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SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

JULY – SEPTEMBER 2021

This quarterly newsletter summarizes recent court decisions of interest to practitioners litigating securities and fiduciary duty claims in Texas. It covers selected cases in both federal and state courts and is intended to spark discussion of new trends and developments.[1]

From July – September 2021, federal and state courts in Texas decided several cases of interest involving alleged securities violations and/or breach of fiduciary duties. Some of the federal and state court decisions reported below include:

- In separate, *per curiam* decisions, the Fifth Circuit affirmed the dismissal of three federal securities actions on grounds that plaintiffs failed to allege falsity, scienter, and/or loss causation (*Yang*, *Callinan*, and *Khoury*);
- Federal district courts in Texas dismissed one securities class action complaint (*Schulze*), which plaintiffs opted not to replead, and denied a motion to dismiss in another (*Venator*);
- District courts entered default judgments in two enforcement actions, one brought by the SEC against an investment advisor and another brought by the CFTC against a digital asset or cryptocurrency promoter; and
- Federal and state courts also issued opinions addressing fiduciary duty claims, settlement bars, motions to compel arbitration, and the crime-fraud exception.

I. FEDERAL CASES

A. Fifth Circuit

1. *Yang v. Nobilis Health Corp.*, 2021 WL 3619863 (5th Cir. Aug. 13, 2021) (per curiam).

The Fifth Circuit affirmed the dismissal of a putative securities class action for failure to meet the heightened scienter pleading requirements. The complaint alleged that Nobilis Health Corporation (Company) and its former CEO, former CFO, and former interim CFO all violated

[1] Although this is the third newsletter published this year, it is the first since Scott Fletcher and Kenneth Held formed Fletcher Held. We previously worked together at Vinson & Elkins, but then Scott left to join Jones Day and Kenneth later joined Skadden. We formed Fletcher Held to combine our large firm experience with the attention, efficiency, and responsiveness of a litigation boutique. We work independently and in coordination with other firms to represent companies and individuals in securities litigation, business disputes, enforcement matters, and internal investigations. For more information, please see our website.

GAAP and failed to write down accounts receivable they knew were uncollectible. The Company admitted in a 10-K filing that it had failed to employ personnel with the requisite knowledge or training in GAAP and failed to appropriately oversee the Company's accounting and financial reporting departments. The district court nonetheless dismissed the case for failure to allege a strong inference of scienter, and that was the only issue addressed on appeal. While the opinion was not selected for publication, it provides a useful summary of key principles and cases in Fifth Circuit scienter law.

The Court began by quoting the Supreme Court's admonition that scienter analysis is a "holistic enterprise" that asks, "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter." *Id.* at *1 (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323 (2007)). It then explained the process district courts should follow: "If 'any single allegation, standing alone, create[s] a strong inference of scienter, the case should proceed'; but if not, the court must then follow the individualized analysis with a holistic review of all scienter allegations together." *Id.* (quoting *Owens v. Jastrow*, 789 F.3d 529, 537 (5th Cir. 2015)).

The plaintiff offered the following to show scienter: (1) the CEO and CFO signed SOX certifications; (2) the GAAP violations showed the CFO knew or was severely reckless in ignoring the Company's financial state; and (3) three confidential witnesses claimed that the Company retained a backlog of unpaid claims the executives knew were uncollectible. The Court quickly dispensed with the first two boilerplate allegations, noting that SOX certifications standing alone were insufficient to allege scienter, *id.* at *2 (citing *Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc.*, 497 F.3d 546, 555 (5th Cir. 2007)), and GAAP violations standing alone were not enough to allege scienter, *id.* (citing *Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 534 & n.3 (5th Cir. 2008)).

As to the confidential witness allegations that executives knew the backlog of receivables were uncollectible, the Court described them as "conclusory" because none indicated how or when the corporate officers became aware of the information. *Id.* According to the Court, the most particularized allegation to support scienter was the CFO's presence in the Company's billing office over the course of several months. But that did not permit the Court to infer that he was aware or severely reckless because "[m]ere proximity to information does not automatically translate to knowledge of it." *Id.* (citing *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 424 (5th Cir. 2001)).

Because none of the allegations standing alone were sufficient to allege scienter, the Court then conducted a holistic analysis and reviewed the allegations against each individual defendant. *See Southland Sec. Corp. v. INSpire, Ins. Sols., Inc.*, 365 F.3d 353, 365 (5th Cir. 2004) (rejecting group pleading allegations and requiring plaintiffs in PSLRA cases to "distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud").

