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SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

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This quarterly newsletter summarizes recent federal and state court decisions of interest to practitioners litigating securities and fiduciary duty claims in Texas. Decisions of particular note this quarter include:

- Securities Fraud Class Actions – District courts denied motions to dismiss in the *Exela Technologies* and *SolarWinds Corporation* securities class actions. Courts granted motions to dismiss in the *Range Resources* (with prejudice) and *Cabot Oil & Gas Corporation* (with leave to replead) actions.
- Shareholder Derivative Cases – Courts applied Delaware’s recently refined standard for pleading demand futility under *United Food & Comm. Workers Union v. Zuckerberg*, 262 A.3d 1034, 1058, 1059 (Del. 2021) to grant motions to dismiss in two derivative cases, *Cabot Oil & Gas* and *Transcontinental Realty Investors*.
- Cases involving the definition of “securities” – Courts also addressed the definition of a “security.” In *Callais Capital Management, LLC*, the court ruled that a loan agreement was a security. In *US v. Sneed*, the court ruled that although membership in an investment group was not a security, misrepresentations made to induce purchase of the memberships and invest in funds offered by the defendants was related to the purchase of securities, and, therefore, actionable under Rule 10b-5.

New this quarter, we are providing some commentary on trends in the law, in addition to summaries of the cases decided.

COMMENTARY ON CASELAW TRENDS

I. Confidential Witnesses in Securities Class Action Complaints

In Texas and other parts of the country, the judicial approach to confidential witness (CW) allegations in securities fraud cases is evolving. Courts have long questioned whether CWs “are described with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.” *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336 (5th Cir. 2002) (citing *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2d Cir. 2000)). But since the U.S. Supreme Court’s 2007 decision in *Tellabs*, courts have begun “discounting” CW allegations. See *Higginbotham v. Baxter Intern., Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (Easterbrook, J.) (“It’s hard to see how information from anonymous sources could be

Fletcher Held Quarterly Newsletter (1Q22)

‘compelling’ or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t even exist.”). The Fifth Circuit follows this approach and appears to require district courts to discount all CW allegations. *See Indiana Elec. Workers’ Pension Tr. Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 535 (5th Cir. 2008) (“Following *Tellabs*, courts must discount allegations from confidential sources.” (citing *Higginbotham*, 495 F.3d at 756-57)).

Federal court decisions in Texas during the past year reference these legal standards, but they appear to be developing additional criteria (or borrowing from other courts) for evaluating confidential witness allegations:

- Adopting different levels of discounting: *generally discounting* allegations made by a witness described with sufficient particularity, and *heavily discounting* allegations from another who was not adequately described. *Electrical Workers Pension Fund, Local 103, I.B.E.W. v. Six Flags Entm’t Corp.*, 2021 WL 807251 (N.D. Tex. Mar. 3, 2021).
- Refusing to entertain *any* scienter allegations from confidential witnesses. *Chun v. Fluor Corp.*, 2021 WL 1788626, at *5 & n. 45 (N.D. Tex. May 5, 2021) (stating it “will not entertain scienter allegations from confidential sources” (citing *Shaw*, 537 F.3d at 535)).
- Placing greater weight on CW allegations based on the corporate position of the CW. *In re Venator Materials PLC Secs. Litig.*, 2021 WL 2980581, at *26 (S.D. Tex. July 7, 2021) (crediting allegations by CW who was the former director of supply chain for the corporate division that was rebuilding after the fire).
- And, most often, describing CW allegations as general, unrelated, vague or conclusory and not relevant to the alleged fraud. *See, e.g., Jacobowitz v. Range Res. Corp.*, 2022 WL 976003, at *19 (N.D. Tex. Mar. 31, 2022) (stating that CW allegations untethered to relevant events “hardly move the needle” after discounting); *Six Flags*, 2021 WL 807251, at *18 (noting that CW allegation that construction was “stalled” was general and vague and never presented to the named defendants).

In general, Texas courts appear highly skeptical of CW allegations, but they have not gone as far as some courts in allowing defendants to depose confidential witnesses and challenge their statements on a motion to dismiss. *See Campo v. Sears Holdings Corp.*, 635 F. Supp. 2d 323, 330 (S.D.N.Y. 2009), *aff’d*, 371 F. App’x 212 (2d Cir. 2010) (with respect to allegations derived from confidential witnesses, the Court considers only those allegations that later were corroborated by those witnesses in depositions.). Nor have they adopted suggestions made by other courts and commentators on how to improve the quality of confidential witness allegations in securities fraud cases. *See, e.g., In re Millennial Media, Inc. Securities Litigation*, No. 14 Civ. 7923 (PAE), 2015 BL169156 (S.D.N.Y. May 29, 2015) (recommending that plaintiff’s counsel personally confirm the accuracy of all factual allegations by confidential witnesses; inform the witnesses that their allegations may appear in the complaint; and inform the witnesses their identities may be revealed in litigation). However, unless plaintiffs stop relying on CWs or develop processes to ensure the accuracy of CW allegations, we expect the trend of heavily discounting confidential witness allegations to continue.

II. Texas Courts' Application of the Delaware Standard for Pleading Demand Futility in Derivative Actions.

To assert claims on behalf of a corporation in a derivative action, a shareholder must first make demand on the company to assert the claims or, if permitted by the law of the state of incorporation, plead with particularity that demand on the board would have been futile. Under the internal affairs doctrine, the law of the state of incorporation determines whether demand is futile. In cases filed against Delaware corporations in Texas, the Texas state and federal courts have been applying Delaware law for many years and are familiar with its contours.

Delaware courts have historically relied on two tests to make this determination: the *Aronson* test (for challenges to conscious business decisions) and the *Rales* test (for challenges when no business decisions were made). While *Aronson* and *Rales* remain good law, the Delaware Supreme Court recently combined them into a single test for demand futility that asks on a director-by-director basis:

- (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

United Food & Comm. Workers Union v. Zuckerberg, 262 A.3d 1034, 1058, 1059 (Del. 2021). If the answer to any of these three questions is “yes” for a majority of the board members, demand is excused as futile.

Two Texas courts have already applied *Zuckerberg*: *In Re Cabot Oil & Gas Corporation Derivative Litigation*, 2022 WL 991999, at *12 (S.D. Tex. Mar. 31, 2022), and *Berger, directly and derivatively on behalf of Income Opportunity Realty Investors., Inc. v. Transcontinental Realty Investors, Inc.*, 2022 WL 799653 (N.D. Tex. Mar. 16, 2022). In both cases, the courts found that plaintiffs failed to plead demand futility. *Zuckerberg*'s restatement of the demand futility test, although noteworthy, should not change the landscape for analyzing demand futility. Indeed, the *In re Cabot Oil & Gas* opinion noted that both the *Aronson* and *Rales* tests remain authoritative and courts may still consider pre-*Zuckerberg* precedents for guidance. *In Re Cabot Oil & Gas*, 2022 WL 991999, at *12 (citing *Zuckerberg*, 262 A.2d at 1059).

CASE SUMMARIES

I. FEDERAL CASES

A. Fifth Circuit

1. *Callais Capital Management, LLC v. Wilhite*, 2022 WL 445160 (5th Cir. Feb. 14, 2022) (*Per Curiam*)

In a short unpublished opinion, the Fifth Circuit affirmed the district court’s Rule 12(b)(6) dismissal of Rule 10b-5 securities fraud claims filed against the directors of digital marketplace platform (Sqor), including former Green Bay Packers quarterback Brett Favre. *See Callais Capital Management, LLC v. Wilhite*, 2021 WL 1216526 (E.D. La. Mar. 31, 2021).

Plaintiff Callais Capital Management, LLC (CCM) entered into a June 2015 Loan and Security Agreement (LSA) pursuant to which it loaned Sqor a total of \$16 million and received warrants to purchase stock. After Sqor went bankrupt, CCM filed suit, alleging that defendants misrepresented (1) the prospects of success of its business plan (2) the number of users of its platform, (3) the prospects for entering into agreements with certain sports teams, and (4) the prospect that certain sports figures’ social media accounts would drive users to the Sqor platform.

The LSA is a Security.

As a threshold matter, the district court determined that the LSA was a “security.” The Securities Exchange Act broadly defines a security, to include “any note, stock, [or] investment contract.” 15 U.S.C. § 78c(a)(10). “A note is presumed to be a ‘security’ and that presumption may be preliminarily rebutted by a showing that it more closely resembles the ‘family’ of instruments found not to be securities.” *Trust Co. of Louisiana v. N.N.P.*, 104 F.3d 1478, 1489 (5th Cir. 1997) (citing *Reves v. Ernst & Young*, 494 U.S. 56, 65-67 (1990)). The family of instruments found not be securities includes:

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a “character” loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business.

Reves, 494 U.S. at 65. The court rejected Defendants’ argument that the LSA resembled a “short-term note secured by a lien on a small business or some of its assets” because the LSA included the right to purchase preferred stock and had a high interest rate of 12% (suggesting a relatively high risk). 2021 WL 1216526, at * 6.

Because the Court determined that the LSA was not sufficiently similar to an item on the family resemblance list, it then examined four factors to determine “whether the instrument at issue is another category that should be added to the list of non-securities.” *Id.* (quoting *Trust Co.*, 104 F.3d at 1489). The four factors are:

Fletcher Held Quarterly Newsletter (1Q22)

- (1) the transaction is examined to assess the motivations that would prompt a reasonable seller and buyer to enter into it;
- (2) the “plan of distribution” of the instrument is examined to determine whether it is an instrument in which there is a “common trading for speculation or investment;”
- (3) the reasonable expectations of the investing public are considered; [and]
- (4) an inquiry into the existence of another regulatory scheme, which would significantly reduce the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

The court applied these factors and concluded that the LSA was a security.

CCM Failed to Plead a Claim Under the PSLRA.

The district court found that the complaint failed to identify which of the individual defendants authored the challenged statements in the business plan. Accordingly, the court dismissed these claims and did not address Defendants’ additional arguments that the alleged misrepresentations were inactionable puffery and Plaintiff failed to allege scienter. *Id.* at *12.

