> To establish scienter, a plaintiff must show that the defendant had “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>164</sup> To understand the issue of imputed scienter and collective scienter, it is necessary to first understand the special pleading requirements for establishing scienter in 10b-5 cases. In order to survive a motion to dismiss on a 10b claim, in addition to satisfying the pleading requirements of Rule 12(b)(6) of the Federal Rules of Civil Procedure (FRCP), a plaintiff must also satisfy the heightened pleading requirements of Rule 9(b) of the FRCP.<sup>165</sup> Rule 9(b) requires that a party alleging fraud “state with particularity the circumstances constituting fraud.”<sup>166</sup> As such, the plaintiff must,

<sup>162</sup> See *supra* note 195 and accompanying text.

<sup>163</sup> See *supra* notes 29–33 and accompanying text.

<sup>164</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); see also *Frank v. Dana Corp.*, 646 F.3d 954, 959 (6th Cir. 2011) (“Scienter may take the form of knowing and deliberate intent to manipulate, deceive, or defraud, and recklessness.”) (citation omitted); Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J. L. & BUS. 1, 2 (2009) (“Scienter generally refers to intent or knowledge of wrongdoing.”).

<sup>165</sup> *SEC v. Landberg*, 836 F. Supp. 2d 148, 153 (S.D.N.Y. 2011).

<sup>166</sup> FED. R. CIV. P. 9(b). Where fraud is not at issue, the federal notice pleading standards of FED. R. CIV. P. 8 apply, which merely require that a complaint contain a short and plain statement of the claim showing that the pleader is entitled to relief.

among other things, specify the fraudulent statements, explain why they are fraudulent, and identify the speaker.<sup>167</sup> Initially, courts of appeals diverged with regard to the meaning of Rule 9(b) in 10b cases, particularly with respect to its effect on the pleading requirements for scienter.<sup>168</sup> For instance, some courts found it was sufficient merely to plead that scienter existed, while other courts required plaintiffs to allege particular facts giving rise to the inference of scienter.<sup>169</sup> In 1995, Congress attempted to clarify this disagreement through the enactment of the Private Securities Litigation Reform Act (PSLRA).<sup>170</sup>

One of the purposes of enacting the PSLRA was to curb abusive securities litigation while still allowing meritorious suits to proceed to enforce federal antifraud securities laws.<sup>171</sup> Through the PSLRA, Congress effectuated this goal by, among other things, imposing certain demanding pleading requirements. For instance, the PSLRA establishes a more stringent rule for inferences involving scienter in securities litigation.<sup>172</sup> Specifically, with respect to scienter, the PSLRA requires that the plaintiff “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>173</sup> At the time it enacted the PSLRA, however, Congress left the meaning of “strong inference” undefined, leading to a division in the circuit courts as to how it should be interpreted.<sup>174</sup> For instance, the Seventh Circuit took a more lenient approach to the pleading requirement, finding that a complaint would survive if it alleged facts from which a reasonable person could infer the defendant acted with the requisite intent.<sup>175</sup> The Sixth Circuit, on the other hand, took a more strict approach, finding that a complaint would only survive if the plaintiff asserted the most plausible of competing inferences.<sup>176</sup>

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FED. R. CIV. P. 8(a)(2); *City of St. Clair Shores Gen. Emps. Ret. Sys. v. Lender Processing Servs., Inc.*, No. 3:10-cv-1073-J-32JBT, 2012 WL 1080953, at \*2 (M.D. Fla. Mar. 30, 2012).

<sup>167</sup> *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

<sup>168</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319–20 (2007).

<sup>169</sup> *Id.*

<sup>170</sup> *Id.* at 320.

<sup>171</sup> *Id.* at 313, 322.

<sup>172</sup> *Id.* at 313–14.

<sup>173</sup> 15 U.S.C. § 78u-4(b)(2) (2006).

<sup>174</sup> *Tellabs*, 551 U.S. at 314.

<sup>175</sup> *Id.* at 317.

<sup>176</sup> *Id.* In other words, the issue came down to whether courts should consider competing inferences in determining whether an inference of scienter is considered “strong” for purposes of the statute. *Id.* at 322.



In 2007, the Supreme Court resolved the circuit split in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*<sup>177</sup> In *Tellabs*, the Supreme Court adopted the more strict of the competing interpretations of the PSLRA's scienter pleading requirement, holding that a plaintiff must plead facts that make the inference more than merely plausible or reasonable.<sup>178</sup> Instead, the plaintiff must plead facts that render an inference of scienter at least as likely as any plausible opposing inference.<sup>179</sup> In so holding, the Court also stated that it must consider the complaint in its entirety because the question is whether all of the facts taken collectively give rise to a strong inference of scienter, not whether any individual allegation meets that standard.<sup>180</sup> If the pleading requirements of the PSLRA are not met, a court must grant a defendant's motion to dismiss.<sup>181</sup>

## 2. Imputing Scienter to the Corporation

When the defendant in a 10b-5 action is the corporation itself, typically the easiest way to raise an inference of scienter is to plead scienter for a particular individual within the corporation.<sup>182</sup> The scienter of the individual wrongdoer, an agent of the corporation, can then be imputed to the corporation.<sup>183</sup> In other words, courts are generally in agreement that, when the corporate insider who made the misrepresentation acted with scienter, that scienter can be imputed to his or her corporate employer to establish the elements of a 10b-5 claim against the issuer itself.<sup>184</sup>

The more problematic question historically has been whether scienter can be imputed to the corporation from a group of insiders, where the one particular wrongdoer within the corporation is not the "maker" of the misstatement or has not necessarily been identified.<sup>185</sup> The willingness of courts to impute scienter of an individual

<sup>177</sup> 551 U.S. 308 (2007).

<sup>178</sup> *Id.* at 314.

<sup>179</sup> *Id.* at 328.

<sup>180</sup> *Id.* at 322–23.

<sup>181</sup> *City of St. Clair Shores Gen. Emps. Ret. Sys. v. Lender Processing Servs., Inc.*, No. 3:10-cv-1073-J-32JBT, 2012 WL 1080953, at \*2 (M.D. Fla. Mar. 30, 2012). It should be noted that the heightened pleading requirements set forth in the PSLRA apply only to private causes of action, not to enforcement actions filed by the SEC. 15 U.S.C. § 78u-4(a)(1) (2006); *SEC v. Landberg*, 836 F. Supp. 2d 148, 153 n.2 (S.D.N.Y. 2011).

<sup>182</sup> *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008).

<sup>183</sup> Bondi, *supra* note 164, at 2–3.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

corporate agent to the corporation itself has evolved out of theories of respondeat superior.<sup>186</sup> But respondeat superior as a theory does not work when the individual who engaged in the act itself—such as making a false statement—is not the same person as the one who has scienter.<sup>187</sup> As such, plaintiffs have argued that the scienter of one or a collection of corporate agents should be combined to establish the required state of mind of the corporation itself.<sup>188</sup> Courts willing to do this—to impute scienter to the corporation from the assumed collective knowledge of all or some combination of its employees—have done so under a theory that has been referred to as “collective scienter.”<sup>189</sup>

Essentially three lines of cases have developed with respect to collective scienter—those that apply a strong version of collective scienter, those that apply a “watered-down” version of collective scienter, and those that reject collective scienter altogether.<sup>190</sup> Under the strong version of collective scienter, courts allow plaintiffs to plead scienter based on the aggregate knowledge of all of the employees of a corporation without pleading scienter to any particular corporate agent.<sup>191</sup> For instance, when a corporation makes a dramatic announcement that is wildly false, this supports an inference of scienter because such an announcement would have had to have been approved by corporate insiders who had enough knowledge about the company to know the announcement was false.<sup>192</sup>

Other courts have not rejected collective scienter outright but have applied a more limited version of the theory. These courts find that, so long as a specific “member of management knew or should have known” that a statement was false, the scienter can be imputed to the corporation, even where “that member of management was

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<sup>186</sup> *Id.*

<sup>187</sup> *Id.* at 7.

<sup>188</sup> *Id.*

<sup>189</sup> *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008). *See also* Bondi, *supra* note 164, at 3. Some courts have applied the functional equivalent of a collective scienter theory without labeling it as such. *See, e.g.*, *City of Monroe Emps. Retirement Syst. v. Bridgestone Corp.*, 399 F.3d 651, 684 (6th Cir. 2005). Additionally, some courts refer to a similar theory of “group pleading.” *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 363 (5th Cir. 2004).

<sup>190</sup> Bondi, *supra* note 164, at 7.

<sup>191</sup> *Id.* at 10. *See also* *City of Monroe*, 399 F.3d at 684; *Teamsters Local 445*, 531 F.3d at 195.