The allegations that the CEO knew about a backlog of uncollectible receivables based on his SOX certifications and corporate position were deemed insufficient. The Court also rejected the suggestion that the interim CFO was aware of any GAAP violations by virtue of his position. As to the former CFO, the Court found that his position, signature on SOX certifications, and the confidential witness allegations that he was present in the billing office did not present a "powerful or cogent" allegation of scienter. *Id.* at *3. The Court emphasized that his day-to-day involvement with the Company and proximity to people who allegedly knew receivables were not collectible was not enough to plead scienter. *Id.*

In a footnote, the Fifth Circuit addressed when motive and opportunity allegations, standing alone, might be sufficient to allege scienter. Describing it as a "narrow exception," the "rare case," and only applicable in "special circumstances," the Court identified four considerations that must be met in "some combination" for motive and opportunity allegations to suffice:

1. The company must be small, s*ee Alaska Elec. Pension Fund v. Flotek Indust., Inc.*, 915 F.3d 975, 985 (5th Cir. 2019) ("[This court] has never found special circumstances permitting an inference of scienter based solely on a defendant's position when the company was large.");
2. The transaction at issue must be "critical to the company's continued vitality," *see Local 731 I.B. of T. Excavators & Pavers Pension Tr. Fund*, 810 F.3d 951, 968 (5th Cir. 2016);
3. The misrepresentation must be "readily apparent to the speaker," *see id.*; and
4. The defendants' statements must be "internally inconsistent," *see Plotkin v. IP Axess Inc.*, 407 F.3d 690, 700 (5th Cir. 2005).

Having stated that only "some combination" of the factors was required, the Court nevertheless concluded the exception did not apply because the corporate defendant "was a large company with hundreds of employees, in 30 locations." *Id.* at *3. Whether this was the only argument raised by plaintiffs or whether the Court thought this factor was the most significant under the circumstances is not clear.

[Exchange Act; Securities Fraud: Class Action, Scienter, Confidential Witnesses; Accounting: GAAP, Internal Controls]

2. *Callinan v. Lexicon Pharmaceuticals, Incorporated*, 858 Fed. Appx. 162 (5th Cir. 2021) (per curiam).

In a short per curiam decision, the Fifth Circuit affirmed Judge Lake's ruling in *Callinan v. Lexicon Pharms., Inc.*, 479 F. Supp. 3d 379 (S.D. Tex. 2020). Because the Fifth Circuit "adopted" Judge Lake's reasoning, the lower court's useful overview and application of Fifth Circuit law on falsity, scienter, and loss causation is discussed below.

In a 114-page opinion, Judge Lake dismissed a securities fraud class action asserting Section 10(b) and Rule 10b-5 claims against Lexicon Pharmaceuticals (Lexicon) and its CEO and CFO. Plaintiffs alleged that Lexicon misrepresented the results of its clinical trials for a type 1 diabetes drug called sotagliflozin and omitted material information. An FDA Advisory Committee met on January 19, 2019, to review the drug and deadlocked eight to eight on whether to approve it. The FDA ultimately refused to approve the drug, resulting in a steep fall in Lexicon's stock price.

Judge Lake viewed the complaint as an impermissible attempt to plead fraud by hindsight, which he found particularly inappropriate in the context of stock drops following denial of FDA approval:

> [W]ere plaintiffs' version of falsity the law, a pharmaceutical company could be sued for securities fraud each and every time it received a NDA rejection from the

> FDA. Potential plaintiffs could merely parrot any deficiency identified by the FDA ... and then claim the company concealed from the market that it failed to include this "necessary" piece of information in its application.

479 F. Supp 3d at 428 (quoting *Immanuel Lake v. Zogenix, Inc.*, No. 19-cv-01975-RS, 2020 WL 3820424, at *9 (N.D. Cal. Jan. 24, 2020). Judge Lake emphasized that issuers are required to accurately disclose facts and cannot be held liable merely because others later draw different conclusions from those facts. 479 F. Supp 3d at 419.

Plaintiffs' Allegations and the Parties' Arguments. An important measure of the efficacy of sotagliflozin was its ability to lower diabetic patients' HbA1c (blood glucose) level to less than 7% while avoiding an insulin deficiency/high blood sugar condition known as DKA. Defendants designed a "composite endpoint" in its clinical trials, which measured the "proportion of patients who achieved an A1c of less than 7% without an episode of severe hypoglycemia or DKA." Plaintiffs alleged that the composite endpoint misleadingly understated the risks of DKA because it did not discuss the incidence of DKA other than in the context of how many more patients benefitted from the drug than experienced DKA.

Plaintiffs alleged that defendants misrepresented the results of the clinical trials on 19 different occasions, including in Form 10-Ks and the related SOX Certifications filed with the SEC in March of 2016, 2017, 2018, and 2019; nine Press Releases; three Earnings Calls; and three presentations at conferences. Plaintiffs alleged that Defendants:

- concealed the increases in DKA associated with sotagliflozin over a placebo;
- failed to disclose that the FDA had warned against using the "composite endpoint" in the Phase 3 Trials;
- misrepresented the benefits of sotagliflozin;
- failed to disclose the Time-in-Range and Glycemic Variability measures Lexicon touted were not validated for use in regulatory decision making for antidiabetic drugs; and
- failed to disclose that Lexicon did not have a meaningful risk management plan for DKA, which was essential to the approval of sotagliflozin.