Next the court considered the alleged misrepresentations regarding a draft agreement with the soccer team, FC Bayern. CCM alleged that defendants showed it a draft agreement in June 2015 and then sent CCM the executed agreement in August 2015 without highlighting the key alterations. These allegations failed to allege any misrepresentation because there was no allegation that Defendants withheld material information or misrepresented the terms of the finalized contract. *Id.* at 12.

The Court next reviewed the allegations that Defendants misrepresented in its “Brand Capabilities Deck” the prospect that certain sports figures’ social media accounts would drive users to the Sqor platform. Like the business plan allegations, the Court found that Plaintiff engaged in impermissible “group pleading” and failed to identify which individual Defendant made the challenged statements.

Finally, the Court reviewed the various remaining alleged misrepresentations and found they failed to comply with the particularity requirement of the PSLRA and Rule 9(b). *Id.* at 13-18.

Other Issues.

Interestingly, after dismissing the federal claims the Court declined to exercise supplemental jurisdiction over CCM’s state law claims. Defendants requested that the Court dismiss these claims on the merits, but the Court declined to exercise jurisdiction because no merits discovery had taken place. *Id.* at *18.

Fletcher Held Quarterly Newsletter (1Q22)

The Court denied CCM leave to file an amended complaint because it had already amended once in response to a prior motion to dismiss and the case had been on file for over a year and a half when the motion to dismiss was filed. *Id.* at *19.

B. District Courts

1. Securities Class Actions

(a) *Shen v. Exela Techs., Inc.*, 2022 WL 198402 (N.D. Tex. Jan. 21, 2022) (Fitzwater, J.)

Judge Fitzwater denied motions to dismiss this putative securities fraud class action, ruling that plaintiffs had alleged sufficient facts to satisfy the heightened pleading standards under at least one theory of liability. The Company allegedly failed to disclose that its highly unpredictable postage revenue made up approximately 20% of its total revenues while at the same time repeatedly claiming that 90% of its revenues came from long-term and renewing contracts that were predictable. *Id.* at *1. The Court initially dismissed the theory for failure to adequately plead scienter because Plaintiffs failed to allege that defendants knew when the statements were made how much of their revenue came from unpredictable postage and postage handling.¹ The decision highlights the risks for corporations in providing overly broad assurances about financial results, even when they are thought to be forward-looking statements protected by the safe harbor.²

Alleged Misstatements.

Between March 2018 and March 2019, Exela and its officers repeatedly touted the predictability of its revenues, stating during earnings calls and other occasions that it had visibility into 90% of the Company's revenue due to long-term and automatically renewing contracts. When asked about the impact of postage revenues during a May 2018 earnings call, the Company's CFO acknowledged that the Company did not break out postage revenue separately. By August 2019, the Company admitted that nonrecurring, low margin postage revenue – which Exela reported as “customer deposits” – was unpredictable and substantial. The Company then revised its 2019 revenue and EBITDA guidance downward, and its stock fell 48% the following day. Three months later, Exela further reduced its guidance, and its stock price dropped another 42%. By June 2020, Exela restated its 2018 and 2019 financials to reflect that 21% of its 2018 revenues and 18% of its 2019 revenues were attributable to postage and postage handling revenues, effectively refuting its class period statements that it had visibility into 90% of its revenue. Based on these allegations, the Court concluded the Plaintiffs adequately alleged falsity, pleading with particularity what each of defendants' misrepresentations was and why each was misleading. *Id.* at *6.

¹ See Securities Fraud and Fiduciary Duty Cases in Texas Newsletter, (“FH Quarterly Newsletter”) at 24-25 (2Q21).

² The Court previously granted defendants' motions to dismiss *without prejudice* and allowed plaintiffs to replead. In that opinion and the current opinion, the Court rejected defense arguments that the alleged misstatements were protected as forward looking because the 90% visibility statements were stated in the present tense. *Id.* at *1 n.2 and *2 n.3.

Fletcher Held Quarterly Newsletter (1Q22)

Scienter Allegations.

While Plaintiffs' 90% revenue visibility claim "founded on the scienter opinion" in their prior complaint, they bolstered these allegations in the amended complaint. The Court listed the following additional allegations:

- Exela's CFO admitted the Company followed ASC 606 in a May 2018 earnings call, and the Company's 2018 10-K admitted that it tracked postage revenue in accordance with that FASB standard. ASC 606 requires separate tracking of this revenue.
- Exela booked customer deposits and disclosed them as a line item in every quarterly and annual filing. If Exela had not tracked postage, its balance sheet would not have balanced.
- According to a chart in the amended complaint, the postage contribution to total revenue ranged from 17% to 20.1% during the class period.
- All quarterly and annual filings were signed by Exela's CEO, CFO, and Board Chair.

Based on these allegations, the Court concluded it was highly unreasonable for defendants to claim that the Company had 90% visibility into its revenues. There was no apparent reason why postage revenue was a predictable component of revenues from March 2018 to March 2019 and unpredictable just a few months later as Defendants claimed. Moreover, Defendants must have been aware of the danger of misleading investors when they touted projected revenues in earnings guidance.

Notably, the Court did not address Plaintiffs' other theories of liability and "expresse[d] no view about, whether plaintiffs have rectified deficiencies in their other theories, which the Court rejected in *Shen I.*" *Id.* at *9. While other Texas federal district courts often use motions to dismiss to narrow the scope of claims for litigation, the Court did not and cited a recent Southern District of New York opinion supporting its approach. *Id.* at *9 n.6 (citing *KDH Consulting Grp. LLC v. Iterative Cap. Mgmt. L.P.*, 528 F.Supp.3d 192, 203 n.6 (S.D.N.Y. 2021) (holding that "[a]lthough KDH raises a number of misrepresentations or omissions made before it invested in January 2018, KDH need only allege at least one actionable misstatement to survive a motion to dismiss on this cause of action.")).

**(b) *In Re SolarWinds Corp. Sec. Lit.*, 2022 WL 958385
(W.D. Tex. Mar. 30, 2022)(Pittman, J.)**

In this 10b-5 class action arising from a cybersecurity breach at a software company that provided services to a host of government and private entities, Judge Pittman denied motions to dismiss filed by Defendants SolarWinds Corporation (SolarWinds) and its VP of Security Architecture, Tim Brown. The Court granted former CEO Kevin Thompson's motion to dismiss the Rule 10b-5 claims asserted against him (with leave to amend) but denied his motion to dismiss the Section 20(a) control person claims. The Court also denied the motions to dismiss control person claims filed against SolarWinds's majority shareholders Silver Lake Group, LLC and Silver Lake Technology Management, LLC (Silver Lake) and Thoma Bravo, LP.

Fletcher Held Quarterly Newsletter (1Q22)

SolarWinds customers—which included the U.S. Pentagon, State Department, Office of the President, FBI, Secret Service, and National Security Administration—utilized SolarWinds' information technology software. Plaintiffs alleged the following false and misleading statements:

- SolarWinds had a robust cybersecurity system and adhered to specific cybersecurity practices set forth in a “Security Statement” on its website.
- The Security Statement represented that SolarWinds had a security team, had an information security policy, provided security training to its employees, followed a password policy, and segmented its network, among other things.
- Brown’s photo and video were featured prominently near the Security Statement, and Brown regularly wrote articles and appeared in interviews and on podcasts touting SolarWinds' focus on “heavy-duty hygiene” and directing customers and investors to the Security Statement.

Plaintiffs alleged that SolarWinds’ commendations of its cybersecurity measures “helped the Company build up its customer base,” “as it gained 300,000 customers worldwide and more than \$230 million in federal government contracts” during the class period.

Plaintiffs alleged that SolarWinds misrepresented its cybersecurity measures because:

- Prior to the beginning of the class period, SolarWinds’ former Global Cybersecurity Strategist made a presentation to the Company's top executives (including individuals who reported directly to CEO Thompson) that addressed SolarWinds' deficient cybersecurity practices.
- Thompson's direct reports noted that Thompson would not be willing to invest in the cybersecurity improvements proposed by the strategist. When SolarWinds refused to implement the proposed improvements, the strategist resigned in protest.
- During the class period, a cybersecurity researcher notified SolarWinds in writing that the password for its Update Server—the server from which customers downloaded software updates for the Company's products—had been publicly available on the website GitHub for around one-and-a-half years. The password was “solarwinds 123.” Brown and SolarWinds changed the password within an hour of receiving the email, but did not disclose the password leak, nor its significance: that any hacker could have used the password to upload malicious files to the server SolarWinds customers used to download updates.

Russian Foreign Intelligence Service (FIS) injected a malicious code into SolarWinds “Orion” software, which was discovered in late 2020. The server hacked by the Russian FIS was completely unrelated to the Update Server whose password had previously been disclosed. When the infected code was downloaded onto a customer's server, it could be used to compromise the server. SolarWinds' stock value plummeted, and this suit followed.

Claims Against SolarWinds and Tim Brown.

Fletcher Held Quarterly Newsletter (1Q22)

Scienter. The Court held that Plaintiffs raised a strong inference that Brown and SolarWinds acted with at least severe recklessness when they touted SolarWinds' security measures. Brown was the head of security architecture, held himself out as an authority on the subject, and spoke frequently about SolarWinds' Security Statement. The Court ruled the "solarwinds 123" password breach supported a finding of scienter even though the Russian FIS hack targeted a different server because it showed that executives "were at least reckless in realizing that something was dangerously amiss." The Court stated that the confidential witness (CW) statements regarding lax security measures bolstered the inference of scienter. Even though the CWs did not work in the cybersecurity group, the Court noted their statements applied to employees of the company broadly and adequately alleged that employees were not aware of any information security policy, did not receive cybersecurity training, and did not comply with password policy. While the pre-class period criticism of SolarWinds' cybersecurity practices by its former Global Cybersecurity Strategist did not, standing alone, create a strong inference of scienter, it bolstered the inference when viewed alongside the other allegations.

