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U.S. Court of Appeals for the Second Circuit Holds That Scheme Liability After Lorenzo Requires Conduct Beyond Misstatements and Omissions

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On July 15, 2022, the United States Court of Appeals for the Second Circuit issued an important decision addressing the scope of scheme liability after *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019), in securities actions brought under Section 10(b) of the Securities Exchange Act of 1934 and Section 17(a) of the Securities Act of 1933. In *SEC v. Rio Tinto plc* (No. 21-2042), the Second Circuit held that *Lorenzo* did not abrogate existing case law holding that scheme liability requires something beyond misstatements and omissions.

As a result of the *Rio Tinto* decision, plaintiffs within the Second Circuit will not be permitted to allege a purported "scheme" based on misrepresentations or omissions unless they can point to some additional fraudulent conduct beyond the misstatements or omissions themselves.

Background

The *Rio Tinto* decision arises out of a securities-fraud suit that the Securities and Exchange Commission ("SEC") filed in 2017 against mining company Rio Tinto and its former CEO Thomas Albanese and former CFO Guy Elliott. The underlying fraud claims pertain to the timing of Rio Tinto's decision to impair an undeveloped, exploratory coal-mining asset in Mozambique that Rio Tinto acquired in August 2011 and recorded as impaired in January 2013.

In March 2019, the district court dismissed the SEC's scheme liability claims as inactionable under *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), because the sole basis for those claims were alleged misrepresentations and omissions—*e.g.*, statements in Rio Tinto's 2011 Annual Report, statements in bond-offering documents, statements to shareholders, and the alleged omission of information previously learned about the coal asset.

A few days later, the Supreme Court issued its *Lorenzo* decision, which expanded the scope of scheme liability to include fraudulent dissemination. The SEC moved to reinstate its scheme liability claims, arguing that *Lorenzo* abrogated *Lentell*'s holding that scheme liability requires fraudulent conduct beyond any misstatements or omissions. Although the district court denied reconsideration, in 2021 the SEC was granted leave to file an interlocutory appeal with the Second Circuit.

After *Lorenzo*, Scheme Liability Still Requires Conduct Beyond Misstatements and Omissions

The issue on appeal in *Rio Tinto* was whether "misstatements and omissions—without more—can support scheme liability" under Rule 10b-5(a) and (c) and related provisions under Section 17. Slip Op. 5.

Long before *Lorenzo*, the Second Circuit had held that additional conduct was required. In *Lentell*, the Second Circuit held that, "where the sole basis for [scheme] claims is alleged misrepresentations or omissions, plaintiffs have not made out a . . . claim under Rule 10b-5(a) and (c)." 396 F.3d at 177.

In *Lorenzo*, the Supreme Court expanded scheme liability to encompass "those who do not 'make' statements" within the meaning of Rule 10b-5(b), "but who disseminate false or misleading statements to potential investors with the intent to defraud." 139 S. Ct. at 1099. The Court noted, however, that "[p]urpose, precedent, and circumstance, could lead to narrowing [the] reach" of the scheme liability provisions "in other contexts." *Id.* at 1101.

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Rio Tinto now establishes that "*Lentell* remains sound" after *Lorenzo*, Slip Op. 2, meaning that scheme liability still "requires something *beyond* misstatements and omissions," *id.* at 4–5. The Second Circuit emphasized that "misstatements or omissions were *not* the sole basis for scheme liability in *Lorenzo*. The *dissemination* of those misstatements was key." *Id.* at 16.

The Second Circuit also provided several reasons why it refused to read *Lorenzo* more expansively:

- If misstatements or omissions alone were sufficient to constitute a scheme, "the scheme subsections would swallow the misstatement subsections" of Rule 10b-5(b) and Section 17(a)(2), Slip Op. 18;
- "*Lorenzo* signaled that it was not giving the SEC license to characterize every misstatement or omission as a scheme," Slip Op. 19 (discussing *Lorenzo*, 139 S. Ct. at 1103); indeed, "*Lorenzo* emphasized the continued vitality of" *Janus*' limitations on primary liability for making misstatements, *id.* (discussing *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011));
- "An overreading of *Lorenzo* might allow private litigants to repackage their misstatement claims as scheme liability claims" and thereby evade statutory pleading requirements in misstatement cases, Slip Op. 20 (discussing 15 U.S.C. 78u-4(b)(1)); and
- "[A] widened scope of scheme liability would defeat the congressional limitation on the enforcement of secondary liability" by the SEC alone and would "multiply the number of defendants subject to private securities actions, and render the statutory provision for secondary liability superfluous." Slip Op. 21–22 (citing 15 U.S.C. 78t(e)).

Conclusion

Rio Tinto is the Second Circuit's first pronouncement on the scope of scheme liability after *Lorenzo*—and the most extensively reasoned analysis of the issue by any court yet. The decision forcefully rejects an expansive interpretation of *Lorenzo*, while upholding meaningful constraints on primary fraud liability for misstatements when the defendant did not actually "make" the statements or omissions at issue. The Second Circuit's decision thereby reaffirms the vitality of a long line of pre-*Lorenzo* cases that curbed the ability of the SEC and private plaintiffs to repackage deficient misrepresentations and omissions claims as "scheme" claims. *See*, *e.g.*, *Alpha Capital Anstalt v. Schwell Wimpfheimer & Assocs. LLP*, No. 1:17-cv-1235-GHW, 2018 WL 1627266, at *11 (S.D.N.Y. Mar. 30, 2018); *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 361 (D.N.J. 2009); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 475 (S.D.N.Y. 2005).

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Gibson Dunn represents Rio Tinto plc and Rio Tinto Ltd. Thomas H. Dupree Jr. argued in the United States Court of Appeals for the Second Circuit on behalf of Rio Tinto on May 19, 2022.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Securities Litigation or Appellate and Constitutional Law practice groups, or the authors of this alert:

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