Defendants argued that the gravamen of the complaint is that investors were blindsided by the FDA's decision not to approve sotagliflozin for type 1 diabetes patients prior to the Advisory Committee Meeting and that "Plaintiffs have failed to identify any information relevant to assessing the risk that FDA would not approve sotagliflozin that was not, in fact, disclosed."

Judge Lake ruled as follows.

The alleged misrepresentations and omissions are not actionable.

- The Court rejected Plaintiffs' allegations that Defendants failed to disclose FDA warnings against using the composite endpoint because (1) the Complaint failed to allege facts demonstrating that the FDA advised Defendants before the January 17, 2019 Advisory Committee meeting, (2) all but one of the alleged misrepresentations were made prior to January 17, 2019, and (3) the FDA warning was publicly disclosed prior to Defendants' alleged misleading statement in its Form 10-K dated March 15, 2019. The Complaint

lacked any allegations of fact to demonstrate that the warnings the FDA made to Lexicon's joint venture partner, Sanofi were communicated to Defendants.

- The Court rejected Plaintiffs' allegations that Defendants misrepresented the extent and severity of DKA. Defendants' failure to disclose an eightfold increase in the incidence of DKA was not actionable because Defendants disclosed the clinical trial data from which this increase could be calculated. Further, although Defendants described the incidences of DKA as "slight," "manageable," or "low," Defendants also disclosed detailed information about the DKA safety concern. The complaint also failed to allege when or how the severity of the incidence of DKA or the difficulty in managing it became known to Defendants.

- The Court rejected Plaintiffs' allegations that Defendants misrepresented the benefits of sotagliflozin. The Court noted that the Complaint did not allege that Defendants misrepresented the design or results of the clinical trials, and the Complaint failed to allege particularized facts demonstrating that Defendants structured the clinical trial to overstate the benefits or understate the risks of the drug. The Court rejected Plaintiffs' contention that Defendants had a duty to disclose the trial results were "not necessarily meaningful" or "clinically significant," as those terms generally refer to subjective concepts, not facts.

- Plaintiffs also alleged that Defendants' touting the results regarding the amount of time a patient's glucose remained within a certain range was misleading because time-in-range has not been validated for use in regulatory decision making for antidiabetic judges. The Court rejected this allegation because the FDA Advisory Committee commented favorably on this data.

- The Court rejected Plaintiffs' allegation that Defendants misrepresented that they had developed an effective DKA risk management plan when, in fact, they had not developed any plan. The Court refused to take judicial notice of certain documents proffered by Defendants, but the Court found that the transcript of the FDA Advisory Committee meeting cited in the complaint reflected that Defendants had developed a risk management plan and that Defendants' public statements accurately described the plan.

Plaintiffs failed to plead a strong inference of scienter. Despite finding that that the alleged misstatements and omissions were not actionable, the Court went on to determine that Plaintiffs also failed to plead facts sufficient to create a strong inference of scienter. The Court held that although sotagliflozin was important to the company, it was not the company's sole product, and the company was not dependent upon it for survival. Thus, there were no "special circumstances" that applied to infer scienter based solely on the CEO's and CFO's roles within the company. The Court also rejected Plaintiffs' arguments that Defendants' incentive compensation tied to FDA approval of the drug demonstrated scienter because such motives are universal to all corporate officers. Finally, the Court found the confidential witness statements (a receptionist and a sales manager) were too general and unrelated to Defendants' knowledge specifically to create a strong inference of scienter.

Plaintiffs Failed to Plead Loss Causation. As further grounds for dismissal, the Court found that Plaintiffs failed to plead loss causation. There was no dispute that the Advisory Committee's deadlock on approving the drug and the FDA's ultimate decision not to approve it caused Lexicon's stock price to fall. However, the FDA's decision did not reveal that Defendants' prior

statements regarding its clinical testing or other facts related to the drug were false. Thus, the FDA's statements were not corrective disclosures, did not reveal prior fraud, and did not establish loss causation.

Because the Court found no primary violation of the securities laws, it also dismissed Plaintiffs' control person claims under Section 20(a) of the Exchange Act.

Finally, Judge Lake denied Plaintiffs' request for leave to file an amended complaint because they failed to specify how they would correct the defects in the complaint.

[Exchange Act; Securities Fraud – Falsity, Scienter, Loss Causation, Confidential Witnesses, Leave to Amend]

3. *Khoury v. Thota*, 2021 WL 3919248 (5th Cir. Sept. 1, 2021 (per curiam).