<sup>192</sup> *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008).

not the person who made the alleged misstatement.”<sup>193</sup> In other words, instead of allowing scienter to be imputed from the aggregate knowledge of all of the employees, courts in these jurisdictions require the plaintiff to show that at least one member of management knew or should have known of the falsity before the bad actor’s state of mind will be imputed to the issuer.<sup>194</sup>

Finally, at least six circuits have rejected collective scienter altogether, instead requiring that, to impute scienter from an individual to the corporation, the individual with scienter must also be the same individual who actually made the misstatement.<sup>195</sup> Even jurisdictions that were once friendly to notions of collective scienter have subsequently questioned whether the theory survived the adoption of the PSLRA in 1995.<sup>196</sup> Some courts have interpreted the PSLRA, in combination with the *Tellabs* holding, as requiring that plaintiffs attribute the misleading statements upon which the 10b-5 claim is based to a *particular* defendant.<sup>197</sup> For instance, in *Southland Securities Corporation v. INSpire Insurance Solutions, Inc.*, the Fifth Circuit held that collective scienter cannot survive in light of the PSLRA, focusing on the PSLRA’s language requiring the plaintiff to set forth allegations of misstatements with respect to “the defendant.”<sup>198</sup> The repeated references in the PSLRA’s pleading requirements to “the defendant,” according to the court, must be read to mean “each

<sup>193</sup> Bondi, *supra* note 164, at 12–13.

<sup>194</sup> *Id.* at 13.

<sup>195</sup> *Id.* at 7. The Eleventh, First, Third, Ninth, Fourth, and D.C. Circuits have all rejected collective scienter. *Id.* at 8, n.27; *see, e.g.*, *Stevens v. InPhonic, Inc.*, 662 F. Supp. 2d 105, 121 (D.C. Cir. 2009); *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 364–65 (6th Cir. 2005); *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1017–18 (11th Cir. 2004); *see also* *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 745 (9th Cir. 2008) (holding that collective scienter would not satisfy the PSLRA in the case before it, but declining to decide whether, in some circumstances, it might be possible to plead scienter under a collective theory); Part III.B.1 *supra*.

<sup>196</sup> *Tellabs*, 551 U.S. at 326, n.6. *See also* *Monk v. Johnson & Johnson*, No. 10-4841-FLW, 2011 WL 6339824, at \*10 (D.N.J. Dec. 19, 2011) (“[T]he Third Circuit made [it] clear . . . that the so-called group pleading doctrine is no longer viable, and any private securities fraud claims against corporate officers ‘must be pleaded with the specificity required by the PLSRA with respect to each defendant.’”) (quoting *Winer Family Trust v. Queen*, 503 F.3d 319, 337 (3d Cir. 2007)). Since the heightened pleading requirements for scienter established by the PSLRA only apply to private 10b-5 claims and not to SEC enforcement actions, however, it is unclear whether collective scienter as a theory would be available to the SEC even in jurisdictions that otherwise refuse to recognize such claims. Until at least 2009, all of the judicial decisions involving collective scienter involved private claims, not SEC enforcement actions. Bondi, *supra* note 164, at 4.

<sup>197</sup> *In re Coinstar Inc. Sec. Litig.*, No. C11-133-MJP, 2011 WL 4712206, at \*3 (W.D. Wash. Oct. 6, 2011).

<sup>198</sup> *Southland*, 365 F.3d at 364.

defendant,” thereby eliminating the ability to plead scienter based on the aggregate of individuals within a corporation.<sup>199</sup> Additionally, the court held that even if a corporate insider’s position within the corporation supports an inference that he would have been negligent in not learning of the falsity in the document that was released to the public, the PSLRA requires more than negligence to satisfy the scienter requirement for 10b-5 liability.<sup>200</sup>

In so holding, the court in *Southland* made it clear that, in the Fifth Circuit, allegations against defendants as a group are not imputable to any individual defendant (such as the corporation) unless the connection between the individual defendant and the misstatement is properly pleaded.<sup>201</sup> To ensure that the connection is “properly pleaded,” the plaintiff must plead with particularity facts showing the state of mind “of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like).”<sup>202</sup> Ultimately, the knowledge necessary to form the requisite intent cannot be imputed to the corporation based on “disconnected facts known by different agents.”<sup>203</sup>

*Janus* will potentially have an effect in jurisdictions that historically have permitted theories of collective scienter. For instance, in such jurisdictions, a split may be developing over whether collective scienter can survive *Janus* or whether such jurisdictions must now reject the theory.<sup>204</sup> Even in jurisdictions that have

<sup>199</sup> *Id.* at 364–65.

<sup>200</sup> *Id.* at 365–66; *see also* *Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp.*, 675 F.3d 1047, 1050 (7th Cir. 2012) (“The most the complaint’s allegation could support is the proposition that [the corporation’s] managers *should* have seen the looming problem, but that’s negligence rather than the state of mind required for fraud.”); *In re Nat’l Century Fin. Enters., Inc.*, 846 F. Supp. 2d 828, 866 (S.D. Ohio 2012) (“Negligence does not suffice; there must be ‘an extreme departure from the standards of ordinary care,’ such that the danger of misleading buyers is ‘either known to the defendant or is so obvious that the defendant must have been aware of it.’”) (quoting *Platts v. E.F. Hutton & Co.*, 946 F.2d 38, 40 (6th Cir. 1991)).

<sup>201</sup> *Southland*, 365 F.3d at 365.

<sup>202</sup> *Id.* at 366.

<sup>203</sup> *Id.* at 367 (quoting *Gutter v. E.I. Dupont De Nemours*, 124 F. Supp. 2d 1291, 1311 (S.D. Fla. 2000)).

<sup>204</sup> For instance, one lower court in the Second Circuit has asserted that “group pleading is alive and well” in the aftermath of *Janus*. *City of Pontiac Gen. Emps. Retirement Sys. v. Lockheed Martin Corp.*, No. 11-cv-5026-JSR, 2012 WL 2866425, at \*14 (S.D.N.Y. July. 13, 2012). Another lower court, however, has stated that “it is uncertain whether [the group pleading doctrine] survived *Janus*.” *Orlan v. Spongetech Delivery Sys., Inc.*, 2012 WL 1067975, slip op. at 10 (E.D.N.Y. Mar. 29, 2012).

historically refused to allow plaintiffs to use collective scienter theories to establish corporate scienter, the effect of *Janus* moving forward is of equal importance. To illustrate, in *Southland*, as discussed above, the court held that scienter would only be imputed if the person with the requisite state of mind was also the person who made the statement.<sup>205</sup> Prior to *Janus*, several individuals could be viewed as having “made” the statement. But after *Janus*, the sphere of individuals who can be considered to have “made” the statement has shrunk, as discussed in Parts II.E and III.A *supra*.<sup>206</sup> Therefore, if the employee who had knowledge of the falsity of the statements being issued is not the same person as the employee with “ultimate authority” over the statements, the scienter of the individual cannot be imputed to the corporation. In such instances, not only will a plaintiff be unable to pursue a claim against the individual “maker,” but the plaintiff will also be without a remedy against the corporation itself.

To illustrate this point further with a hypothetical, assume the V.P. of Finance of Corporation X supplies false financial data to the CFO of Corporation X to include in the company’s public filings. The CFO neither knows, nor has reason to know, that the information is false. Corporation X makes the filings, which contain the CFO’s signature. After *Janus*, the V.P. of Finance likely cannot be pursued under 10b-5 as the maker of the statement. That leaves only the individual CFO or the corporation itself, either of which—or both, if *Janus* is read to allow for more than one maker—could arguably be seen as the statement’s maker. But the V.P. of Finance is the only individual with the requisite scienter and, in jurisdictions disallowing collective scienter, this scienter cannot be imputed to the corporation or the CFO. Jurisdictions rejecting collective scienter have made it clear that the fact that the plaintiff can show that a different executive—someone other than who made the misstatement—knew about the falsity of the statements would do nothing to save that plaintiff’s claim from dismissal.<sup>207</sup>

Arguably, some of the cases from jurisdictions rejecting collective scienter can be read more broadly than the above discussion would suggest. For instance, in *Southland*, the court does not limit the individual from whom the scienter can be imputed to the maker of the statement alone. Rather the court states that it will look to the state of mind of the officials who made the statement *and*

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<sup>205</sup> *Southland*, 365 F.3d at 366.

<sup>206</sup> Rains, *supra* note 36, at 12.

<sup>207</sup> *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 744–45 (9th Cir. 2008).

to those who “order[ed] or approve[d]” the issuance of the statement, or who “furnish[ed] information or language” to include in the statement.<sup>208</sup> This would allow scienter to be imputed to the corporation even if the plaintiff was unable to establish that the individual with scienter was the same person who had ultimate authority over that statement for purposes of *Janus*.<sup>209</sup> But other courts rejecting collective scienter have not used the broad language used by the Fifth Circuit in *Southland*. For instance, the Ninth Circuit, in rejecting collective scienter in *Glazer Capital Management, LP v. Magistri*, said that scienter can only be imputed from the individual to the corporation if the “officer making the statement has the requisite level of scienter.”<sup>210</sup> Moreover, in the aftermath of *Janus*, many courts have yet to test whether corporate scienter could be inferred from those who merely “furnish[ed] information or language” to the maker of the statement. It would not require an overly broad reading of *Janus* and the collective scienter cases to conclude that it could not.<sup>211</sup>

Because *Janus* may do away with theories of collective scienter altogether, the prediction of the dissent in *Janus* may in fact come to fruition, where “guilty management” could incorporate “materially false statements” into public filings and “fool[] both board and public into believing they are true.”<sup>212</sup> Not only would it be impossible for a plaintiff to assert a claim against the individuals—i.e., the guilty management—but in a jurisdiction that rejects collective scienter, it may also be impossible for a plaintiff to assert a claim against the issuer itself. The majority in *Janus* used the analogy of the relationship between a speechwriter and speech giver to support its holding that it is the speech giver, not the speechwriter, who has ultimate authority over the communication.<sup>213</sup> But it is easy to see how this analogy breaks apart when viewed in light of the other elements of a 10b-5 action—in reality, the speech giver often does not

<sup>208</sup> *Southland*, 365 F.3d at 366.