Material Misstatements. The Court held the Plaintiffs adequately alleged material misstatements. SolarWinds' statements regarding its cybersecurity measures were not mere puffery or inactionable opinions under *Omnicare Inc. v. Laborers Dist. Council, Constr. Indus. Pension Fund*, 575 U.S. 175, 186 (2015). 2022 WL 958385, at *8. The Court also rejected Defendants' argument that the risk disclosures in SolarWinds' SEC filings regarding the possibility of cyberattacks required the Court to conclude that the alleged statements were not false and misleading.

Loss Causation. Defendants challenged loss causation. The Court noted:

Loss causation can be demonstrated circumstantially by (1) identifying a "corrective disclosure" (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud); (2) showing that the stock price dropped soon after the corrective disclosure; and (3) eliminating other possible explanations for this price drop, so that the factfinder can infer that it is more probable than not that it was the corrective disclosure—as opposed to other possible depressive factors—that caused at least a 'substantial' amount of price drop.

2022 WL 958385, at *9 (quoting *Pub. Emps. Ret. Sys. of Mississippi v. Amedisys, Inc.*, 769 F.3d 313, 320–21 (5th Cir. 2014)) (citations omitted).

Defendants argued that although disclosures of the Russian FIS hack "may have given an unfavorable impression of SolarWinds' security protocols, they do not reveal the falsity of any challenged statement." The Court disagreed, holding that "The 'corrective disclosures' at the very least circumstantially suggest that the security breach was more likely than not caused by the company's allegedly deficient security." *Id.*

Fletcher Held Quarterly Newsletter (1Q22)

Claims Against CEO Kevin Thompson.

Control Person Claims. The Court denied Thompson’s motion to dismiss the Section 20(a) control person claims against him. His sole argument was that Plaintiffs failed to allege a primary violation, which the Court ruled they had.

Rule 10b-5 Claims. The Court held that SolarWinds’ Security Statement could be fairly attributed to Thompson because Plaintiffs alleged that the statement was “reviewed and approved by Defendants Brown and Thompson.” Thus, Thompson was a “maker” of the statement under *Janus Cap. Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011). *Id.* at *10.

The Court ruled, however, that Plaintiffs failed to adequately allege that Thompson made any misstatement with scienter. Unlike Brown, Thompson did not speak regularly about cybersecurity issues. Nor did Thompson’s stock sales create a strong inference of scienter because Thompson “offered the competing assertion that [he] sold these shares shortly ahead of his previously announced departure from the company and executed according to a 10b5-1 plan that was put in place in August 2020, before SolarWinds was purportedly given notice of the breach.” *Id.* at *11. Finally, the former Global Cybersecurity Strategist’s critique of SolarWinds’ deficient cybersecurity practices prior to the beginning of the class period did not create a strong inference of scienter. The Court granted leave to replead, but Plaintiffs declined to do so, opting to move forward against Brown with their control person claims only and allow the case to proceed to discovery.

Claims Against SolarWinds’ Majority Shareholders.

Plaintiffs asserted control person claims against SolarWinds’ majority shareholders, Silver Lake and Thoma Bravo. Having previously found an underlying primary violation, the Court observed that “Courts in the Fifth Circuit apply a ‘relaxed’ and ‘lenient’ pleading standard for evaluating whether a plaintiff has sufficiently alleged a claim for control person liability.” *Id.* at *12. “Plaintiffs need not allege that the controlling person actually participated in the underlying primary violation to state a claim for control person liability.” *Id.* The Court found that Plaintiffs sufficiently alleged that Silver Lake and Thoma Bravo acted in concert to control SolarWinds and denied the motion to dismiss these claims.³

(c) *Jacobowitz v. Range Res. Corp.*, 2022 WL 976003 (N.D. Tex. Mar. 31, 2022)(Pittman, J.)

Judge Pittman dismissed with prejudice a putative securities class action filed against Range Resources and four of its senior executives. The litigation was filed after the Pennsylvania Department of Environmental Protection (DEP) concluded in 2021 that Range improperly classified certain wells as “inactive” rather than “abandoned.” The DEP investigation centered on an internal Company memorandum that was inadvertently attached to the Company’s application for inactive status on a specific well. While the application stated that significant reserves remained in place and the Company planned to return the well to production, the internal

³ For additional discussion of the Fifth Circuit’s control person liability decisions, see FH Quarterly Newsletter (2Q21), at 6-8.

Fletcher Held Quarterly Newsletter (1Q22)

memorandum stated the well had “become incapable of economic production” and “was ‘not capable’ of gas sales going forward.” At the end of the investigation, the DEP concluded that Range misclassified 42 wells from July 2013 to October 2017 – slightly less than 1% of Range’s wells in the region. The Company and DEP entered into a Consent Assessment of Civil Penalty (“CACP”) agreement, and the Company paid a \$294,000 civil penalty.

Plaintiffs in the putative class action alleged that defendants fraudulently misclassified Range’s wells and hid the misclassification and DEP investigation from investors. Plaintiffs alleged the following categories of misstatements: (1) statements that the Company was in “substantial compliance” with relevant laws and regulations; (2) statements about ongoing legal proceedings; (3) statements and accounting calculations regarding the Company’s Asset Retirement Obligations (AROs); (4) statements in the Company’s Code of Ethics; and (5) SOX certifications signed by two of the officer defendants. In a detailed and well-organized opinion, the Court reviewed each alleged misstatement category and then addressed allegations of scienter.

Alleged Misstatements.

1. *“Substantial compliance” statement.* Range’s 10-K included the following statement: **“We believe we are in substantial compliance with currently applicable laws and regulations** However, ... past non-compliance with environmental laws or regulations may be discovered.” *Id.* at *5 (bold in original). Plaintiffs alleged the bold language was materially false or misleading based on the conclusions of the DEP investigation. Defendants countered by citing a case involving similar language where the court concluded that a reasonable investor would not understand “substantial compliance” to mean “absolute compliance” or reasonably infer the company had fully complied with every regulation or requirement. *Id.* at *6 (citing *In re Plains All Am. Pipeline, L.P. Sec. Litig.*, 307 F.Supp.3d 583, 635 (S.D. Tex. 2018)). The Court ruled the statement was immaterial and that it was properly construed as an opinion statement which Plaintiffs did not adequately allege omitted material facts. *Id.* at *6-7.

2. *“Pending legal issues” statements.* Plaintiffs alleged that Range’s general statements disclosing “pending or threatened legal actions” in its annual and quarterly filings were materially misleading because they failed specifically to discuss the DEP investigation into 42 of Range’s wells. They further alleged that Range’s disclosure of a DEP investigation into potential gas migration at another well improperly stated it was the “only” environmental proceeding that could result in monetary sanctions of more than \$100,000. *Id.* at *8. The Court chastised Plaintiffs for adding the word “only” to Range’s disclosure language and rejected the Plaintiffs argument. “It does not follow that Range, by disclosing *one* proceeding, was then obligated to disclose *every* legal and regulatory proceeding in which it was involved. To hold otherwise would transform routine securities disclosures into a corporate rite of confession.” *Id.* at *8. The Court also ruled the statements were immaterial since 42 wells comprised less than 1% of Range’s total wells and the \$294,000 civil penalty was miniscule compared to Range’s \$6 billion in assets and \$2.8 billion in total revenue in 2019.

3. *“Asset Retirement Obligation” Estimates.* Range disclosed ARO estimates quarterly and annually that reflected the estimated present value of amounts it would incur to plug,

Fletcher Held Quarterly Newsletter (1Q22)

abandon, and remediate its producing properties at the end of their productive lives. Plaintiffs alleged these ARO amounts were artificially decreased by knowingly misclassifying the 42 wells as inactive rather than abandoned. The Court disagreed because the Plaintiffs “failed to plead with particularity any facts showing why Range’s AROs were incorrect, by what amount they were off, what the correct figures would be, or why Range should have reported differently.” *Id.* at *12. Even if Plaintiffs had done so, the Court ruled the alleged misstatements were immaterial because Range made qualifying and hedging statements about its ARO assessments, noting they required the Company to make “estimates and judgments” based on a variety of factors that would cause a reasonable investor to be skeptical about their precision. *Id.* at *12.

4. *Code of Ethics Published on Range’s Website.* Plaintiffs alleged that the Code of Ethics on Range’s website was false and misleading because it assured investors it was Range’s policy to comply with applicable laws and regulations and be a steward of the environment. *Id.* at *12-13. The Court rejected this allegation noting: (a) Range’s securities filings expressly stated that information contained on its website was “not incorporated by reference” into its filings, *id.* at *12; and (b) “Companies’ codes of ethics are inherently aspirational, and these statements rarely ‘go beyond aspirational or general puffery’ or ‘falsely present a record of past or present compliance’ with Range’s policies.” *Id.* at *14 (quoting *Plains*, 307 F.Supp.3d at 625).

5. *SOX Certifications.* The Court rejected Plaintiffs’ suggestion that SOX certifications were false or misleading for failure to allege particular facts showing they were false and for failure to adequately allege a strong inference of scienter.

No Strong Inference of Scienter.

Plaintiffs argued they adequately alleged scienter based on confidential witness (CW) allegations; defendants’ access to pertinent information and reports; defendants’ alleged “admissions” in the DEP settlement; and defendants’ potential motives for classifying wells as inactive rather than abandoned. The Court rejected each of these allegations.

The Court discounted CW allegations because their “general assertions are instead untethered from the events relevant to [Plaintiffs] theories of fraud.” *Id.* at *16. They focused generally on Range’s “incentive” to classify wells as inactive but said nothing about “whether there was actual misclassification; who knew about the classifications; how often, where, or when that occurred.” *Id.* at *19. After proper discounting, they “hardly move the needle on scienter.” *Id.*

As to the alleged admissions in the DEP settlement, the Court noted that Range did not concede intentional or reckless wrongdoing in the CACP settlement agreement. Range merely adopted background facts in the agreement and did not admit to the misconduct or the DEP’s other findings. As to the internal memorandum that initiated the DEP investigation, Plaintiffs never alleged who was aware of it or why its decision to classify the well as “inactive” because it had not produced within the last 12 months was incorrect. *Id.* at *18.

The Court rejected Plaintiffs other scienter allegations as lacking in particularity and failing to raise a strong inference. The case was dismissed with prejudice.