The Fifth Circuit applied well-settled precedent to affirm affirmed Judge Hoyt's dismissal of Section 10(b) and Rule 10b-5 claims. Khoury asserted individual claims against Thota relating to Khoury's purchase of ownership interests in two nursing homes. The Fifth Circuit found that none of the alleged misrepresentations stated a claim:

- Certain misrepresentations made in 2014 were barred by the five-year statute of repose. 28 U.S.C. § 1658(2).
- The district court was not required to address alleged misrepresentations made in 2015 because Khoury asserted them only in his briefing and not in his operative complaint.
- The complaint failed to identify any misleading statement relating to the allegations that in 2016 and 2019 Thota "convinced [him] and other investors to sign a loan modification agreement with the bank." Thus, Khoury failed to plead fraud with particularity as required by Rule 9(b) and the PSLRA [15 U.S.C. § 78u-4(b)].
- Khoury also complained that after he paid a $50,000 cash call, Thota falsely stated she had raised a total for $1 million from all the investors when she had only raised $650,000. Because Thota's false statement was made after Khoury paid his contribution, Khoury did not rely on the misrepresentation, and it was not actionable.

The Fifth Circuit also held that the district court did not abuse its discretion by denying Khoury leave to file an amended complaint – even though Khoury asserted that his claims risked being time-barred – because Khoury failed to identify how he would amend his complaint to cure its defects.

[Exchange Act; Securities Fraud: Falsity; Procedure: Leave to Amend]

B. District Courts

1. *Schulze v. Hallmark Finan. Servs., Inc.*, 2021 WL 3190529 (N.D. Tex. July 28, 2021) (Starr, J.).

Judge Starr dismissed a putative securities fraud class action filed against Hallmark Financial Services (Company), its CEO, and former CFO. Hallmark sold auto insurance and was required to estimate anticipated claims expenses and show them as an expense in the current period and as a loss reserve on its balance sheet. Plaintiffs alleged the defendants knew about a "reserve project" to arbitrarily lower loss reserves, violated GAAP and SOX by improperly lowering the reserves and certifying them, and made material misstatements about the soundness and quality of the Company's methodology for estimating loss reserves. While the complaint was supported by allegations from two confidential witnesses (CWs), their allegations were conclusory, based on hearsay statements by others, and not given much weight. The Court ultimately dismissed all claims but granted plaintiffs leave to file a second amended complaint. Plaintiffs opted not to amend their complaint and voluntarily dismissed the case with prejudice.

Confidential Witnesses and Scienter Allegations

The Court first addressed whether it could consider the allegations of two CWs: (1) a Claims Program Manager who oversaw day-to-day operations of claims, loss-reserve requests, and the reporting of results to upper management; and (2) another employee who worked at the Company for five years evaluating liability exposure on claims and lawsuits, determining the level of loss reserves, and completing loss reports. The Court ruled the complaint's description of the CWs was adequate to show that the information pled fell within their scope of knowledge, but it gave their statements less weight than if they were named or independent facts were alleged.

The Court then analyzed the scienter allegations against each individual defendant. As to the former CFO, neither of the CWs mentioned him and no facts suggested he was aware that any statements he made or oversaw were false. Other than mentioning he signed certain documents, the complaint only alleged that he had control over materials published by the Company. Since "mere control over materials containing false or misleading statements does not establish scienter" and the complaint failed to plead facts indicating the CFO was severely reckless, the Court dismissed the claims against the former CFO.

The complaint's scienter allegations against the CEO were more detailed. It alleged through CW accounts that the CEO (1) participated in meetings when "project reserve" was discussed; (2) directed "project reserve"; and (3) was identified as responsible for lowering reserves by another employee in a phone call with a CW. The Court found each allegation lacking in particularity.

First, while a CW stated the CEO was present at a meeting where reserves were discussed, there was no description of what was said or how the CEO participated. The confidential witness did not state that the CEO was present when reserves were arbitrarily adjusted lower.

Second, there was nothing to suggest the CW was in a position to know whether the CEO was directing a project to lower reserves, and it was "too great a leap of logic" from the alleged facts to assume that he did.

Third, the alleged phone call claiming the CEO directed lowering of reserves was based on *quadruple hearsay* which the Court gave little weight. To make the point the Court quoted from "Ferris Bueller's Day Off" when a student tells her teacher that Ferris Bueller is sick because her "best friend's sister's boyfriend's brother's girlfriend heard from this guy who knows this kid who's going with the girl who saw Ferris pass out at 31 Flavors last night," adding that it might be serious. In fact, Ferris Bueller was not sick at all; he was just skipping school.

Looking at these allegations both individually and collectively, the Court concluded the complaint failed to adequately allege scienter against either defendant.

Particularity of Allegations

The Court then reviewed each statement alleged to be fraudulent in press releases, public filings, and a conference call. Parsing the statements carefully, the Court pointed out that none of them alleged facts supporting a strong inference of scienter, some were "future-focused and aspirational," and the allegations did not show many to be materially false.