<sup>209</sup> Thus, in the above-described hypothetical, the scienter of the V.P. of Finance might be imputed to the corporation since the V.P. of Finance furnished information to the CFO for inclusion in the public statement.

<sup>210</sup> *Glazer*, 549 F.3d at 744 (quoting *Apple Computer Inc., Sec. Litig.*, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002)). In other words, *Glazer* does not allow imputing scienter from those who merely furnished information or language to include in the statement.

<sup>211</sup> Rains, *supra* note 36, at 12 n.14 (“*Southland*’s logic seems to limit the state of mind inference to the corporate officials who ‘make’ a statement within the meaning of *Janus*.”). In other words, the broad language in *Southland* might not survive *Janus*.

<sup>212</sup> *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting).

<sup>213</sup> *Id.* at 2302.

have the requisite scienter.

*C. Expansion of Janus Beyond 10b-5 Claims*

*Janus* may serve to limit the liability of secondary parties, corporate insiders, and corporate issuers even further through its application to claims brought under federal securities laws other than Section 10(b) and Rule 10b-5(b). For instance, lower courts have had to address whether *Janus* applies only to claims of misrepresentation brought under Rule 10b-5(b) or whether it also should apply to cases involving scheme liability brought under Rule 10b-5(a) or 10b-5(c). In *SEC v. Kelly*, the U.S. District Court for the Southern District of New York held that *Janus* would apply in cases of scheme liability that involve defendants “who did no more than facilitate preparation of material misrepresentations or omissions actually communicated by others.”<sup>214</sup>

Other courts have had the opportunity to determine whether *Janus* extends even beyond Rule 10b-5. For example, a handful of lower courts have had to opine on whether *Janus* should be extended to claims brought under Section 17(a) of the Securities Act.<sup>215</sup> Under Section 17(a), it is unlawful:

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission [of] material fact . . . or (3) to engage in any . . . course of business which . . . would operate as a fraud . . . upon the purchaser.<sup>216</sup>

Litigants arguing in favor of applying *Janus* to 17(a) claims point out that the elements of a claim under 17(a) are essentially the same as those under 10b-5.<sup>217</sup> And to succeed in a 17(a) claim for misstatement, the SEC must prove that the defendant made materially false statements or omissions, just as it would have to prove if it were bringing a misstatement claim under 10b-5.<sup>218</sup> In fact, the

<sup>214</sup> *SEC v. Kelly*, 817 F. Supp. 2d 340, 343 (S.D.N.Y. 2011) (citation omitted).

<sup>215</sup> *SEC v. Sentinel Mgmt. Grp., Inc.*, No. 07-C-4684, 2012 WL 1079961, at \*14–15 (N.D. Ill. Mar. 30, 2012); *SEC v. Pentagon Capital Mgmt. PLC*, 844 F. Supp. 2d 377, 421–22 (S.D.N.Y. 2012); *SEC v. Perry*, No. CV-11-1309R, 2012 WL 1959566, at \*8 (C.D. Cal. May 31, 2012); *SEC v. Mercury Interactive, LLC*, No. 5:07-cv-02822-WHA, 2011 WL 5871020, at \*3 (N.D. Cal. Nov. 22, 2011); *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139, at\*5–6 (N.D. Cal. Aug. 1, 2011); *Kelly*, 817 F. Supp. 2d at 345.

<sup>216</sup> 15 U.S.C. § 77q(a) (2006).

<sup>217</sup> Reply Brief in Support of Daifotis’s Motion for Reconsideration at 12, *SEC v. Daifotis*, No. 11-cv-00137-WHA, 2011 WL 7095660 (N.D. Cal. July 13, 2011).

<sup>218</sup> *Kelly*, 817 F. Supp. 2d at 345; *SEC v. Trabulse*, 526 F. Supp. 2d 1001, 1004

SEC's primary purpose in adopting 10b-5 was to make the same prohibitions contained in 17(a), which applies in connection with the offer and *sale* of a security, applicable to *purchases* of securities as well.<sup>219</sup> Conversely, litigants arguing that *Janus* should not apply to Section 17(a) claims generally point out that the operative word in 10b-5 that was the subject of the *Janus* ruling—"make"—is not even included in Section 17(a).<sup>220</sup> Rather under Section 17(a), it is unlawful for one "to obtain" money or property "by means of" any untrue statement that is used to perpetrate the fraud.<sup>221</sup> Nowhere does Section 17(a) require that it be the one who obtains the money or property be the same as the one who has made the untrue statement.<sup>222</sup> Moreover, since *Janus* is silent with respect to 17(a) claims, the holding should not be extended to that provision.<sup>223</sup> Some litigants have also looked to the policy underlying the *Janus* decision, arguing that *Janus* was aimed at narrowing the definition of "make" under Rule 10b-5 so as to curb the expansion of *private* suits under that rule.<sup>224</sup> Since only the SEC can bring actions under Section 17(a), however, there is no concern of expansion of the private right of action, and therefore the *Janus* definition of "make" should not be applied.<sup>225</sup>

At the time of writing this Article, most district courts that have considered the issue have refused to apply *Janus* to Section 17(a) claims.<sup>226</sup> But at least two courts have held that the *Janus* requirement that the "maker" of a statement be the one with "ultimate authority"

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(N.D. Cal. 2007).

<sup>219</sup> Reply Brief in Support of Daifotis's Motion for Reconsideration, *supra* note 217, at 12.

<sup>220</sup> Plaintiffs Memorandum in Opposition to Defendant Daifotis's Motion for Reconsideration at 9, SEC v. Daifotis, No. 11-cv-00137-WHA, 2011 WL 7095645 (N.D. Cal. July 6, 2011); *see also* Daifotis, 2011 WL 3295139, at \*5; *Mercury Interactive*, 2011 WL 5871020, at \*3.

<sup>221</sup> 15 U.S.C. § 77q(a).

<sup>222</sup> Plaintiffs Memorandum in Opposition to Defendant Daifotis's Motion for Reconsideration, *supra* note 220, at 10 (citing SEC v. Tambone, 550 F.3d 106, 128 (1st Cir. 2008)) ("[P]rimary liability may attach under Section 17(a)(2) even when the defendant has not himself made a false statement in connection with the offer or sale of a security.").

<sup>223</sup> *Id.* at 9.

<sup>224</sup> *Id.* at 11.

<sup>225</sup> *Id.*

<sup>226</sup> *See, e.g.*, SEC v. Sentinel Mgmt. Grp., Inc., No. 07-C-4684, 2012 WL 1079961, at \*14–15 (N.D. Ill. Mar. 30, 2012); SEC v. Pentagon Capital Mgmt. PLC, 844 F. Supp. 2d 377, 421–22 (S.D.N.Y. 2012); SEC v. Mercury Interactive, LLC, No. 5:07-cv-02822-WHA, 2011 WL 5871020, at \*3 (N.D. Cal. Nov. 22, 2011); SEC v. Daifotis, No. C 11-00137 WHA, 2011 WL 3295139, at \*5–6 (N.D. Cal. Aug. 1, 2011).



over it applies to misstatement claims brought under 17(a) (2), just as it would apply to claims brought under 10b-5(b).<sup>227</sup> The issue is still largely untested as only a handful of district courts have as yet analyzed the issue.

While the question of application of *Janus* to Section 17(a) claims has thus far received the greatest amount of attention, litigants have also argued that *Janus* should apply to claims brought under two other federal securities laws—Section 14(a) of the Exchange Act and Section 34(b) of the Investment Company Act.

Section 14(a) of the Exchange Act proscribes the solicitation of proxies “by means of” false or misleading statements.<sup>228</sup> To date, one court has addressed whether *Janus* should be extended to Section 14(a) claims. In *S.E.C. v. Mercury*, the U.S. District Court for the Northern District of California held that *Janus* does not apply to claims brought under Section 14(a) because the language of the statute does not include the word “make.”<sup>229</sup> Similarly, at least one court has refused to extend *Janus* to claims brought under Section 34(b) of the Investment Company Act.<sup>230</sup> Section 34(b) makes it “unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted.”<sup>231</sup> Though the language of Section 34(b) includes the operative word “make,” in *S.E.C. v. Daifotis*, the U.S. District Court for the Northern District of California held that *Janus* should still not apply because that case was limited to primary violations of Rule 10b-5.<sup>232</sup> The rationale behind the *Janus* decision focused largely on the need to limit the scope of the implied private right of action.<sup>233</sup> Since there is no private right of action under Section 34(b), the same rationale does not apply, according to the court.<sup>234</sup>

While most courts addressing this issue have determined that *Janus* should not be extended outside of 10b-5 claims, not enough

<sup>227</sup> SEC v. Perry, No. CV-11-1309R, 2012 WL 1959566, at \*8 (C.D. Cal. May 31, 2012); SEC v. Kelly, 817 F. Supp. 2d 340, 345 (S.D.N.Y. 2011). At least one administrative decision has also taken this position. *In re* Flannery, Exchange Act Release No. 438, 2011 WL 5130058, at \*35 (ALJ Oct. 28, 2011).