Fletcher Held Quarterly Newsletter (1Q22)

(d) *Delaware Cty. Emps. Ret. Sys. v. Cabot Oil & Gas Corp.*, 2022 WL 112029 (S.D. Tex. Jan. 12, 2022) (Rosenthal, J.)

Judge Rosenthal dismissed certain claims and allowed plaintiffs to replead others in a putative securities fraud class action against Cabot Oil & Gas Corporation (Cabot or Company) and three of its corporate officers. The case was filed ten years after Cabot entered into an environmental Consent Order and a few months after the State of Pennsylvania filed felony charges against Cabot for failing to fix known faulty gas wells that leaked pollutants into residential water supplies.

Plaintiffs in the securities action alleged that defendants falsely told investors Cabot was remediating environmental problems and complying with legal requirements when it was not. As the Court described it, the motion to dismiss posed the question of “when a company’s public description of its environmental issues minimize the costs and risks and violate the securities laws.” In a careful and well-organized opinion, the Court dismissed with prejudice claims based on statements of “corporate cheerleading” and generalized statements about the risk of environmental violations, but the Court gave plaintiffs the opportunity to replead claims based on statements that Cabot believed it had remediated and resolved the specific environmental violations identified by the State of Pennsylvania.

The Court’s opinion addressed categories of statements that were allegedly false or misleading and then turned to the allegations of scienter in the complaint.

Inactionable “Corporate Cheerleading.”

Plaintiffs alleged that Defendants made false or misleading statements about (1) its Code of Business Conduct which set forth a policy requiring compliance with environmental laws; (2) Cabot’s “unwavering commitment to comply with or exceed all [environmental] regulations”; and (3) statements that the Company “is making efforts to reduce its environmental impact,” “is committed to having the least possible impact to the environment,” and “hopes to improve the environment by ‘being a beacon of light.’”

The Court characterized all these statements as “corporate cheerleading” or “puffery” that was not actionable. *Cabot*, 2022 WL 112029, slip op. at *9-10. The Court cited numerous decisions supporting this ruling, including *Nathenson v. Zonagen*, 267 F.3d 400, 419 (5th Cir. 2001) (“generalized positive statements about a company’s progress” is not a basis for liability under the securities laws); *In re Plains All Am. Pipeline, L.P., Sec. Litig.*, 307 F.Supp.3d 583, 624-26 (S.D. Tex. 2018) (code of conduct describing commitment to safe and environmentally responsible operations is a nonactionable general commitment); and *Emp. Retirement Sys. v. Whole Foods Market, Inc.*, 905 F.3d 892, 901 (5th Cir. 2018) (generalized, positive statements are immaterial corporate puffery).

Inactionable Generalized Statements About the Risk of Environmental Violations.

Plaintiffs alleged that Defendants made false or misleading statements based on two generalized environmental risk disclosures in its SEC filings. Plaintiffs claimed the risk disclosures downplayed the significance of environmental violations or failed to disclose that

Fletcher Held Quarterly Newsletter (1Q22)

Cabot was already facing such risks. The Court disagreed, noting that (1) plaintiffs did not explain how the language in one disclosure was materially false or misleading or (2) how the language about what can happen when an environmental violation occurs would mislead investors to believe that Cabot was free of violations.

Plaintiffs further alleged that Cabot's CFO stated in an August 2018 presentation that the Company was completing wells in the Upper Marcellus Shale using a more environmentally friendly completion method. The Court pointed out that plaintiffs did not allege any facts contrary to the statement nor did they explain how it would lead investors to believe Cabot was in compliance with environmental requirements.

Plaintiffs alleged that Cabot's statement in 10-Ks that it "believe[s] that it substantially compl[ies] with the Clean Water Act and related federal and state regulations" was false and misleading. The Court noted that plaintiffs did not allege whether the 25 wells that allegedly had compliance issues were a substantial piece of Cabot's production or a substantial number of its total wells. Moreover, even accepting as true the testimony of a former Cabot geologist regarding cement bond log issues, the Court could not conclude that the defects identified existed at a substantial number of Cabot's wells.

Actionable Statements that Cabot Believed it Had Remediated Specific Violations.

The Court ruled that three categories of statements relating to notices of violation Cabot received from Pennsylvania's Department of Environmental Protection ("PaDEP") were actionable:

- Statements that Cabot "ha[s] performed appropriate remediation efforts" and "believed the source of methane has been remediated" with respect to a PaDEP Notice of Violation in 2011;
- A statement that Cabot "believe[s] the source of methane has been remediated" with respect to a 2016 Consent Order; and
- A statement that Cabot "believed the water quality complaints had been resolved through remediation" relating to 2017 Notices of Violation.

The Court ruled the complaint alleged sufficient facts to make these statements actionable and specifically noted that the 2020 criminal charges were based on compliance issues with wells that received Notices of Violation in 2011, 2014, 2017, 2018, and 2019.

No Strong inference of Scierter, But Leave to Replead.

The plaintiffs alleged the following facts to support their claim that the CEO, CFO, and Senior VP and Regional Manager acted with scierter:

- Defendants' knowledge of and access to reports reflecting that Cabot was not in compliance with relevant environmental laws;
- Defendants' obligations associated with disclosure controls and environmental compliance;
- The alleged misstatements and omissions concerned the Company's core operations;

Fletcher Held Quarterly Newsletter (1Q22)

- The CEO’s sale of \$1.8 million of Cabot stock on November 2, 2017; and
- The SVP’s alleged daily attendance at meetings to “discuss well operations, including any problems with those wells.”

First, citing *Plains*, the Court noted that without more details general allegations that officers received reports with material information are not sufficient to create a strong inference of scienter.

Second, while the CEO and CFO were aware of Notices of Violations, Plaintiffs pleaded no facts sufficient to infer they were aware of continuing violations and failures to remediate.

Third, although the Court did not discuss the “core operations doctrine” in any detail, the opinion noted in the background facts that 93% of Cabot’s proved reserves were allegedly in the Marcellus Shale by the end of 2016 and all the Company’s proved undeveloped reserves were located in Susquehanna County, Pennsylvania by 2019. Because the 2009 PaDEP investigation was focused on Susquehanna County fracking operations and the 2020 criminal charges related to multiple Notices of Violation in the Marcellus, the Court may be considering whether this is a rare case in which the core operations doctrine might apply.

Fourth, as to the stock sale by Cabot’s CEO, the plaintiffs did not allege how many shares the CEO retained, how the sale was timed to maximize his personal benefit, or that any other defendants sold stock during the period.

Finally, with respect to the SVP’s daily attendance at meetings discussing well operations, the Court stated this was “the closest the [plaintiffs] come to alleging that an individual officer had knowledge of Cabot’s ongoing violations.” But the complaint did not allege that the SVP made any misstatements or that he signed off or certified as true the challenged statements in Cabot’s SEC filings.

Based on the allegations presented, the Court ruled that Plaintiffs did not meet the heightened pleading standards supporting a strong inference that Defendants knew or were severely reckless in making the alleged false statements. Ultimately, the Court allowed plaintiffs to replead and try to make a case: “Because a well-pleaded complaint with additional allegations as to scienter might cure the deficiencies identified, the motion to dismiss as to these categories of misstatements is without prejudice and with leave to amend.”

2. Derivative Actions/Fiduciary Duty Cases

(a) *In Re Cabot Oil & Gas Corporation Derivative Litigation*, 2022 WL 991999 (S.D. Tex. Mar. 31, 2022)(Rosenthal, J.)

In addition to the securities class action filed against Cabot, several shareholders filed derivative actions against three of the Company’s executive officers and eight of its directors asserting claims for breaches of fiduciary duties, insider trading, waste of corporate assets, unjust enrichment, and contribution under §§10(b) and 21D of the Exchange Act. The derivative plaintiffs alleged that a majority of Cabot’s nine-member board and certain of its executives

Fletcher Held Quarterly Newsletter (1Q22)

(1) knew of the Company’s continuing environmental violations but failed to take action to remediate them, and (2) knew or recklessly permitted the Company to make untrue statements about its revenues and overall prospects.

Prior to filing, the derivative plaintiffs obtained documents from the Company pursuant to a Section 220 request.⁴ Relying on these documents, the derivative plaintiffs alleged that from 2015 to 2020 the Cabot defendants received materials and heard information at meetings that put them on notice the Company was not in compliance with environmental laws, regulations, and consent orders.

Since the derivative action was filed without making demand on Cabot’s Board of Directors, the Court first evaluated whether demand was excused (i.e., whether a majority of the Board was interested or lacking independence at the time suit was filed). Delaware courts have historically relied on two tests to make this determination: the *Aronson* test (for challenges to conscious business decisions) and the *Rales* test (for challenges when no business decisions were made). While *Aronson* and *Rales* remain good law, the Delaware Supreme Court recently combined them into a single test for demand futility that asks on a director-by-director basis:

(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

United Food & Comm. Workers Union v. Zuckerberg, 262 A.3d 1034, 1058, 1059 (Del. 2021).⁵ If the answer to any of these three questions is “yes” for a majority of the board members, demand is excused as futile.

The only aspect of the *Zuckerberg* test raised by plaintiffs in *Cabot* was whether a majority of the board faced a substantial likelihood of liability on the claims in the complaint. The Court methodically reviewed the Plaintiffs’ allegations to see if any met this test (also known as the *Rales* test).

First, with respect to purported environmental violations, the Court stated that plaintiffs alleged a type of *Caremark* claim, i.e., that the board consciously disregarded conduct known to

⁴ Section 220 of the Delaware General Corporation Law, 8 Del.C. § 220, allows stockholders to access a corporation’s books and records if they satisfy certain procedural requirements and state a “proper purpose” (e.g., to investigate self-dealing or mismanagement). While the scope and purpose of Section 220 requests are frequently litigated, Delaware courts often require companies to provide stockholders with some documents. As described by the Delaware Supreme Court in *Rales v. Blasband*, 654 A.2d 927 (Del. 1993), Section 220 is one of the “tools at hand” for plaintiffs to obtain corporate documents before filing suit.