[Exchange Act; Securities Fraud: Confidential Witnesses, Scienter]

2. *In re Venator Materials PLC Secs. Litig.*, 2021 WL 2980581 (S.D. Tex. July 7, 2021) (Eskridge, J.).[2]

Judge Eskridge ruled on motions to dismiss a putative securities fraud class action filed against Venator Materials PLC (Venator or Company) and other defendants. Plaintiffs alleged that defendants made material misrepresentations about the impact of a fire at the Company's Pori, Finland manufacturing plant and the Company's plans to rebuild it. Plaintiffs filed claims under Section 10(b) and Rule 10b-5 for alleged misstatements in public filings and public statements by the Company and its corporate officers (Executive Defendants). Plaintiffs also filed claims under Sections 11 and 12(a)(2) for alleged misstatements in offering documents against the Company, the Executive Defendants, Venator's corporate directors (Director Defendants), underwriters (Underwriter Defendants), and the shareholders who sold stock in a secondary public offering (Shareholder Defendants). After a detailed review of the allegations and evaluation of materiality and scienter,[3] the Court allowed the Section 10(b) and Section 11 claims to proceed but dismissed the Section 12(a)(2) claims against the Underwriter Defendants without prejudice. Plaintiffs subsequently filed an amended complaint, which Defendants answered. Discovery is proceeding.

Factual Background

Before its IPO, Venator was a division of Huntsman Corporation that manufactured specialty chemicals, including pharmaceutical-grade titanium dioxide (TiO_2). The Company's Pori, Finland site was its second largest TiO_2 facility.

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[2] The Court previously ruled on motions to dismiss certain defendants for lack of personal jurisdiction and outlined the same factual allegations. *See* Scott Fletcher Law, Securities Fraud and Fiduciary Duty Cases in Texas Newsletter, at 12-14 (1Q21).

[3] The Court's eight-page discussion of Legal Standards provides a useful summary of key Fifth Circuit cases addressing securities fraud claims. *Id.* at *11-18.

In January 2017, Huntsman announced plans to spin-off Venator as a separate, publicly traded corporation with shares distributed amongst Huntsman's shareholders.[4] Thirteen days after the announcement, a massive fire broke out at the Pori, Finland facility. The entire facility was damaged, and all four production lines were destroyed. Only one finishing portion of one line survived. During a February 2017 earnings call, Huntsman stated that it was committed to rebuilding the Pori facility and would not spin-off Venator until it had "absolute clarity."

In April 2017, Huntsman announced a change in plans, stating that it would sell off its interest in Venator through an initial public offering. The IPO was completed in August 2017 with more than 26 million shares sold at an offering price of $20 per share for proceeds of approximately $522 million. The IPO was followed by a secondary public offering (SPO) of more than 21 million shares sold at an offering price of $22.50 per share for proceeds of approximately $490 million. The SPO required a waiver from the Underwriter Defendants because it was completed two months before the end of a scheduled 180-day lock-up period.

After the fire and until the SPO, Huntsman began to ship partially processed TiO_2 to the Pori facility for finishing. Plaintiffs called this the "Europe-Pori Shuffle" and alleged it was a ploy to assuage investor concerns about the capacity of the facility and create the appearance that the Pori facility was producing TiO_2 when it was not. Plaintiffs also alleged that demolition of the Pori facility was still underway in July 2018, and former employees stated no work beyond demolition occurred after the fire. By September 2018, Venator (now an independent company) announced the plant would be shut down and reconstruction would cease. It further disclosed that it had incurred $415 million in additional restructuring expenses and expected to incur additional charges of $220 million through the end of 2024.

During the putative class period, Venator's stock declined 68% from the IPO price and 71% from the SPO price.

Exchange Act Claims

The Court first addressed the material falsity of the alleged misstatements by the Company and the Executive Defendants (collectively "10b-5 Defendants") and then evaluated the allegations of scienter against each of the 10b-5 Defendants. The Court grouped the alleged misstatements into four categories.

Capacity Statements

Plaintiffs claimed the 10b-5 Defendants misstated the "production capacity" of the Pori facility and Venator overall when they claimed Pori had achieved "20% of total prior capacity" or "20% of site capacity" after the fire. Plaintiffs argued the Pori facility only reached 17% of its prior capacity for finished product and that Pori's "white-end finishing" was not comparable to the full production capacity it had before the fire. Finally, Plaintiffs claimed the shipment of partially completed for "white-end finishing" (the Europe-Pori Shuffle) showed that the defendants were trying to conceal the bad news about the Pori plant. Defendants responded that 17% and 20% were not materially different in terms of production capacity and that there was no concealment of

[4] The spin-off was part of Huntsman's longstanding plan to separate its pigments and textiles businesses, but there was some urgency to complete the transaction to satisfy antitrust concerns before the merger of Huntsman and Clariant AG was announced in May 2017. Ultimately, the Huntsman-Clariant merger was abandoned in October 2017 after an activist shareholder of Clariant opposed the deal.

Pori's capacity because investors understood Venator was referring to "white-end finishing" at Pori rather than full production.