<sup>228</sup> 15 U.S.C. § 78u-4 (2006); 17 CFR § 240.14a-9(a) (2011). See also, *Mercury Interactive*, 2011 WL 5871020, at \*3.

<sup>229</sup> *Mercury Interactive*, 2011 WL 5871020, at \*3.

<sup>230</sup> *Daifotis*, 2011 WL 3295139, at \*6.

<sup>231</sup> 15 U.S.C. § 80a-33(b) (2006).

<sup>232</sup> *Daifotis*, 2011 WL 3295139, at \*6.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

courts have considered the issue yet for this holding to be considered a trend. And if these cases do not hold up on appeal, and *Janus* is applied to an even broader universe of federal securities claims, private litigants and the SEC's ability to pursue violators of the anti-fraud provisions of the securities laws will be further hamstrung.

#### IV. POLICY REASONS FOR MORE EXPANSIVE 10B-5 LIABILITY

As discussed above, *Janus* could have potentially far-reaching effects that limit the ability of private litigants and the SEC to pursue claims against violators of the anti-fraud provisions of the federal securities laws. Specifically, as courts attempt to apply *Janus* outside of the mutual fund context, there will certainly be further restrictions on the ability to bring claims against other secondary actors, such as accountants, lawyers, investment banks, and underwriters. But in addition to restrictions on secondary actors, plaintiffs will also have more difficulty bringing claims against corporate insiders and even, in some jurisdictions, against the issuers themselves if theories of collective scienter are rejected.

Due to the complexities of the public disclosure process, particularly in large publicly traded companies, the notion that one person or entity has "ultimate authority" over any given publicly transmitted representation is unrealistic.<sup>235</sup> After *Janus*, this reality of diffused responsibility in the creation of public filings and other publicly disclosed corporate statements will make it difficult to find an appropriate defendant in securities fraud actions for corporate misrepresentations.<sup>236</sup> And since the *Janus* holding has been extended to enforcement actions, the SEC is similarly limited by the holding. Moreover, it is possible that the SEC's ability to bring claims under other securities laws—not just Section 10(b) and Rule 10b-5—may be affected as well.

The ability of private litigants and the SEC to pursue violators of the anti-fraud provisions of the federal securities laws has historically been viewed as necessary to support the three main purposes of the

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<sup>235</sup> Himes, *supra* note 151 ("The signing of an SEC or a SOX certification by a senior officer is meaningful conduct—but does signing alone mean that one has 'ultimate authority' over all of the contents of a document, when many others perform significant roles for the corporate-reporting function? . . . The complex realities of corporate public disclosures may present uncertainty whether a given insider actually has final authority over supposed misstatements.").

<sup>236</sup> King, *supra* note 105, at 426 ("In a large organization, the 'ultimate authority' over language may be diffused and seemingly shared between many parties. In such a situation, the court will find it difficult to determine which party actually has 'ultimate authority' without extensive discovery and a trial.").

federal securities laws: “(1) deterrence of fraud, (2) compensation of victims, and (3) increase of confidence in investor markets.”<sup>237</sup> The need for stringent securities regulation is as compelling now as it ever has been. The unraveling of the Bernard Madoff Ponzi scheme, the discovery of the widespread fraud involved in the mortgage scandals, the still-lingering questions about potential wrongdoing that occurred in connection with the resulting financial crash, and, most recently, the uncovering of the Libor rate-rigging scandal are just a few indicators from the past five years that corporate securities fraud is, more than ever, a powerful force.

The success of the U.S. markets relies heavily on investor confidence in the integrity of the markets.<sup>238</sup> The ability of the SEC and private litigants to hold wrongdoers accountable for violations of the federal securities laws supports the integrity of the markets by giving investors faith that appropriate measures are in place to deter fraud and, when necessary, punish wrongdoers and compensate victims.<sup>239</sup> It is no coincidence that the U.S. markets are both the safest and the strongest in the world.<sup>240</sup> To maintain this investor confidence, the private right of action against wrongdoers must remain strong.

The Supreme Court in *Stoneridge*, *Central Bank*, and *Janus* expressed its concern over expanding the private cause of action for 10b-5 violations.<sup>241</sup> While the Court still recognizes the implied private right of action,<sup>242</sup> it has attempted to reverse the decades of expansion of that right.<sup>243</sup>

One reason asserted for limiting the private right of action is to curb the frequency of attorney-driven strike suits that subject innocent corporations, insiders, and secondary actors to expensive discovery and litigation, with the goal of extracting large nuisance

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<sup>237</sup> Cosenza, *supra* note 1, at 1027.

<sup>238</sup> *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 174 n.10 (2008) (Stevens, J., dissenting).

<sup>239</sup> *Id.*

<sup>240</sup> *Id.* at 175.

<sup>241</sup> *Janus*, 131 S. Ct. at 2302.

<sup>242</sup> The private right of action is referred to as an “implied” right because neither the language of Section 10(b) nor Rule 10b-5 expressly provides for that right. But district courts first began recognizing the right in 1946, and the Supreme Court validated the private right of action in 1971. Cosenza, *supra* note 1, at 1027 n.31.

<sup>243</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011); see also King, *supra* note 105, at 411–12; Andy Seitz, Case Note, *Securities Law—The Implied Private Right of Action Under Rule 10B-5 Does not Extend Liability to Aiders and Abettors*, 42 CUMB. L. REV. 425, 439 (2011).

settlements.<sup>244</sup> While certainly the prevalence of abusive litigation is an important concern, the goals of deterring meritless suits on the one hand and protecting innocent investors from fraud on the other are not mutually exclusive. For instance, Congress attempted to satisfy both goals simultaneously with the implementation of the PSLRA in 1995. In enacting the PSLRA, Congress recognized the need to balance the important interest of encouraging meritorious private suits to enforce federal antifraud securities laws with the interest of corporations in avoiding abusive litigation.<sup>245</sup>

The heightened pleading requirements of the PSLRA strike that balance, “requir[ing] plaintiffs to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter.”<sup>246</sup> The PSLRA appropriately limits the private right of action by imposing certain exacting substantive and procedural requirements on would-be plaintiffs, thereby protecting corporations from strike suits. This should sufficiently address the concern expressed by the Supreme Court in *Stoneridge* and *Janus* about the expansion of the private right of action without overly narrowing the scope of who can be considered a “maker” of a statement,<sup>247</sup> to the point of rendering the 10b-5 private right of action toothless. Yet in the face of the Supreme Court decisions since *Central Bank* that further narrowed the private right of action under 10b-5, the PSLRA has yet to achieve the balance it seeks; rather, “fraud has become increasingly prevalent.”<sup>248</sup>

The Supreme Court’s decisions curtailing the 10b-5 private cause of action are not without their supporters. Those who support this line of cases point to the benefits of predictable rules as one

<sup>244</sup> *Stoneridge*, 552 U.S. at 163–64. For instance, it is not uncommon for plaintiffs’ attorneys to file suit based solely on a significant change in the issuer’s stock price or a restatement of financials, without regard to any actual wrongdoing of the issuer in the hope that, through discovery, they might uncover a plausible cause of action. Brief for Attorney’s Liab. Assurance Soc’y, Inc., As Amici Curiae in Support of Respondent, at 10 n.2, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008) (No. 06-43), 2007 WL 2363261.

<sup>245</sup> *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 551 U.S. 308, 313 (2007).

<sup>246</sup> *Id.*

<sup>247</sup> *Janus*, 131 S. Ct. at 2302.

<sup>248</sup> Cosenza, *supra* note 1, at 1083. And the perpetrators of these frauds are often repeat players. Edward Wyatt, *Promises Made, and Remade, by Firms in S.E.C. Fraud Cases*, N.Y. TIMES, Nov. 7, 2011, available at <http://www.nytimes.com/2011/11/08/business/in-sec-fraud-cases-banks-make-and-break-promises.html?pagewanted=all> (“Nearly all of the biggest financial companies [on Wall Street, including Citigroup], Goldman Sachs, Morgan Stanley, JPMorgan Chase and Bank of America among them, have settled fraud cases by promising the S.E.C. that they would never again violate an antifraud law, only to do it again in another case a few years later.”).

reason for the narrow interpretation of the right.<sup>249</sup> But the “ultimate authority” test set forth in *Janus* is far from providing a bright-line rule and, as illustrated in Part III *supra*, certainly does not lend itself to predictable results. Moreover, the realities of the creation and publication of corporate statements, particularly within large, publicly traded corporations, make it difficult to apply the *Janus* rule. A rule requiring the identification of one person (or entity), and one alone, who has “ultimate authority” over statements issued to the public, when really the process of disclosure is a complex one involving diffuse responsibility of a team of individuals, will lead to inconsistent results, as evidenced by lower courts’ interpretation and application of *Janus*. Moreover, attributing “maker” status automatically to the signatory of the document containing the misstatement seems an imprecise means of designating fault.