⁵ Both the *Aronson* and *Rales* tests remain authoritative, and courts may still consider pre-*Zuckerberg* precedents for guidance. *In re Cabot Oil & Gas*, 2022 WL 991999, at *12 (citing *Zuckerberg*, 262 A.2d at 1059).

Fletcher Held Quarterly Newsletter (1Q22)

be illegal and failed to bring Cabot into compliance. *In re Cabot Oil & Gas*, 2022 WL 991999, at *13-14 (comparing plaintiffs' allegations to a "prong two" *Caremark* claim). The Court summarized the information presented to board members at various meetings, noting when each meeting occurred, what directors were present, and what issues were allegedly raised. *See In re Cabot Oil & Gas*, Civil Action No. H-21-2046, slip op. at 26-31 (chart summarizing "red flags" for directors at various meetings). The Court then analyzed the allegations to see if they supported the claims.

While the allegations that the Board discussed allegations about gas migrating into residential water wells, standing alone, might have been sufficient to support demand futility, the Court observed that those allegations were based on documents obtained through a § 220 request. *In re Cabot Oil & Gas*, 2022 WL 991999, at *16. When a stockholder obtains and relies on §220 documents to make a derivative complaint, a court may consider the documents in their entirety to draw any competing inferences. *Id.* at *17 (citing *Rojas v. Ellison*, 2019 WL 3408812, at *1 & n. 3 (Del. Ch. July 29, 2019) and *Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808, 818 (Del. 2013)). While the documents showed the Board was made aware of gas migration allegations, they also showed that the Board was told "what actions Cabot was taking to address environmental issues or allegations" and "if there were no actions, why." *Id.* at *17. When viewed in their entirety, the Court concluded the Section 220 documents did not support a reasonable inference that the Company was ignoring the environmental issues. *Id.* "[G]ood faith attempts to address compliance issues, even if unsuccessful, cannot serve as the basis for *Caremark* claims." *Id.* (citing *Richardson on behalf of MoneyGram Int'l, Inc. v. Clark*, 2020 WL 7861335, at *11 (Del. Ch. Dec. 31, 2020)).

Second, with respect to untrue statements about Cabot's revenues and overall prospects, the Court reviewed each category of alleged misstatements set forth in the complaint. For reasons similar to its dismissal of the class action complaint, the Court ruled that the complaint failed to allege with particularity why any of the alleged misstatements were false.

Third, with respect to the Delaware insider trading allegations (*Brophy* claim) that were made only against the Company's CEO, the Court found it was insufficient to establish demand futility since a majority of the Board was not implicated in this claim.

The Court dismissed the action without prejudice, permitting the shareholders to file an amended complaint "if, upon information and belief, the allegations will cure the deficiencies identified in this opinion." *Id.* at *20.

(b) *Berger, directly and derivatively on behalf of Income Opportunity Realty Investors., Inc. v. Transcontinental Realty Investors, Inc.*, 2022 WL 799653 (N.D. Tex. Mar. 16, 2022) (Brown, J.)

Judge Brown dismissed four claims that a shareholder asserted derivatively on behalf of Income Opportunity Realty Investors, Inc. (IOR) against IOR's outside investment manager, Pillar Income Asset Management Inc. (Pillar). The court granted Plaintiff leave to replead the claims.

Fletcher Held Quarterly Newsletter (1Q22)

IOR's primary business was investing in mortgage receivables. IOR and Pillar entered into a Cash Management Agreement (CMA) and an Advisory Agreement. Plaintiff alleged that Pillar used the CMA to transform IOR into an unregistered investment management company in violation of the Investment Company Act of 1940, 15 U.S.C § 80a, *et seq.* (the ICA). Moreover, Pillar invested IOR's funds almost exclusively with Transcontinental Realty Investors, Inc. (TCI), which (along with its affiliates) owned 87.58% of IOR's shares.

Demand Futility.

As a threshold matter, the Court applied Delaware law to find that demand on IOR's board would have been futile because a majority of IOR's directors were officers or directors of TCI or its parent company and, therefore, not disinterested. 2022 WL 799653, at *4 (citing *United Food & Com. Workers Union & Participating Food Indus. Emp'rs Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021)). The Court summarized the demand futility standard under *United Food* (and *Rales v. Blasband*) as follows:

Courts ask the following three questions when evaluating allegations of demand futility: (1) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (2) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (3) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

United Food, 262 A.2d at 1059.

Investment Company Act Claims.

The ICA prohibits investment companies from engaging in interstate commerce unless they register with the SEC. 15 U.S.C § 80a-7(a). Moreover, registered investment companies cannot engage in interested party transactions without prior SEC consent. 15 U.S.C § 80a-17. Plaintiff alleged that IOR violated both these provisions and, therefore, it had the right to rescind the CMA pursuant to Section 47(b) of the ICA [15 U.S.C. § 80a-46], which allows for rescission of any "contract that is made, or whose performance, involves a violation of" the ICA. Although the Third, Fourth, and Ninth Circuits have held there is no private right of action under Section 47(b), the Court "presumed" that such a right exists, relying on a decision by the Second Circuit recognizing a private right of action under Section 47(b) and a Fifth Circuit opinion allowing private claims for violations of other provisions of the ICA.

The Court found that IOR did not violate the ICA and, therefore, there was no right to rescind the CMA. First, the Court found that the even if IOR engaged in interstate commerce in violation of the ICA, Plaintiffs failed to plausibly allege that performance of the CMA involved interstate commerce: "The activities alleged to be in violation of the prohibition on interstate commerce are too tangential to the contract to be rescinded." 2022 WL 799653, at * 5. Second, the Court found that the ICA only prohibits registered investment companies from engaging in

Fletcher Held Quarterly Newsletter (1Q22)

related party transactions without prior SEC approval; there is no such prohibition on unregistered companies such as IOR.

Contractual Claims.

Plaintiff argued that Pillar breached the CMA because it only allowed Pillar to invest “excess” funds, and IOR’s board never designated any funds as “excess.” Because the CMA does not require any such designation by the Board, however no term of the contract was breached. Similarly, Pillar did not breach the CMA by failing to obtain a fidelity bond because the CAM only required Pillar to obtain a bond if IOR’s directors required it, which they never did.

3. Enforcement Matters

(a) *SEC v. Milles*, 2022 WL 206808 (W.D. Tex. Jan. 24, 2022)(Pittman, J.)

Judge Robert Pitman granted summary judgment for the SEC against William J. Milles and Donald J. Lutz. The individual defendants were CEO and President, respectively, of Capital Energy Group, LLC (CEG or the Company), an entity that offered investors “units” in investment funds for new and existing oil wells in Texas and Oklahoma. The units were not registered as securities, and the SEC sued the defendants under §§5 and 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. For anyone who has been involved in a Ponzi scheme case,⁶ the factual allegations will sound familiar. We describe them here because the rise in oil and gas prices during the past year make such schemes more likely.

From July 2014 to March 2017, defendants raised nearly \$3.9 million through a nationwide cold-calling campaign conducted by contract salesmen. Investors were lured with promises of guaranteed returns ranging from 227% to 363% over six years, but the pitch to investors (1) contained materially false and misleading statements regarding historical and projected oil production, (2) falsely guaranteed 72 monthly production payments “regardless of the price of oil,” and (3) failed to disclose prior regulatory actions against oil-and-gas entities controlled by Milles. The investment funds never generated any actual revenues. Instead, the “production payments” sent to investors were funded by their own and new investors’ capital contributions. Investor funds were also used to hire the cold-calling salesmen and pay defendants’ personal expenses.

The Court granted summary judgment for the SEC on all counts. While the Court cited evidence the SEC presented, it was also swayed by defendants’ repeated invocation of their Fifth Amendment privilege when asked deposition questions about their misleading statements, attempts to hide their scheme when production payments ceased, and their use of investor funds to pay “production payments.” While both defendants claimed they were duped by a third party who allegedly falsified ownership leases and production reports on which they relied, they produced no evidence to support this claim. The Court also noted that even assuming the third

⁶ For an entertaining summary of the life of Charles Ponzi, see <https://www.damninteresting.com/the-eponymous-mr-ponzi/>.

Fletcher Held Quarterly Newsletter (1Q22)

party existed, the defendants offered no evidence rebutting the SEC’s allegations about their own misrepresentations, including the use of investor funds to make “production payments.”

The Court entered a permanent injunction and ordered defendants to disgorge ill-gotten gains and benefits in amounts to be determined by future motion of the SEC.

4. Others

(a) *Seybold v. Charter Communications, Inc.*, 2022 WL 675804 (N.D. Tex. Mar. 7, 2022) (Starr, J.)

Judge Starr denied Charter Communications, Inc.’s (Charter) motion for judgment on the pleadings on its former employee’s Sarbanes-Oxley (SOX) whistleblower claim [18 U.S.C. § 1514A(a)] but granted the motion with respect to his breach of employment contract claim.

Darrell Seybold made four reports to Charter challenging certain policies: (1) Charter’s 2015 policy to retag customers to make old customers appear to be new, but not paying salespeople on the “new” customers, (2) 2019 policy change to classify senior homes as both a commercial account with the owner, as well as individual accounts for each tenant, (3) changes to the “sales funnel” (projected sales) that led employees to exaggerate information passed on to shareholders and prospective buyers, and (4) errors in paying sales commissions. He alleged that these policies were securities fraud, cooking the books, and shareholder fraud. Charter fired him after he followed up on his fourth report.

SOX forbids publicly traded companies from retaliating against an employee for

any lawful act done by the employee ... to provide information ... regarding any conduct which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343 [wire fraud], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders

when the information or assistance is provided to a government agency or a supervisor. 2022 WL 675804, at *2 (quoting 18 U.S.C. § 1514A(a)). To prevail on a SOX whistleblower claim, “an employee must prove by a preponderance of the evidence that

(1) []he engaged in protected activity; (2) the employer knew that []he engaged in the protected activity; (3) []he suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action. *Id.* at *3 (quoting *Allen v. Admin. Rev. Bd.*, 514 F.3d 468, 475–76 (5th Cir. 2008)).