The Court resolved the dispute over the alleged "capacity" misstatements by citing the Fifth Circuit's decision in *Spitzberg v. Houston American Energy Corp.*, 758 F.3d 676, 690 (5th Cir. 2014), where the Court held that using the industry-specific term "reserves" in the oil-and-gas context while simultaneously claiming a non-industry specific definition was actionably misleading. Defendants countered that Plaintiffs had not pleaded that "capacity" had an industry-specific definition, but the Court rejected that argument at the pleading stage. *Id.* at *19 ("Where terms are 'reasonably susceptible to different interpretations,' it's appropriate to resolve that issue with evidence at a later stage."). The Court allowed claims against the Company and two Executive Defendants who made statements (Venator's CEO and CFO) to go forward.

Rebuilding Statements

Plaintiffs alleged the 10b-5 Defendants misrepresented the timeline to rebuild the Pori facility, the progress of its rebuilding efforts, and the extent of damage caused by the fire. Specifically, while the defendants made statements that the rebuild was "continuing," "on schedule" and "on pace," Venator had not yet completed the demolition phase of the project when these statements were made. Defendants responded that the statements were forward-looking and that the individuals who made the statements were not aware of contrary material facts at the time the statements were made.

The Court sided with Plaintiffs for several reasons. First, the statements were not solely forward looking because they mixed present facts and future statements. Second, the complaint adequately alleged that Venator's CEO and CFO were aware of the damage to the Pori facility. Third, the Europe-Pori Shuffle supported an inference that Venator and the Executive Defendants knew the rebuilding timeline was misleading, if not outright false, and sought to hide that fact. Accordingly, the Court allowed claims based on these statements against the Company, the CEO, and the CFO to go forward.

Market-Demand Statements

Plaintiffs alleged the 10b-5 Defendants misrepresented the cause of rising TiO_2 prices, which Plaintiffs claimed were attributable to decreased supply after the Pori fire. Specifically, they claimed that the CEO and CFO made statements linking rising prices to "improvement in business conditions for TiO_2"and "solid demand, good demand around the world." Plaintiffs asserted this was false based on deposition testimony from a Venator executive (Maiter) in an antitrust case that there was "some shuffling of production from [Venator] plant to plant." Plaintiffs then cited the district court's opinion in that case stating that "a fire at a large TiO2 plant in Pori, Finland, decreased the available titanium dioxide in Europe and caused a rapid and significant price increase." *Id.* at 21 (quoting *FTC v. Tronox, Ltd.,* 332 F.Supp.3d 187, 203-04 (D.D.C. 2018)). Defendants argued that Venator disclosed the lost capacity after the fire and the extent to which it impacted global supply, and that the statements of opinion were not actionable.

The Court agreed with defendants, noting that plaintiffs conceded that the allegation was based solely on the deposition testimony from the antitrust case. After reviewing the deposition statements in depth, the Court concluded they only related to the limited supply of TiO_2 and could

not form the basis for any inconsistency relating to market demand for the product. Accordingly, the Court dismissed the claims against defendants based on market-demand allegations.

Insurance and Impact Statements

Plaintiffs alleged the 10b-5 Defendants misrepresented the amount of insurance proceeds available from the fire. They contrasted (a) 2017 statements that the fire did not "have a material impact" because "losses incurred were offset by insurance proceeds" with (b) late 2017 and early 2018 statements about "over-the-limit costs" of $100-150 million, costs "as much as $375 million," and "more self-funding than our previous estimate of $325 to $375 million."

The Court rejected this argument, ruling that all the alleged misstatements included words such as "expect, could, and may," clearly indicating their forward-looking nature. Moreover, the Company's public disclosures contained cautionary language that they were estimates based on assumptions and "the amount by which insurance proceeds does not cover our damages may exceed current estimates." The Court also rejected other insurance-related misstatement claims.

Scienter

Based on its conclusion that alleged misstatements regarding capacity and rebuilding were sufficiently pleaded, the Court evaluated allegations of scienter concerning those statements. Plaintiffs claimed (1) the CEO and CFO were motivated to make false statements because they would receive substantial incentive compensation if the IPO/SPO were completed; (2) they were aware of adverse information concerning the Pori facility's capacity and construction progress from weekly progress reports and weekly meetings they attended; and (3) the Pori facility was uniquely important to Venator because of the high-margin TiO_2 materials it produced, making it implausible for defendants to be ignorant of the truth. *Nathenson*, 267 F.3d at 424-25 (finding strong inference of scienter where CEO of one-product company publicly stated that patent covered the product).

The Court rejected the suggestion that incentive compensation, standing alone, was sufficient to allege scienter. *Id.* at 25 (citing *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 434 (5th Cir. 2002) ("Incentive compensation can hardly be the basis on which an allegation of fraud is predicated …."). However, the Court found the complaint adequately alleged the CEO and CFO "were privy to regular reports about the status of production at and rebuilding of the Pori facility" and the lack of precision about "dates and contents of specific reports" was "not necessarily fatal at this juncture." *Id.* at *26. The Court placed substantial weight on the fact that the Plaintiff's source for this allegation was the former director of supply chain for the specialty chemical division at Venator. *Id.* As to the "special circumstances" allegation, the Court recognized that Venator was not a one-product company but nonetheless concluded a strong inference of scienter existed because more than half the company's sales came from "high value TiO_2 categories" and the Pori facility was one of its most profitable facilities in Europe. *Id.* at 27.