Supporters of *Janus* would also argue that the SEC enforcement arm is sufficient protection for investors and deterrence for wrongdoers.<sup>250</sup> Yet the SEC is just as limited as private litigants by the *Janus* decision. As noted above, though *Janus* only involved a private action, courts have almost uniformly found that *Janus* applies equally to SEC enforcement actions.<sup>251</sup> It is true that the SEC has certain causes of action available to it that are not available to private litigants, which some supporters of *Janus* have used to suggest that the SEC enforcement arm still adequately protects investors.<sup>252</sup> For instance, the SEC can bring claims of aiding and abetting against potential violators of 10b-5, claims which are not available to private litigants after *Central Bank*.<sup>253</sup> But in order to bring a claim of secondary liability—such as an aiding and abetting claim under Section 20(e) of the Exchange Act or a control person liability claim under Section 20(a) of the Exchange Act<sup>254</sup>—the SEC must first

<sup>249</sup> Brief for Attorney’s Liab. Assurance Soc’y, Inc., As Amici Curiae in Support of Respondent, *supra* note 244, at 5.

<sup>250</sup> *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 166 (2008) (“The enforcement power is not toothless. Since September 30, 2002, SEC enforcement actions have collected over \$10 billion in disgorgement and penalties, much of it for distribution to injured investors.”).

<sup>251</sup> See *supra* note 105 and accompanying text. This is very similar to what happened in the aftermath of *Central Bank*. Though that case only involved a private 10b-5 action, courts subsequently imposed the holding—that claims of aiding and abetting were no longer available under 10b-5—on the SEC as well. This became accepted such that it took Congressional action for aiding and abetting claims to be available to the SEC. See *supra* notes 38–44 and accompanying text.

<sup>252</sup> *King*, *supra* note 105, at 430.

<sup>253</sup> See *supra* text accompanying note 44.

<sup>254</sup> Section 20(a) creates a cause of action against individuals who exercise

establish an underlying primary violation.<sup>255</sup> Since *Janus* will apply to any primary violation the SEC seeks to litigate, the SEC's ability to establish the requisite underlying primary violation will be limited. Without the ability to establish the underlying violation, the SEC will be unable to utilize its claims of secondary liability against those wrongdoers who participated in the fraud. And the fact that the *Janus* holding may ultimately be extended to litigation under other securities laws like Section 17(a) of the Securities Act further frustrates this problem.<sup>256</sup>

Furthermore, the private right of action takes on increased importance as a means of achieving the goals of the federal securities laws when one considers the current political and regulatory environment. The SEC is frequently criticized for failing to adequately police markets and for routinely settling claims with wrongdoers, who are not required to admit the charges against them, rather than pursuing litigation.<sup>257</sup> For instance, the fact that the SEC failed to identify the Bernie Madoff Ponzi scheme, despite having made numerous inquiries into his business, generated a large backlash against the regulatory agency.<sup>258</sup>

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control over a controller person, such as a corporation, that has committed a violation of 10(b). 15 U.S.C. § 78t(a) (2006). It imposes secondary liability on the controlling person for the fraud committed by the one who is controlled. *In re Merck & Co., Sec. Derivative & "ERISA" Litig.*, No. 2:05-cv-02367-SRC-MAS, 2011 WL 3444199, at \*36 (D.N.J. Aug. 8, 2011).

<sup>255</sup> See, e.g., *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 168 (1994) (setting forth the first element of a claim of aiding and abetting as requiring a showing of "a primary violation of Section 10(b)"); *Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 635–36 (11th Cir. 2010) (holding that, since 20(a) imposes derivative liability on control persons for violations committed by others, a plaintiff must plead an underlying primary violation to state a viable 20(a) claim). See also, Rains, *supra* note 36, at 11 ("Courts generally have agreed that, at a minimum, a plaintiff must prove that the 'controlled' person committed a primary violation, and that the 'control' person, in some fashion, had 'control' over the 'controlled' person.").

<sup>256</sup> See *supra* notes 215–25 and accompanying text.

<sup>257</sup> See, e.g., Amitai Etzioni, *What Happens When Wall Street Breaks the Law? Not Much*, CNN OPINION (Nov. 30, 2011, 7:33 AM), <http://www.cnn.com/2011/11/30/opinion/etzioni-sec/index.html>. It should be noted that settling with defendants and allowing them to avoid admitting liability is not necessarily as negative a consequence as this critic would suggest. Settling, rather than litigating, conserves already scarce resources. Additionally, allowing defendants to not admit liability potentially allows recovery from the deeper pocket of the D&O insurer rather than the individual him or herself who may in effect be judgment-proof. See *infra* notes 271–274 and accompanying text for further discussion of this issue.

<sup>258</sup> See, e.g., Declan McCullagh, *Court Documents Show How SEC Failed to Nab Madoff in 2006*, CBS MONEY WATCH (Mar. 12, 2009, 4:09 PM), [http://www.cbsnews.com/8301-503983\\_162-4862380-503983.html](http://www.cbsnews.com/8301-503983_162-4862380-503983.html).

Few critics seem to recognize, however, the limited resources that the SEC has to pursue such investigations.<sup>259</sup> In 2011, for instance, the Congressional appropriations committee cut the SEC's budget request for 2012 by \$222.5 million,<sup>260</sup> despite the fact that the SEC's responsibilities were expanded by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>261</sup> In so cutting the budget request, the committee specifically referenced the SEC's track record dealing with Ponzi schemes and pointed to concern over the federal deficit.<sup>262</sup> Each of these rationales for cutting the SEC's budget is puzzling. It is likely, at least in part, *because* of the SEC's lack of resources that it was unable to detect the Madoff scheme in the first place.<sup>263</sup> Additionally, the SEC's use of funds does not contribute to the deficit in that the SEC is financed by the fees it imposes on those it regulates and, in fact, the SEC actually generates revenue in the form of fines and disgorgements.<sup>264</sup> It is likely that the SEC's ability to police the market is subject to shifting political winds.

Even before the SEC was charged with the expanded

<sup>259</sup> Cosenza, *supra* note 1, at 1027–28 (“Even though the SEC has broad authority to bring enforcement actions, its limited resources prevent it from detecting and/or prosecuting even the most flagrant abuses of the securities laws.”).

<sup>260</sup> James B. Stewart, *As a Watchdog Starves, Wall Street is Tossed A Bone*, N.Y. TIMES, Jul. 15, 2011, *available at* [http://www.nytimes.com/2011/07/16/business/budget-cuts-to-sec-reduce-its-effectiveness.html?\\_r=1&pagewanted=all](http://www.nytimes.com/2011/07/16/business/budget-cuts-to-sec-reduce-its-effectiveness.html?_r=1&pagewanted=all).

<sup>261</sup> According to the United States Senate Committee on Banking, Housing, & Urban Affairs, the Dodd-Frank Act was enacted to “create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street and big bonuses, end bailouts and too big to fail, [and] prevent another financial crisis.” S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, *available at* [http://banking.senate.gov/public/\\_files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf). It expands in the SEC's regulatory reach in a number of ways. For instance, Dodd-Frank gives the SEC authority to regulate over-the-counter derivatives, requires hedge funds and private equity advisors to register with the SEC, creates an Office of Credit Ratings at the SEC, and institutes a new SEC whistleblower program, just to name a few of the changes. *Id.*

<sup>262</sup> Stewart, *supra* note 260.

<sup>263</sup> In fact, at least one investigation was stalled when the team investigating Madoff was shifted to a different, seemingly higher priority investigation, since the SEC did not have enough staff to conduct both simultaneously. *Id.* In this light, the idea of cutting funding because of failure to adequately catch wrongdoers seems preposterous. If the police were unable to prevent a rash of murders in a high-crime area of a city due to lack of police presence in that area, surely the most immediate response would not be that, since the police were incompetent, their budget should be cut, thereby leaving even fewer officers to monitor and respond to calls in the high-crime area.

<sup>264</sup> *Id.*

responsibilities of Dodd-Frank, the SEC struggled with underfunding.<sup>265</sup> Manpower is costly (and additional manpower is potentially unavailable due to a recent hiring freeze), litigation is expensive, and resources—such as sophisticated IT functions to ease the burden of document review and production in cases that are frequently document-intensive—are limited or nonexistent.<sup>266</sup> As such, the SEC may find itself in the position of having to restrict its operations by settling cases it might otherwise litigate, closing investigations sooner than desired, and restricting investigations of overseas companies due to the expense of travel.<sup>267</sup> Making sure the private right of action remains strong can help supplement the SEC enforcement arm, particularly in this political climate where the SEC, serving as Congress's scapegoat for corporate greed, is struggling with underfunding.

Additionally, allowing private litigants and the SEC to pursue claims against individual wrongdoers and secondary actors provides compensation to victims of fraud where otherwise no remedy would be available. For instance, in *Janus*, JIF—the business trust set up to hold the mutual funds—was the only entity that could be held liable.<sup>268</sup> But since it had no assets of its own with which to compensate plaintiffs, plaintiffs were left without a remedy.<sup>269</sup> Even in instances where the issuer does have assets from which to satisfy claims, allowing recovery against corporate insiders and secondary actors removes the problem of the circular recovery whereby plaintiffs are limited to recovering only from the corporate entity itself, thereby reducing the share value of all shareholders' stock, and effectively transferring wealth from the shareholders who are outside of the class of plaintiffs to those within.<sup>270</sup> By allowing litigants to

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<sup>265</sup> The SEC regulates more than 35,000 institutions. Under the new legislation, hedge fund advisors would be added as well. *Id.*

<sup>266</sup> Punctuating the resources issue is the stark disparity between the resources of the SEC and those it regulates. “[I]n 2009 Citigroup and JPMorgan Chase . . . spent \$4.6 billion each—four times the S.E.C.’s entire annual budget—on information technology alone.” *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> *Janus*, 131 S. Ct. at 2304.