Relying on a Tenth Circuit case, Charter argued that Seybold’s claim should be dismissed because he participated in the alleged fraud. The Court rejected this argument, stating that it would not “engraft a common-law unclean hands defense onto a federal law without the Fifth Circuit saying so.” *Id.* at *3. The Court also rejected Charter’s argument that a plaintiff is required to plead that the “purportedly fraudulent information would have had a material impact on the reported information,” holding that there is no materiality requirement for a whistleblower claim. The Court found that Charter’s other critiques of the complaint could be cured through repleading,

Fletcher Held Quarterly Newsletter (1Q22)

such as pleading that plaintiff believed there was a violation at the time he made his reports and identifying the specific conduct he thought was illegal.

The Court dismissed Seybold's breach of contract claim, finding that he was an at-will employee because Charter's compensation plan specifically stated that "nothing in this Plan shall constitute a contract of employment or contract of any other kind." *Id.* at *5.

**(b) *Rotstain v. Trustmark Nat'l Bank*, 2022 WL 179609
(N.D. Tex. Jan. 20, 2022) (Godbey, J.)**

In this chapter of the long-running R. Allen Stanford Ponzi scheme litigation, Judge Godbey denied substantially all the motions for summary judgment filed by HSBC Bank PLC (HSBC), Independent Bank, Trustmark National Bank (Trustmark), Toronto-Dominion Bank (TD Bank), Société Générale Private Banking S.A. (SG Suisse), and Blaise Friedli. Plaintiffs, the Receiver and the Official Stanford Investors Committee (OSIC) and certain named plaintiffs, alleged that the Defendants provided banking services that supported and furthered Stanford's scheme.

Timeliness of Plaintiff's Claims. The Court found that Plaintiffs' claims under the Texas Securities Act (TSA) were timely even though Plaintiffs did not assert TSA claims until after the limitations period expired because (1) Plaintiffs alleged sufficient facts to state a TSA claim prior to the expiration of the limitations period and (2) timeliness is based upon the adequacy of the factual allegations under Rule 8, not the articulation of a precise legal theory. 2022 WL 179609, at *3. The court also found that OSCI timely pled its breach of fiduciary duty claims.

The Court next held that Plaintiffs' constructive fraudulent transfer claims under the Texas Uniform Fraudulent Transfer Act (TUFTA) [TEX. BUS. COMM. CODE §§ 24.006(a) and 24.005(a)(2)] were time barred because equitable tolling under *American Pipe* during the pendency of a motion for class certification does not override a pure statute of repose such as the one set forth in Section 24.010(a)(2). However, the statute of limitations applicable to claims under Section 24.005(a)(1) includes a discovery provision. *See* Section 24.010(a)(1). Thus, these claims are not time barred. *Id.* at *4-5.

Texas Law Recognizes Liability for Knowing Participation. The Court noted that Texas recognizes a claim for knowing participation in a breach of fiduciary duty and denied summary judgment on these claims. *Id.* at *5.

Plaintiffs' Damages Are Cognizable. The Court held that Plaintiffs' "increased liability theory" of damages was sufficient to state a claim. Defendants cited a Fifth Circuit decision that dismissed Clayton Act claims for failing to articulate a viable damages model to argue that a viable damages model is required to survive summary judgment. The court, however, distinguished Clayton Act claims, which require plaintiffs to provide some indication of the *amount* of damages, from other claims, which only require a showing of the *existence* of damages. The court also found that defendants' other arguments "elide the distinction between direct and derivative liability." Plaintiffs calculated damages attributable to Stanford's primary violations and sought to hold Defendants liable for those losses pursuant to knowing participation and aiding and abetting theories of derivative liability.

Fletcher Held Quarterly Newsletter (1Q22)

Plaintiffs' Aiding and Abetting TSA Violations Are Viable. The Court found that R. Allen Stanford and James Davis committed primary violations of the TSA as “sellers” of securities because they solicited the sales even if they did not personally pass title to the securities. *Id.* at * 6. Further, Stanford International Bank Limited (SIBL) committed primary TSA violations even if it did not know of the Ponzi scheme because scienter is not an element of a claim. TEX. REV. CIV. STAT. ART. 581-33A(2). Lack of knowledge is an affirmative defense, and the fact that the Fifth Circuit previously refused to impute knowledge of the scheme to SIBL (in the context of the Receiver’s fraudulent transfer claims on behalf of SIBL) does not establish this affirmative defense as a matter of law. *Id.* at *7.

The Court also found that Plaintiffs had sufficient evidence to create a genuine issue whether the false or misleading statements induced the purchase of securities. The Court noted that Plaintiffs allege that Defendants materially aided primary TSA violations by Stanford, Davis, and SIBL by providing banking services to SIBL. The Court found that “Plaintiffs may prevail by establishing their theory of wholesale causation corresponding to the ongoing, systematic violations of the TSA that they allege.” *Id.* at *8.

Fiduciary Duty Claims Are Viable. The Court found that OSIC, as an assignee of the Receiver, can enforce the fiduciary duties owed to SIBL and can therefore bring a derivative action related to an alleged breach of those duties. Moreover, Stanford could not ratify the fraudulent conduct giving rise to those breaches. *Id.* at *9.

Defendants' Financial Services Can Constitute Substantial Assistance. Defendants argued that their routine banking services cannot amount to substantial assistance of the Ponzi scheme. The Court recognized a “distinction between common services – which may rise to the level of substantial services – and merely routine services – which do not.” The distinction is based on whether “the alleged aider exercised professional judgment or discretion in providing service to the primary violator.” The Court found that Defendants’ services were significant and nonroutine, including providing pouching services for CD investors’ checks, providing unusual loans and revolving credit, and lending their reputation to Stanford.

Defendants' Mental States in Genuine Dispute. Although scienter is not an element of a claim for primary violations of the TSA, to establish a claim for aiding and abetting, “the evidence must reasonably suggest that Defendants assisted in the perpetration of the primary TSA violations ‘with intent to deceive or with reckless disregard for the truth or the law.’” *Id.* at *10 (quoting TEX. REV. CIV. STAT. art. 581-33F(2)). Although the Court noted that “should have known” is insufficient, a plaintiff “a plaintiff can still establish a defendant’s scienter as an aider and abettor without showing knowledge of the Ponzi scheme itself.” The Court held that “the evidence must simply suggest a subjective awareness of material misstatements being made in connection with the sales of CDs.” *Id.* at *11. The court reviewed each Defendant's access to information and determined that there was a genuine issue of fact as to each defendant’s “general awareness” of improper behavior by the Stanford entities.

The Court similarly found that fact issues precluded summary judgment on Plaintiffs’ claims for knowing participation in a breach of fiduciary duties.

Fletcher Held Quarterly Newsletter (1Q22)

TSA and TUFTA Claims Can Be Asserted Against Foreign Defendants. The Court held that even if the TSA cannot be applied to sales of securities outside the state of Texas, a fact issue exists as to the possible connections between Defendants' services to the Stanford entities and sales that occurred in Texas. The Court also found that even if TUFTA cannot be applied extraterritorially, there was a fact issue whether the Defendant "understood itself to be dealing with a Texas-based network of affiliated entities." *Id.* at *15.

Forum Selection Clauses Do Not Bind OSIC. Finally, the Court held that the forum selection clauses in SG Suisse's agreements with its Stanford clients are not binding on OSIC or the individual plaintiffs. Thus, Switzerland is not the sole forum for claims against SG Suisse.

(c) ***Setliff v. Zoccam Techs., Inc.*, 2022 WL 504395 (N.D. Tex. Feb. 18, 2022) (Boyle,J.)**

Plaintiff Reuben Setliff is a minority shareholder in a closely held Texas corporation, Zoccam Technologies, Inc. (Zoccam). Setliff sued Zoccam and its CEO, Ashley Cook, alleging that they fraudulently induced him to convert his preferred stock to common stock by misrepresenting his rights and protections under a restated certificate of incorporation. He asserted claims for declaratory judgment, breach of contract (regarding a settlement agreement and the original certificate of formation), conversion, breach of fiduciary duty, state securities fraud [TEX. REV. CIV. STAT. art. 581-33], statutory fraud [TEX. BUS. & COMM. CODE ANN. § 27.01], common law fraud, and fraud by nondisclosure, and negligent misrepresentation. The Court dismissed the bulk of the claims, with leave to replead.

Applying the factors set forth in *St. Paul Ins. Co. v. Trejo*, 39 F.3d 585, 590–91 (5th Cir. 1994), the Court dismissed Plaintiff's declaratory judgment claims because they were duplicative of his breach of contract claims. 2022 WL 504395, at *4-6.

Addressing Plaintiffs' two breach of contract claims, the Court found that Plaintiff sufficiently identified provisions in the settlement agreement that were allegedly breached, but it found that Plaintiff failed to "pin down any particular sub-paragraphs [of the certificate of formation] that form the basis of the breach-of-contract claim." *Id.* at *8. The Court also found that because only the company was a party to the contracts, the breach of contract claims against the CEO must be dismissed.

The Court dismissed Plaintiff's conversion claim in which Plaintiff alleged that Defendants denied him possession of his preferred stock (and cancelled it). The Court found that this claim was governed by the settlement agreement and certificate of formation. Thus, the claim sounds in contract, not the tort of conversion. *Id.* at *10. The Court dismissed Plaintiff's negligent misrepresentation claim for the same reason. *Id.* at *16.

The Court dismissed Plaintiff's breach of fiduciary duty claims against the CEO because under Texas law, corporate officers and directors owe duties to the corporation, not to individual shareholders. *Id.* at *10.

The Court dismissed Plaintiff's TSA claims because the conversion of preferred stock to common stock does not constitute a "sale" under the TSA. *Id.* at *11 (quoting TEX. REV. CIV. STAT. art. 581-4(E) (excluding from "sale" definition any "sale of a security under conditions which

Fletcher Held Quarterly Newsletter (1Q22)

entitle the purchaser or subsequent holder to exchange the same for, or to purchase some other security”)).