Securities Act Claims

Defendants first argued that all claims under Section 11 and Section 12(a)(2) were time-barred because they could and should have discovered the alleged omissions more than one year before the case was filed on July 31, 2019. Specifically, the IPO offering document from August 2017 disclosed that Venator initially planned to restore a portion of the "white end" of the Pori facility and had "lost access" to its nameplate capacity. By October 2017, Venator had disclosed

revised estimates of the rebuilding timeline and had stated it expected restructuring costs to exceed its $500 million insurance limit.

Plaintiffs responded that that the earliest they could have discovered sufficient information to plead a case was October 2018 when the Company announced that Pori would be shut down, disclosed that it was not operating at 20%, and revealed that its costs would exceed insurance limits. They pointed to statements in the SPO registration statement that the Company "would repair Pori's remaining specialty product capacity by the end of 2018" and reiterated that timeline in subsequent filings. Based on these allegations, the Court concluded that defendants had not met their burden of proof and that the allegations in the amended complaint "plausibly support a finding that the statute of limitations didn't begin to run until July 31, 2018 or later." *Id.* at 31.

Turning to the Section 11 claims, the Court observed that the same facts alleged with respect to the Exchange Act claims were repeated for the Section 11 claims. The Court rested on its analysis of the material falsity of the alleged misstatements and concluded that they were adequately plead. Accordingly, it allowed the Section 11 claims against the Company, the Executive Defendants, the Director Defendants, and the Underwriter Defendants to proceed as to the alleged capacity and rebuilding of the Pori facility.

As to the Section 12(a)(2) claims for rescission, the Court noted that Plaintiffs claimed they purchased common stock "traceable" to the IPO and SPO but did not provide details. "The amended complaint lacks direct allegations as to who purchased what securities and from which underwriter." *Id.* at *32. While Plaintiffs argued such information was not typically included in a securities fraud complaint, the Court dismissed the claims as pleaded but allowed Plaintiffs to replead to address this defect.

[Securities Act: Leave to Amend; Exchange Act; Securities Fraud: Falsity, Forward-Looking Statements, Scienter]

3. *Smith v. Insurance Adjusters Group, LLC*, 2021 WL 3477362 (E.D. Tex. July 13, 2021) (Payne, M.J.), *report and recommendation adopted*, 2021 WL 3471210 (Aug. 6, 2021) (Gilstrap, J.).

Magistrate Judge Payne recommended defendants' motion to dismiss fiduciary duty claims arising out of a partnership dispute be denied. Because no party objected to the recommendation, Judge Gilstrap adopted it. Although not a traditional shareholder derivative case, the opinion helpfully summarizes what is required to plead a breach of fiduciary duty claim in Texas.

Background

Plaintiffs Duane and Rachel Smith are insurance adjusters licensed in Texas. Duane Smith entered a partnership with William Cox and his company, Insurance Adjustment Group (IAG), to provide services in various states, including Texas. Because Cox had a felony conviction that prevented him from obtaining a Texas license, the partners conducted their work in Texas through a company owned by the plaintiffs, Premier Adjustment Group, LLC (PAG). The proceeds of the partnership were to be split 50/50, and Rachel Smith was to be compensated for all her work on its behalf. After Cox allegedly shorted the Smiths on their half of the proceeds and barred their

access to the company computer system, they sued for breach of contract and breach of fiduciary duty.

Motion to Dismiss

Plaintiffs pleaded that Cox and IAG were their business partners and owed fiduciary duties to them. They alleged that defendants "repeatedly shorted [them] on the portion of insurance proceeds they were to receive as part of their work" and did not share monies they were entitled to receive. According to the complaint, the defendants instructed attorneys handling the insurance claims to send funds directly to IAG, depriving the Plaintiffs of hundreds of thousands of dollars.

Cox and IAG moved to dismiss all claims, arguing that there was no fiduciary relationship between the parties; they did not breach any fiduciary duties; and there was no injury to the defendants.

The Court rejected each of these arguments, noting that the plaintiffs adequately alleged each element of a claim for breach of fiduciary duty: (1) the existence of a fiduciary duty; (2) breach of the duty; (3) causation; and (4) damages. *Id.* at *4 (citing *First United Pentecostal Church of Beaumont v. Parker*, 514 S.W.3d 214, 220 (Tex. 2017)).