<sup>269</sup> Editorial, *So No One’s Responsible*, *supra* note 86.

<sup>270</sup> Cosenza, *supra* note 1, at 1075 (“Because damages in securities actions against issuers are ultimately borne by the issuer’s own shareholders, such lawsuits have been criticized as a series of pocket-shifting wealth transfers from shareholders who purchased outside the class period to shareholders who purchased during the class period. This criticism does not apply to actions brought against secondary actors.”) Just as this criticism does not apply to actions brought against secondary actors, it would not apply to actions brought against corporate insiders, assuming indemnification by their corporate employers was not permitted.



proceed against the corporate insiders, and not just the corporate issuer, victims of fraud have an additional avenue of relief. While allowing plaintiffs to pursue claims against corporate insiders might not provide the same deep pockets as does pursuing claims against secondary actors like investment banks and accounting firms,<sup>271</sup> it would at least avoid the circularity problem, assuming indemnification from their corporate employers is not an option, and provide plaintiffs with another avenue for relief.<sup>272</sup> And given the fact that executive compensation has soared in the past decade, some of these individuals may have fairly substantial personal assets capable of satisfying these claims.

Even in those instances where the individual does not have substantial personal assets, such claims may be able to be satisfied out of corporate directors and officers (D&O) insurance policies. It is true that D&O policies typically contain conduct-based exclusions, which exclude losses arising from certain conduct, such as fraud or intentional violation of the law.<sup>273</sup> But such exclusions frequently are limited to situations where such fraudulent conduct has been established by a final adjudication of a court of competent jurisdiction.<sup>274</sup> The SEC has long had a policy of resolving

<sup>271</sup> For instance, in the Enron securities litigation, plaintiffs obtained approximately seven billion dollars in settlement from investment bank advisors alone. Cosenza, *supra* note 1, at 1077.

<sup>272</sup> See *infra* Part V.B.1 for additional discussion of indemnification considerations.

<sup>273</sup> See, e.g., *Farkas v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 861 F. Supp. 2d 716, 723 (E.D. Va. 2012) (involving a D&O policy with an exclusion for acts "arising out of, based upon or attributable to the committing in fact of any criminal, fraudulent or dishonest act, or any willful violation of any statute, rule or law."); *Endurance Am. Specialty Co. v. Lance-Kashian & Co.*, No. CV-F-10-1284-LJO-BAM, 2011 WL 5417103, at \*5 (E.D. Cal. Nov. 8, 2011) (discussing a D&O policy with an exclusion for acts that are intentionally dishonest, fraudulent, or criminal); *In re Enron Corp. Securities, Derivative & "Erisa" Litigation*, 391 F. Supp. 2d 541, 559 (S.D. Tex. 2005) (involving an exclusion to a D&O policy for acts "brought about or contributed to by the dishonest, fraudulent, criminal or malicious act or omission"); see also, Kara Altenbaumer-Price, *Loss of SEC 'Neither Admit, Nor Deny' Settlements Could Have Significant Impact*, PLUS BLOG (May 22, 2012, 8:26 AM), <http://plusblog.org/2012/05/22/loss-of-sec-neither-admit-nor-deny-settlements-could-have-significant-impact/>.

<sup>274</sup> See, e.g., *Farkas*, 861 F. Supp. 2d at 721-22 (interpreting a D&O policy's exclusion for the commission of certain acts "in fact" as requiring a final adjudication or "at least some evidentiary proof that the insured reaped an illegal profit") (quoting *PMI Mortg. Ins. Co. v. Am Int'l Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 WL 825266, at \*5-6 (N.D. Cal. Mar. 29, 2006)); *Endurance Am. Specialty Co.*, 2011 WL 5417103, at \*5 (E.D. Cal. 2011) (analyzing a D&O policy with an exclusion for acts that are "intentionally dishonest, fraudulent, or [a] criminal act of any Insured as determined by a final adjudication . . ."); *In re Enron Corp.*, 391 F. Supp. 2d at 572 (interpreting a D&O policy with an exclusion for acts involving "dishonest,

enforcement actions without requiring the defendant to admit liability.<sup>275</sup> Instead, the SEC frequently allows defendants to settle claims on a “neither admit, nor deny” basis.<sup>276</sup> As such, in enforcement actions at least, the limits of a D&O policy may still be available to satisfy judgments. Even when recovery under a D&O policy is not possible and where the individual defendant does not have substantial assets to satisfy the claim, the goal of deterrence is still satisfied by allowing litigants to pursue these individual wrongdoers.

## V. RECOMMENDATIONS

### A. Legislative Adoption of the Creator Standard

In the wake of *Janus* and its ensuing confusion in the lower courts about how to apply the “ultimate authority” test and the potential for the 10b-5 right of action for misrepresentation to be unreasonably curtailed, it is clear that legislative action is necessary. The extremely pro-business stance taken by the Supreme Court in *Janus* has left some wondering whether some businesses are not only too big to fail, but also “too big to be held accountable.”<sup>277</sup> As such, just as Congress took up the issue of 10b-5 liability in the wake of the *Central Bank* decision, Congress must do so again now.

Through Congressional action, the *Janus* “ultimate authority”

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fraudulent, criminal, or malicious act[s] or omission[s]” if a “final adjudication establishes that acts of active and deliberate dishonesty were committed . . . with actual dishonest purpose and intent and were material to the cause of action so adjudicated”).

<sup>275</sup> Thomas O. Gorman, *Neither Admit Nor Deny is Not the Issue in SEC Settlements*, LEXISNEXIS COMMUNITIES: SEC. L. BLOG (May 21, 2012, 10:17 AM), <http://www.lexisnexis.com/community/corpsec/blogs/corporateandsecuritieslaw/blog/archive/2012/05/21/neither-admit-nor-deny-is-not-the-issue-in-sec-settlements.aspx>.

<sup>276</sup> The practice of allowing defendants to resolve litigation with the SEC through settlements on a neither admit nor deny basis was recently called into question by Judge Rakoff in *SEC v. Citigroup* when he rejected a settlement, citing the practice. 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011). But the Second Circuit upheld the SEC’s practice on appeal. *SEC v. Citigroup Global Mkts., Inc.*, 673 F.3d 158, 163–65 (2d Cir. 2012).

<sup>277</sup> *Barriers to Justice and Accountability: How the Supreme Court’s Recent Rulings Will Affect Corporate Behavior: Hearing Before the S. Comm. on the Judiciary*, 112th Cong. (2011) (statement of the Honorable Patrick Leahy, U.S. Senator), *available at* [http://www.judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit\\_id=3d9031b47812de2592c3baeba607fb62-0-1](http://www.judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit_id=3d9031b47812de2592c3baeba607fb62-0-1). Senator Leahy pointed out that this was the most pro-business Court in seventy-five years, noting that under Chief Justice Roberts, the Court has ruled in a pro-business fashion in sixty-one percent of its cases.

test should be abandoned in favor of a version of the SEC's proposed "creator" standard.<sup>278</sup> Under the creator standard, there would be no limit on the number of individuals who could be held accountable for a particular misstatement. In other words, any suggestion in *Janus* that there can be only one maker of a misstatement held responsible would be set aside. Under the "creator" standard, individuals will be able to "make" a statement if they created it, wrote it, or played a substantial enough role in the creation or writing of it so as to be considered the author or co-author of the statement.<sup>279</sup> This should be so even if the creator is not expressly publicly identified.<sup>280</sup> Express attribution of a statement to an individual or entity could certainly be strong evidence suggesting that someone was a maker of a statement, but it would not be necessary to find liability and it would not limit liability solely to the person to whom the statement was expressly attributed.

Using the creator standard instead of the ultimate authority test would serve to eliminate the flawed analogy presented in *Janus* of the relationship between the speechwriter and the speech giver.<sup>281</sup> The Court's notion that it is the speech giver who has ultimate authority over the statements delivered, not the speechwriter—and therefore it is the giver, not the writer, who should be held liable—leads to potentially haphazard results. For instance, if it is only the speech giver who can be liable in that scenario, it becomes impossible to impose liability in the frequent circumstance where the equivalent of the speech giver (e.g., the CFO signing a public filing) does not have the requisite scienter. Using the creator standard and abandoning the speechwriter analogy would enable plaintiffs to hold culpable individual corporate insiders accountable for the wrongdoing and reflect the corporate reality that it is typically not just one person who has responsibility for a statement.

Replacing the ultimate authority test with the creator standard would also alleviate the problem that, to the extent that there is one

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<sup>278</sup> Brief for the United States as Amicus Curiae Supporting Respondent, *supra* note 92, at 14.

<sup>279</sup> *Id.*; see also, Cosenza, *supra* note 1, at 1047.