The Court dismissed Plaintiff’s statutory and common law fraud claims because Plaintiff failed to identify who made the alleged misrepresentations. The Court found that Plaintiff sufficiently identify the allegedly false statements made at a November 9, 2018, board meeting. However, the statements were all made by a lawyer, and the Court found that the Complaint failed to sufficiently plead that the lawyer acted as an agent of either the Company, the CEO, or both. Thus, the Court dismissed the claims for failure to plead with particularity. *Id.* at *16.

(d) *United States v. Sneed*, 2022 WL 35801 (N.D. Tex. Jan. 4, 2022) (Boyle, J.)

Judge Boyle denied motions to dismiss indictments, exclude testimony, and sever claims against defendants Clifton Sneed and Marva Sneed. The defendants allegedly created and marketed investment groups that would allow investors to purchase a membership in an investment group and gain access to investment platforms offering 300% returns in 90 days. *Id.* at *1. The Court’s thorough opinion discusses each motion in detail, but this summary will only address defendants’ arguments that (1) memberships in an investment group are not securities and the sales of memberships were not “in connection with” the purchase or sale of a security; and (2) the congressional delegation of rulemaking authority to the SEC in Section 10(b) of the Exchange Act was an unconstitutional delegation of legislative power.

Are Memberships in Investment Groups Securities?

Section 10(b) and Rule 10b-5 prohibit (1) using any deceptive device, (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission. *United States v. O’Hagan*, 521 U.S. 642, 651 (1997). The Securities Act defines the term “security” and includes “investment contracts” within its scope. In *SEC v. Howey*, 328 U.S. 293, 298-99 (1946), the Supreme Court defined an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Clifton Sneed first challenged the securities fraud count of the indictment by arguing that memberships in investment clubs are not securities and were not made “in connection with” the purchase or sale of securities.

The Court agreed that memberships in an investment club did not qualify as securities because “the investors expected profits from their individual investments and not from the memberships.” *Id.* at *6. Investors were required to pay a non-refundable investment fee of \$20,000, but that only granted them access to investor platforms. Investors subsequently wired money to the Sneeds to invest. Accordingly, because investors did not expect any profit from the memberships, they did not qualify as securities. *Id.* But that did not end the Court’s analysis.

The Court cited numerous cases in which acts that “coincide” with securities investments were deemed fraudulent practices subject to the securities laws. In *SEC v. Zandford*, 535 U.S. 813 (2002), the Supreme Court reversed dismissal of wire fraud charges because the defendant’s inducement of an investor to open an investment account – which the defendants managed and used to misappropriate funds – was in connection with the purchase or sale of a security. The

Fletcher Held Quarterly Newsletter (1Q22)

Supreme Court ruled “[t]he securities sales and [defenda]nt’s fraudulent practices were not independent events.” *Id.* at 820. In *Roland v. Green*, 675 F.3d 503, 512 (5th Cir. 2012), *aff’d sub. nom. Chadbourne & Parke, LLP v. Troice*, 571 U.S. 377 (2014), the Fifth Circuit ruled that the best definition of the “coincide” requirement is whether “there is a relationship in which the fraud and stock sale coincide or are more than tangentially related.” The Court found that although the sale of investment club memberships did not coincide with the sales of securities, the misrepresentations “were the impetus for the investors to buy a membership and invest in the funds offered by the Sneeds” and, thus, directly related to the purchase of securities. *Sneed*, 2022 WL 35801, at *7.

Was Rule 10b-5 the Result of an Unconstitutional Delegation of Legislative Power?

Clifton Sneed’s second challenge to the securities fraud count of the indictment recycled an old challenge to the constitutionality of criminal charges under Rule 10b-5. Article I of the Constitution vests legislative powers in the Congress and prohibits Congress from delegating its legislative power to another branch. *Mistretta v. United States*, 488 U.S. 361, 371 (1989). A delegation by Congress is only considered sufficient if it (1) clearly delineates its general policy, (2) the public agency which is to apply it, and (3) the boundaries of that delegated authority. *Big Time Vapes, Inc. v. FDA*, 963 F.3d 436, 443-44 (5th Cir. 2020) (quoting *Mistretta*, 488 U.S. at 372-73). Clifton Sneed argued that Section 10(b) of the Exchange Act violates Article I because it grants too much power to the SEC to promulgate rules and regulations “in the public interest” that “govern every conceivable sector of the economy,” and violates the legal tradition of preference for “legislative action in the enactment of offenses.”⁷

The Government responded by citing *National Broadcasting Co. v. United States*, 319 U.S. 190, 215 (1943), a case in which the Supreme Court upheld a congressional delegation of authority to the Federal Radio Commission to impose regulations on licensing based on the intelligible principle that it was in “the public interest, convenience, or necessity” and would “provide a fair, efficient, and equitable distribution of radio service.” The Government urged the Court to rule broadly that “the public interest” was a catch-all intelligible principle sufficient to delineate the boundaries of delegated authority. The Court refused, noting that “[w]hile limited by the availability of capital, securities far exceed the availability of radio waves.” The Court then proceeded to analyze the relationship between Section 10(b) and Rule 10b-5.

Section 10(b) delegates to the SEC the power to “prescribe ... such rules and regulations ... as necessary or appropriate in the public interest or for the protection of investors” to make unlawful the usage or employment of “any manipulative or deceptive device or contrivance” “in connection with the purchase or sale of any security.” 15 U.S.C. §78j(b). The “public interest” or “protection of investors” is the intelligible principle to guide the SEC’s drafting of rules and

⁷ According to SEC lore, Rule 10b-5 was drafted one morning and presented to the Commission for approval that afternoon. See Feb. 8, 1996 Letter from Mayer U. Newfield to Milton V. Freeman discussing Freeman’s 1993 Foreword to the Fordham Law Review on the 50th anniversary of Rule 10b-5. http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197e579b45.r81.cf1.rackcdn.com/collection/papers/1990/1996_0208_Newfield_Rule10b5.pdf

Fletcher Held Quarterly Newsletter (1Q22)

regulations. In addition, Section 2 of the Exchange Act elucidates this intelligible principle by describing the necessity for regulation as:

a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions[.]

15 U.S.C. 78(b).

The Court ruled the intelligible principle elucidated by the necessity for regulation provided a “standard to guide determinations” for the SEC. *Sneed*, 2022 WL 35801, at *10. Rule 10b-5 makes unlawful the employment of “any device, scheme, or artifice to defraud,” making misstatements or omissions of material facts, and engaging “in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” “Such a reformulation of a statute as a rule hardly runs afoul of nondelegation principles.” *Id.* (citing *United States v. Pray*, 452 F.Supp. 788, 797 (M.D. Pa. 1978)).⁸ The Court deemed the congressional delegation constitutionally sufficient. *Id.* It also found support in the Supreme Court’s decision in *United States v. O’Hagan*, 521 U.S. 642, 651 (1997), which did not deal with delegation but stated that Rule 10b-5 “d[id] not extend beyond conduct encompassed by §10(b)’s prohibition.”

II. STATE COURT CASES

A. Texas Appellate Courts

1. *Conestoga Tr. Servs., LLC, Tr. of Conestoga Tr. v. Focus Med. Underwriters, LLC*, 2022 WL 599344 (Tex. App. – Hou. [14th Dist.] Mar. 1, 2022)

The 14th Court of Appeals in Houston reversed the trial court’s dismissal of fraud and negligent misrepresentation claims filed against a group of defendants who sold life settlements. Plaintiffs alleged that Defendants prepared reports projecting shorter life expectancies to make the life settlement investments appear more valuable. Defendants moved to dismiss under TRCP 91a,

⁸ Although not cited by the Court, one of the early cases that Scott worked on challenged the constitutionality of criminal actions under Rule 10b-5 for insider trading. *See United States v. Lang*, 766 F.Supp. 389, 399 (D. Md. 1991) (addressing defense argument that Congress did not intend to criminalize insider trading under §10(b) or Rule 10b-5 because the legislative history did not mention insider trading and Congress refused to criminalize “short swing” trading by insiders in §16(b)). At that time, only seven criminal indictments for insider trading had been filed. While the defense lost this academic, pretrial argument, the clients were acquitted of insider trading at trial.

Fletcher Held Quarterly Newsletter (1Q22)

arguing that life expectancy reports are estimates, projections, and predictions and pure expressions of opinion that cannot provide a basis for fraud or negligent misrepresentation claims. The trial court agreed and awarded attorney's fees to Defendants.

The appellate court summarized Texas case law governing expressions of opinion as follows:

Pure expressions of opinion are not representations of material fact. *Italian Cowboy Partners*, 341 S.W.3d at 337-38. However, whether a statement is an actionable statement of fact or merely one of opinion depends on the circumstances. *Id.* at 338. Special or one-sided knowledge can establish that a statement is one of fact, not opinion. *Id.* Moreover, an opinion based on past or present facts may establish a basis for fraud or negligent misrepresentation when the speaker has or purports to have superior or special knowledge of the facts underlying the opinion. *See id.*; *see also Eckmann v. Des Rosiers*, 940 S.W.2d 394, 398 n.3 (Tex. App.—Austin 1997, no writ) (“A pretended opinion is actionable if made to deceive and a false statement of existing fact is actionable.”). In that connection, “[a] statement of value may be actionable if the speaker knows it is false.” *Transp. Ins. Co. v. Faircloth*, 898 S.W.2d 269, 276 (Tex. 1995).

Id. at *2.

The Court then reviewed the allegations in the petition, construing them liberally in favor of Plaintiffs and accepting all factual allegations as true Plaintiffs alleged:

- The life expectancy reports were based on misrepresentations involving facts only accessible to Defendants;
- The projections were not derived from accepted data and methods used in the industry, and this was known to Defendants;
- The lower/shorter life expectancies in the projections made the policies appear more valuable to investors; and
- Defendants knew investors would rely on the artificially short life expectancy projections.

The Court concluded these allegations were sufficient to allege claims for fraud and negligent misrepresentation. With respect to opinion statements, the Court noted that Plaintiffs alleged that the “projections were more than pure expressions of opinion because they were based on knowing misrepresentations about past or present facts.” *Id.* In addition, Plaintiffs had superior information and access to the insureds’ medical records and history. The Court of Appeals reversed the dismissal and remanded the case for further proceedings.

The case is a useful reminder that courts approach statements of opinion differently. In *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175 (2015), the Supreme Court addressed when statements of opinion might be actionable under section 11 of the

Fletcher Held Quarterly Newsletter (1Q22)

Securities Act. The Supreme Court addressed two ways in which statements can be misleading under section 11: (1) whether defendants made untrue statements of material fact, and (2) whether defendants omitted to state material facts necessary to make other statements not misleading.

In discussing the first theory of liability (making untrue statements of material fact), the Supreme Court considered how it would apply to two hypothetical statements by a company's CEO: (1) "The TVs we manufacture have the highest resolution available on the market" and (2) "I believe ... the TVs we manufacture have the highest resolution available on the market." *Id.* at 183-84. The first would be an untrue statement of fact if a competitor had introduced a higher resolution TV a month before, whether or not the CEO knew it. The second would be true, provided the CEO actually believed the statement and did not support it with facts that were untrue.

The second theory of liability (omitting to state facts necessary to make an opinion not misleading) requires greater consideration of the context in which statements are made. The Supreme Court posed a hypothetical about legal compliance in which the CEO stated: "We believe our conduct is lawful." The Court noted that investors reasonably believe the statement "fairly aligns with the information in the issuer's possession at the time." *Id.* at 189. Thus, the statement would be misleadingly incomplete if made without consulting a lawyer, if made contrary to the lawyer's advice, or if made knowing the Federal Government took the opposite view. But the statement would not necessarily be misleading if an issuer knows, but fails to disclose, some fact cutting the other way. For example, if the issuer did not disclose that a single junior attorney expressed doubts about the practice's illegality but six of his more senior colleagues gave a stamp of approval. *Id.* at 190. As the Court stated: "A reasonable investor does not expect that *every* fact known to an issuer supports its opinion statement." *Id.*

2. *Hrdy v. Second St. Properties LLC*, 2022 WL 903952 (Tex. App. Mar. 29, 2022)

The First Court of Appeals in Houston issued its post-trial opinion in a fiduciary duty dispute arising out of a real estate development project. Walker Royall and his cousins inherited a tract of land (the "Blaffer Tract") along the Brazos River. They formed a limited partnership ("LP") to manage the land with Walker's commercial real estate company ("Briarwood Capital") as the general partner. In 2002, the City of Freeport approached Walker with a proposal to develop a marina using a portion of the Blaffer Tract and other properties. The LP eventually entered into two development agreements with the City, but the project did not move forward as anticipated.

By 2009, the LP and the City were in litigation and a rift had developed between Walker and his cousins ("Other Limited Partners"). Walker and his cousins mediated their dispute, and two months later, the LP settled its dispute with the City. But that did not end the matter. The Other Limited Partners removed Briarwood Capital as the general partner of the LP, and Walker sued for a declaration that the action was invalid because the partnership agreement required unanimity when designating a new general partner. The Other Limited Partners then countersued for millions in damages alleging that Walker and Briarwood Capital had breached their fiduciary duties when they acquired several tracts of land for the marina project that were bought or should have been bought by the LP.

Fletcher Held Quarterly Newsletter (1Q22)

The case was tried to a jury which found:

1. A relationship of trust and confidence existed between Walker and the Other Limited Partners, and Walker also controlled Briarwood Capital, the general partner of the LP.
2. Walker and Briarwood Capital complied with their fiduciary duties when Walker acquired certain tracts of land (the Stanley and Henderson Tracts) but breached their fiduciary duties when they transferred other tracts (the City and District Tracts) out of the LP and into another entity controlled by Walker.
3. The Other Limited Partners abandoned their claim for damages so the jury awarded \$2 in damages for the breach associated with transfer of the City and District Tracts.

After hearing post-trial motions, the district court entered a final judgment that imposed a constructive trust requiring Walker and related entities to convey certain tracts to the LP and for the LP to pay \$100,000 as an equitable adjustment. The district court also ordered a court-appointed receiver to wind down the LP's affairs and liquidate the assets by public auction or private sale, with the proceeds distributed to all parties including Briarwood Capital and another company controlled by Walker in accordance with their respective partnership interests. Finally, the court ordered each side to bear their own costs and attorney's fees.

On appeal, the Other Limited Partners challenged (1) the legal and factual sufficiency of the jury findings; (2) the trial court's award of an equitable reimbursement; (3) the order dissolving the LP; (4) the court's failure to award them attorney's fees; and (5) several other issues. Walker and the entities he controlled challenged the trial court's failure to award them attorney's fees. The Court of Appeals affirmed the trial court's judgment except for the award of an equitable reimbursement and the failure to award attorney's fees to the Other Limited Partners. One member of the panel disagreed with the majority's determination that no fiduciary duties were breached when the Stanley and Henderson Tracts were purchased. The factually dense, 38-page opinion about the marina development is worthy of further review for those handling similar cases, but this summary will focus only on the dispute between the majority and dissenting opinions over the Stanley Tract.

The First Development Agreement for the marina project was signed in 2003. The LP contributed the Blaffer Tract and \$75,000 to a separate entity which purchased two properties from the City. Separate from the First Development Agreement, Walker secured an option for the LP to purchase another tract inside the marina development area known as the Stanley Tract. After the marina project stalled, the City threatened to exercise its contractual right to repurchase the two properties it had sold. Walker negotiated to stave off the repurchases, and the City agreed to do so if the Stanley Tract were purchased as a show of good faith to continue the project.

Walker recommended that the LP purchase the Stanley Tract. Although the partnership agreement only required a simple majority to acquire the land, Walker asked 100% of the Other Limited Partners to participate to avoid complaints about dilution. He said that if the Other Limited Partners were not willing to buy the Stanley Tract, he would do so to avoid disruption of the project. While a majority of the Other Limited Partners approved the proposed purchase (all that was required by the partnership agreement to do so), some did not. Since there was not unanimous

Fletcher Held Quarterly Newsletter (1Q22)

participation, Walker purchased the Stanley Tract himself. At trial, Walker claimed this separate purchase was disclosed to and approved by the Other Limited Partners in a telephone call, but it was not memorialized in writing.

The jury found that Walker and Briarwood Capital did not breach their fiduciary duties to the LP when Walker's separate company acquired the Stanley Tract. On appeal, the Other Limited Partners argued the evidence was insufficient to show Walker met his fiduciary duties because (1) he acquired the property surreptitiously, pretending the partnership agreement required unanimity when it did not; (2) no reasonable jury would credit Walker's disputed testimony that Other Limited Partners authorized him on a telephone call to purchase the Stanley Tract directly; (3) even if the phone call occurred, Walker's disclosure about the potential transaction was so incomplete it was unfair; and (4) the Stanley Tract purchase was unfair because it made Walker a direct competitor of the LP and he paid no consideration for taking the LP's option to acquire the Stanley Tract as his own.

The majority addressed each of these points, explaining how the jury could have concluded based on the evidence presented that no breach occurred.

First, Walker acknowledged that unanimity was not required but that he desired 100-percent participation as a precondition for buying the tract to avoid dilution. The record included evidence from which the jury could have concluded that the Other Limited Partners were not misled because they signed the partnership agreement that did not require unanimity, and some of them responded in writing that unanimity was not required.

Second, as to Walker's testimony that Other Limited Partners approved the purchase on a telephone call, there was conflicting testimony. Some participants recalled a phone call, others did not. There was additional testimony that the parties did not exclusively communicate in writing about the Stanley Tract, leaving open the possibility that approval was given on the call. The jury was entitled to resolve this conflicting testimony in favor of Walker.

Third, the Other Limited Partners claimed Walker did not disclose that the City was willing to pay rent on the Stanley Tract. The dissent noted that Walker never testified that he told the Other Limited Partners the City had threatened to repurchase the other tracts or that they had a right to compensation for his use of the partnership's option. Nor did he disclose the consequences and effect of the Stanley Tract transaction, claiming "he did not remember" when he received monthly rental checks from the City for use of the Stanley Tract. While the Other Limited Partners asked Walker to manage the LP because of his real estate experience, the dissent argued he still had a duty to explain the details and consequences of the proposed action. By contrast, the majority ruled there was no evidence the City offered to pay rent until several years later and refused to base its decision on events that happened later, rather than evaluating the circumstances at the time.

Fourth, the Court ruled there was evidence from which the jury could conclude the transaction was not unfair to the LP. Specifically, the partnership agreement allowed any partner to "engage in or possess an interest in other business ventures of any nature or description, independently or with others, similar to, or competitive with the business" or the LP. Since the parties were allowed to limit the scope of their fiduciary duties in this manner under Texas law,

Fletcher Held Quarterly Newsletter (1Q22)

the existence of a conflict of interest resulting from competition, standing alone, did not make Walker's purchase of the Stanley Tract unfair. *See Strebel v. Wimberly*, 371 S.W.3d 267, 284 (Tex. App. – Houston [1st Dist.] 2012, pet. denied).

The dissent ignored that provision and argued that Walker gave no monetary consideration to the partnership when he exercised its written purchase option and then caused the LP to transfer the Stanley Tract to an entity he controlled. Citing *Lee v. Hasson*, 286 S.W.3d 1, 27-28 (Tex. App. – Houston [14th Dist.] 2007, pet. denied), the dissent argued that “principal's exchange of something valuable for no consideration precludes a finding that the fiduciary placed the principal's interests before his own.” According to the dissent, Walker was already obligated to preserve the marina's viability so that non-monetary benefit was no consideration for taking the partnership's purchase option for himself. Nor could Walker claim that he enhanced the value of the original inherited tract as consideration because he had already agreed to act as a fiduciary in this regard.

The majority rejected the comparison to the *Lee* case noting the facts there were undisputed. It emphasized that Walker paid \$90,000 out of his own pocket for the Stanley Tract and by doing so “staved off the repurchase” of the other tracts by the City and “helped protect [the partnership's] existing investment in the marina development area during a time of uncertainty.” Viewing the challenged transaction in this light, the majority upheld the sufficiency of the jury findings and ruled that Walker was not obligated to pay the LP for the option to acquire the Stanley Tract.

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