<sup>280</sup> *Id.*

<sup>281</sup> Additionally, lower courts and administrative agencies have already begun to abandon the analogy in their application of the ultimate authority test. For instance in the administrative proceeding, *In re Flannery*, the administrative law judge held that the person who gave a presentation was not the one with ultimate authority over the content of the presentation because he was merely delivering the message created by another that he was asked to deliver as part of his job. *In re Flannery*, Exchange Act Release No. 438, 2011 WL 5130058, at \*38 (ALJ Oct. 28, 2011). For a more complete discussion of this case, see *supra* Part III.A.

person who might be considered to have ultimate authority based on a public attribution of the statement to the individual, that person often does not have the requisite scienter for liability to attach. For instance, under the creator standard, if a CFO signs a SOX certification attached to financials containing misstatements, that public attribution to the CFO might be seen as evidence that he was the (or one of the) creator(s) of the statement. If the other elements of 10b-5 liability could be met, including scienter, he could be held liable. But if the CFO was duped by other less senior officers within the enterprise into thinking the financials were true, that CFO would likely not have the requisite scienter to establish liability, unless he was severely reckless. Under *Janus*, in this scenario, potentially no one would be held accountable (particularly if the wrongdoer's scienter could not be imputed to the corporation). Under the creator standard, however, though the CFO might not be liable, the less senior officers with culpability could be.

Finally, by allowing the imposition of liability on corporate insiders and secondary actors in appropriate circumstances, beyond what is allowable under *Janus*, the creator standard will give victims of fraud additional avenues of relief over and above the relief from the issuer itself, thereby avoiding the problem of the circular recovery, or as in the case of *Janus*, no recovery at all. This would serve to promote the underlying goals of the federal securities laws to deter and punish fraud, to compensate victims, and to increase investor confidence in the markets.

Ideally, this legislative solution of adopting the creator standard would apply to the SEC enforcement action and to the private cause of action alike. At a minimum, however, this standard should be adopted for SEC enforcement actions.

#### *B. Judicial Considerations Prior to Congressional Action*

While waiting for congressional action to replace the "ultimate authority" test of *Janus* and resolve the question of who the "maker" of a statement is for 10b-5 purposes, district courts and circuit courts will be faced with considering two issues in particular: (1) how the issue of collective scienter should be resolved in light of *Janus*, and (2) whether the *Janus* ultimate authority test should be applied to other federal securities laws.

##### 1. Collective Scienter Issue

Courts looking at the issue of collective scienter should adopt a hybrid rule that does not go as far as the broadest forms of collective

scienter—allowing imputation of scienter from the aggregate knowledge of all employees—or even so far as the watered down version of collective scienter—allowing imputation so long as at least one management-level employee had scienter.<sup>282</sup> But the proposed rule should also not reject collective scienter outright. Specifically, rather than allowing imputation of the scienter only from the “maker” of the statement (which post-*Janus* would presumably be the one person or entity with “ultimate authority” over the statement), courts should allow imputation of scienter from anyone who contributed to the making of the statement. In other words, courts should impose something of a “creator” standard to the issue of collective scienter. This is not without precedent prior to *Janus*.<sup>283</sup> At least one district court has considered this issue since *Janus* and held that the court can look not only to the state of mind of “the individual corporate official . . . who made the statement, but also [to] those who order or approve it or its making or issuance, or who furnish information or language for inclusion therein or the like.”<sup>284</sup>

Critics of the collective scienter theory have pointed out that it places the onus of identifying employees with knowledge of the falsity of the statement on the corporation, an approach that “may be akin to finding a needle in a haystack.”<sup>285</sup> Because the knowledge in those instances is so deeply embedded within the corporation, the corporation is in no better position than the SEC to detect the person with actual scienter and therefore, imposing liability on the corporation does not promote deterrence.<sup>286</sup> Additionally, the costs of focusing perhaps “more [corporate] resources than appropriate on the area of corporate disclosures . . . outweigh [any] marginal benefits” that might result in the public disclosures.<sup>287</sup> Critics have also argued that the use of collective scienter makes it difficult to predict what types of cases would be pursued and therefore difficult to counsel corporate clients on compliance.<sup>288</sup>

But these concerns would be tempered by the fact that the form of collective scienter proposed here is more similar to the rule proposed in that line of cases rejecting collective scienter than it is to

<sup>282</sup> See *supra* Part III.B.2 for a more thorough discussion of collective scienter.

<sup>283</sup> *Southland Securities Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004); see also *supra* notes 201–204 and accompanying text.

<sup>284</sup> *Kerr v. Exobox Techs.*, CV No. H-10-4221, 2012 WL 201872, at \*14 (S.D. Tex. Jan. 23, 2012) (citation omitted).

<sup>285</sup> Bondi, *supra* note 164, at 26.

<sup>286</sup> *Id.*

<sup>287</sup> *Id.* at 27.

<sup>288</sup> *Id.* at 28.

those jurisdictions that permit theories of collective scienter. The limited form of collective scienter proposed here would merely serve to counter-act the potential effect of *Janus* of eliminating not only claims against secondary actors and corporate insiders, but also claims against the issuer itself. With the new limitations imposed on asserting 10b-5 claims, Senator Patrick Leahy has commented that plaintiffs' ability "to band together to hold corporations accountable" that have engaged in fraud "has been seriously undermined by the Supreme Court."<sup>289</sup> In the aftermath of *Janus*, the benefits of a weak form of collective scienter would outweigh the potential costs.

Additionally, this proposal only applies to situations where scienter is imputed from the wrongdoer to the corporate issuer itself—it does not go so far as to say that the scienter of the wrongdoer should be able to be attributed to a different officer or employee. If courts are willing to impute the scienter of the wrongdoer to the employee or officer to whom attribution is given, there is a real possibility there would be a significant chilling effect of such a rule that imposes liability on the CFO or other corporate officer merely for signing a public filing. Though state corporate codes typically allow for indemnification of directors and sometimes officers when they are sued in their corporate capacity, such indemnification provisions are typically limited. For instance, under the Model Business Corporation Act, indemnification by the corporation is only permissible if the individual acted in good faith and believed his actions were in the best interests of the corporation.<sup>290</sup> Corporations are also free to put additional limitations on indemnification in their charter documents,<sup>291</sup> and some elect to limit indemnification to directors or officers who did not act in a way that was reckless or involved willful misconduct.<sup>292</sup> For a director or officer to be found liable for (or guilty of) 10b-5 securities violations, the showing of scienter would likely be enough to establish that indemnification would not be appropriate.<sup>293</sup>

<sup>289</sup> *Barriers to Justice and Accountability: How the Supreme Court's Recent Rulings Will Affect Corporate Behavior: Hearing Before the S. Comm. on the Judiciary*, 112th Cong. (2011) (statement of the Honorable Patrick Leahy, U.S. Senator), *available at* [http://www.judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit\\_id=3d9031b47812de2592c3baeba607fb62-0-1](http://www.judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit_id=3d9031b47812de2592c3baeba607fb62-0-1).

<sup>290</sup> MODEL BUSINESS CORPORATION ACT § 8.51 (2008); *see also* DEL. CODE. ANN. tit. 8, §145 (2011). And, in a criminal proceeding, indemnification is only permissible if the defendant had no reasonable cause to believe his or her conduct was unlawful. *See, e.g.*, DEL. CODE. ANN. tit. 8, § 145.

<sup>291</sup> *See, e.g.*, WISC. STAT. § 180.0852 (2012).

<sup>292</sup> Rains et al., *supra* note 101, at 5.

<sup>293</sup> *In re Crazy Eddie Securities Litigation*, 740 F. Supp. 149, 151 (E.D.N.Y. 1990)

Moreover, many courts have expressly held that indemnification is not available for federal securities law claims, especially for claims involving intentional—rather than negligent—misconduct.<sup>294</sup> The threat of liability without indemnification—even where the accused was an unknowing participant—could have a negative impact on the ability of corporations to find qualified individuals willing to serve in these roles.<sup>295</sup> This proposal attempts to avoid that outcome by allowing courts to impute scienter of the wrongdoer, but only for purposes of assessing the corporation’s liability—not that of other corporate insiders.

Arguably, if Congress were to adopt the creator standard of liability, thereby rejecting the *Janus* standard, the issue of collective scienter would take care of itself. Even in jurisdictions that reject notions of collective scienter, scienter can be imputed from the “maker” of the statement. If the “maker” is defined using the creator standard, the proposed rule for collective scienter articulated above would, by default, be adopted. Therefore, the proposed judicial action is only necessary as a stop-gap until a legislative solution is

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(holding that because indemnification is not available to parties who have knowingly and willfully violated the securities laws, and because scienter is required to be liable for 10(b) violations, indemnification was not available); see also EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORP. OFFS. & DIRS., DUTIES & LIAB. § 19:9 (2011).

<sup>294</sup> Dept. of Econ. Dev. v. Arthur Anderson & Co., 747 F. Supp. 922, 931 (S.D.N.Y. 1990); Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540, 549 (D. Colo. 1989); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969). In fact, courts have consistently held that indemnification with respect to willful violations of the securities laws, such as 10(b) of the Exchange Act, is against public policy. BRODSKY & ADAMSKI, *supra* note 293, at §19:9. Even in cases involving securities laws that require only a negligence standard of liability, some courts have found that indemnification is inappropriate. *Id.* The exception to the basic rule that directors and officers cannot recover for securities laws claims is that they will be able to recover when they did not admit liability or they otherwise prove they were not at fault. Greenwald v. Am. Medcare Corp., 666 F. Supp. 489, 493 (S.D.N.Y. 2006); Raychem Corp. v. Federal Ins. Co., 853 F. Supp. 1170, 1177–79 (N.D. Cal. 1994). The PSLRA, for instance, allows for indemnification where the defendant prevails. See 15 U.S.C. § 78u-4(f)(2)(B)(ii) (2006). It should be noted that at least one state’s corporate code expressly provides that directors and officers can be indemnified for violations of securities laws. WISC. STAT. § 180.0859 (2012). But such indemnification is still subject to the other provisions of the code, and elsewhere in the code, indemnification is disallowed for behavior involving willful misconduct or a transaction from which the director or officer received an improper personal benefit. WISC. STAT. § 180.0851(2)(a) (2012). As such, indemnification would likely still not be possible in the face of a 10b-5 violation where scienter has been established.

<sup>295</sup> One way that this chilling effect is mitigated is through a corporation’s offer to indemnify defendants for settlements in which they have not admitted liability. BRODSKY & ADAMSKI, *supra* note 293, at § 19:9; see *supra* note 275 and accompanying text for further discussion.

enacted.

It is not just the courts that will have the opportunity to act in the interim before a legislative solution is adopted; corporations may be able to take ameliorating actions as well. Specifically, if courts continue to find that express attribution is enough to satisfy the *Janus* test, it may be wise for corporations and corporate insiders to begin to use strategic allocation of liability through attribution.<sup>296</sup> For instance, a board of directors might adopt a resolution delegating “ultimate authority” over particular public statements to a specific officer or employee.<sup>297</sup> It is not clear whether such a non-public attribution would be effective after *Janus* to immunize all others from liability who are not mentioned in the corporate resolution. This would likely be analyzed as a case of “implicit” attribution.<sup>298</sup> But even a decision by a corporation to allocate attribution publicly—by having a particular officer sign a filing for instance—may be ineffective. While it may be a seemingly good prophylactic measure by corporations to distribute potential liability to whom it considers to be the appropriate parties, it is unclear what effect this will have on liability distribution. For instance, if this is in fact a successful means of limiting the universe of potential “makers” of a statement to one individual, the question will become whether or not such a “maker”—for instance, one who has signed a public filing—will have the requisite scienter to find 10b-5 liability, as discussed in Part III.A *supra*. Even though the effectiveness of such express attribution to cut off liability to some and assign it to others is still in question, however, attribution will certainly at least be a factor in courts’ decisions and may help corporations allocate liability to the person or persons within the entity who should most appropriately bear responsibility.<sup>299</sup>

## 2. Application to Other Federal Securities Laws

In addressing the issue of whether *Janus* should be extended beyond 10b-5 to other federal securities laws such as Section 17(a) of the Securities Act, Section 14(a) of the Exchange Act, and Section 34(b) of the Investment Company Act, district courts should

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<sup>296</sup> Rains et al., *supra* note 101, at 7.

<sup>297</sup> *Id.* at 4.

<sup>298</sup> Obviously, questions of implicit attribution are even more complicated than those of express attribution. While *Janus* seems to specifically account for this scenario of implicit attribution, the Court did not illustrate what kinds of actions on the part of a defendant would allow for “implicit attribution” of misstatements to an individual, such that he or she would be considered the maker of that statement.

<sup>299</sup> Rains et al., *supra* note 101, at 7.



continue to follow the lead of the majority of the handful of district courts that have already decided this issue and similarly hold that *Janus* should not be so extended. Federal securities laws that do not contain the operative word “make” should easily be excluded from application of the *Janus* rule. And those that provide for the operative word, such as Section 34(b) of the Investment Company Act, frequently do not include private rights of action. Therefore, the policy behind the *Janus* decision—to curb the expansion of the private right of action—would not be served by application of the rule in these cases. Extending *Janus* to these other areas of securities laws would unnecessarily and unreasonably further limit the ability of private litigants and the SEC to fulfill the goals of the federal securities laws.

## VI. CONCLUSION

A year has passed since the Supreme Court handed down its decision in *Janus*. In *Janus*, the Court attempted to curb the expansion of the 10b-5 private right of action by providing a bright line rule between what constitutes a primary violation of 10b-5—and thus actionable by private litigants—and what merely constitutes a secondary violation for which private litigants should have no recourse. In the year since the opinion, however, activity in the lower courts has shown that this rule does not provide the clear line that it purports to.

In the wake of *Janus*, lower courts have been faced with a number of questions for which the Supreme Court provided no obvious answers. For instance, generally the lower courts are in agreement that *Janus* applies to corporate insiders, not just secondary actors as in *Janus*. But they are not necessarily in agreement as to how *Janus* should apply.<sup>300</sup> Some lower courts have dismissed claims involving insiders on the grounds that these individuals did not have ultimate authority over the statement.<sup>301</sup> Other courts have allowed claims against insiders to proceed where the misstatements were expressly publicly attributed to the insiders.<sup>302</sup> Even if these claims are allowed to proceed to trial, however, success of the plaintiffs on the merits seems unlikely in light of the other requirements of 10b-5 liability—specifically, the requirement that the defendant have the requisite state of mind. In such cases, the individual director or

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<sup>300</sup> See *supra* notes 111–33 and accompanying text.

<sup>301</sup> See *supra* notes 112–28 and accompanying text.

<sup>302</sup> See *supra* notes 129–33 and accompanying text.

officer to whom a statement is publicly attributed—such as the CFO signing a SOX certification or a chief marketing officer making a press announcement—may have no reason to know that the data he or she is signing off on contains fraudulent information. While there may be policy reasons for holding this individual liable for the misstatement anyway, such liability will not attach pursuant to Rule 10b-5 because of a lack of scienter. And the person who actually prepared the fraudulent information upon which the public announcement was made also will not be liable under 10b-5 because, after *Janus*, such an individual did not “make” the misrepresentation. It would seem that Justice Breyer’s prediction—that “guilty management” might fool both the board and management, yet, after *Janus*, no one would be liable<sup>303</sup>—will have come true.

Yet even more troubling than the impact of *Janus* on the potential liability of culpable insiders is the fact that, in many jurisdictions, *Janus* has the potential to thwart claims against even the issuers to which the misstatements are attributed. In jurisdictions rejecting theories of collective scienter, courts will only impute the scienter of an individual to the entity in instances where the individual also was the “maker” of the statement. Since *Janus* limits the universe of who can be a potential “maker,” there is a distinct possibility that the insider who is considered the “maker” of the misstatement will not be the same as the insider who has scienter. If the maker and the individual with scienter are not the same person, a court may find that the scienter of the individual cannot be imputed to the corporation, and therefore the issuer will not be found liable. In such a circumstance, a plaintiff may be entirely without recourse for a 10b-5 violation. Even in jurisdictions that have historically allowed a theory of collective scienter, the question of whether such theory survives *Janus* remains unanswered.

Moreover, since the *Janus* holding most likely applies to the SEC just as it does to corporate insiders, the SEC’s enforcement arm is just as limited by the holding as are private litigants. And even though the SEC has the ability to pursue other secondary claims—such as for aiding and abetting and for control person liability—each of these requires a showing of an underlying primary violation. Since any underlying violation would be subject to *Janus*, the SEC’s ability to pursue these secondary violations is limited. Finally, since some lower courts are extending the *Janus* ruling to actions brought under other federal securities laws, the SEC’s reach may be even further

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<sup>303</sup> *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2310 (2011) (Breyer, J., dissenting).

limited.

As these cases continue to work their way through the lower courts and into the courts of appeals, we will hopefully see resolution of some of the uncertainty surrounding the *Janus* decision. But as the courts apply *Janus* to corporate insiders, and fail to resolve the collective scienter issue, issuers and insiders alike will be able to perpetrate frauds unchecked. Corporations and corporate insiders should not be able essentially to launder public misstatements by making sure the corporate mouthpiece to whom they are attributed is not the same as the person with the fraudulent intent.

A legislative solution appears necessary to remedy the injustice that *Janus* promotes. Through Congressional action, the ultimate authority test should be abandoned in favor of the SEC's proposed creator standard, and this standard should apply to both SEC enforcement actions and the private right of action. This would allow imposition of liability on those who created a statement, wrote it, or played a substantial enough role in its making so as to be considered an author or co-author. Further, this would alleviate the problem of not being able to establish one person or entity that has both the requisite scienter and is considered the maker of the statement.

In the absence of legislative action, courts should resolve the collective scienter issue by adopting a hybrid rule that allows imputation of scienter not only from the maker of the statement but also from anyone who contributed to the making of the statement in such a way to be considered its author or co-author. This would ensure that the issuer will not be able to avoid liability simply because the person with the scienter was not also the person with "ultimate authority" over the statement. Instead, scienter of any individual who played a large enough role in the authoring of the misstatement could be imputed to the corporation. Finally, courts should refuse to extend the *Janus* rule to claims involving other federal securities laws, such as Section 17(a) of the Securities Act and Section 14(a) of the Exchange Act. Corporate securities fraud is as big of an issue as it ever has been and reform is necessary in order to ensure the sanctity and vitality of the U.S. capital markets.