First, the complaint alleged that the parties were business partners or in a joint venture, and a fiduciary relationship exists between partners or joint venturers as a matter of law. *Id.* at *4 (citing *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938) and *Lawler v. Dallas Statler-Hilton Joint Venture*, 793 S.W.2d 27, 33 (Tex. App. – Dallas 1990, writ denied)). The Court rejected defendants' argument that "no written partnership agreement existed," noting that whether an agreement was written or implied is irrelevant on a motion to dismiss. *Id.* at *5.

Second, the complaint alleged a breach, causation, and damages by claiming defendants made material misrepresentations, failed to disclose all material facts, and breached the duty of good faith and fair dealing by intentionally concealing hundreds of thousands of dollars due to the plaintiffs.

The Court denied the motion to dismiss.

[Breach of Fiduciary Duty]

4. ***SEC v. Sneed*, 2021 WL 4202171 (N.D. Tex. Sept. 10, 2021) (Ramirez, M.J.), *report and recommendation adopted*, 2021 WL 4408425 (N.D. Tex. Sept. 27, 2021) (Scholer, J.).**

The SEC obtained a default judgment against Sneed for violations of Sections 206(1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(1), (2); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, and (3) Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q.

Sneed misrepresented his credentials, failed to disclose prior regulatory sanctions and criminal convictions, misrepresented the size and scope of his firm, and misled investors about the investment returns and risks of the investments in digital asset mining pools ("DAMPs") he offered clients. Sneed marketed investments primarily to churchgoers and pastors. His investors lost substantially all the $1.1 million they invested.

The Court permanently enjoined Sneed from (1) violating the securities laws and (2) participating in the issuance, purchase, offer, or sale of any securities, other than purchasing or selling for his own personal account. The Court also entered judgment for disgorgement of net profits of $429,072 (plus prejudgment interest) and a civil penalty of $260,000.

[Enforcement: Unregistered Offering; Securities Fraud]

5. *CFTC v. Maldonado*, 2021 WL 4295250 (S.D. Tex. Sept. 21, 2021) (Lake, J.).

Based on a complaint filed by the CFTC, Judge Lake issued a default judgment, permanently enjoined, and awarded restitution and civil money penalties against defendant Rodrigo Jose Castro Molina (Castro) for his role in a scheme to defraud investors in Bitcoin. Castro and others operating under the name Global Trading Club (GTC) solicited at least 27 customers to speculate in Bitcoin price movements then caused misleading trading statements to them. Castro was served but did not answer the complaint. Thus, although it was a default judgment, the ruling provides some insight into claims involving digital assets like Bitcoin and the governmental entities that pursue them.

GTC marketed itself as an opportunity for non-English speaking investors to profit from price fluctuations in Bitcoin. It promoted the business through a website, a smartphone app, a YouTube channel; a Facebook page; and "cryptocurrency" seminars held in Houston and other locations. Castro conducted the seminars and claimed that GTC (a) employed "over 75 master traders"; (b) that the traders had years of experience in "crypto currency" trading; (c) used automated trading software and monitoring systems; and (d) guaranteed specific daily earnings that increased based on the customer's membership level at GTC. According to the default judgment, GTC employed no traders and concealed its fraudulent conduct by causing misleading trading statements to be posted online.

The Court first noted that Bitcoin is a "commodity" under Section 1a(9) of the Commodity Exchange Act (CEA), citing numerous cases holding that virtual currencies fall within the definition of "commodity." *See, e.g., CFTC v. Reynolds*, 2021 WL 796683-MKV, at *5 (S.D.N.Y. Mar. 2, 2021); *CFTC v. Laino Grp. Ltq.*, 2021 WL 2886013, at 12 (S.D. Tex. June 30, 2021). The Court further noted that the CFTC has jurisdiction to seek injunctive and other relief against any person who has engaged, is engaging, or is about to engage in a violation of the Commodity Exchange Act.

The ruling that Bitcoin is a commodity and, therefore, under the CFTC's jurisdiction sheds some practical light on the ongoing debate about which US regulators should have enforcement authority over digital assets like Bitcoin. The CFTC is actively engaged in enforcement actions involving digital assets. But the SEC has also settled numerous cases involving digital assets in which the government brought actions against companies that ranked digital assets that were "securities," companies that failed to register digital tokens, and companies that operated trading platforms for digital assets without registering as a securities exchange.

SEC Chair Gary Gensler testified before a Senate Committee in mid-September that the SEC and the CFTC "each have relevant, and in some cases, overlapping jurisdiction in the crypto markets" but that Congress should pass laws to provide greater protection of investors in this area.

By contrast, CFTC Commissioners seem divided on the issue. In early August, CFTC Commissioner Brian Quintenz and former CFTC Chair Christopher Giancarlo declared on Twitter that digital assets are commodities that fall under the CFTC's jurisdiction but not the SEC's. A few weeks later, CFTC Commissioner Dawn DeBerry Stump responded, stating:

> The recent growth in popularity of crypto products and other digital assets has drawn much attention to the question of how this new financial asset class is regulated in the United States. In response, there has often been a grossly inaccurate oversimplification offered which suggests these are either securities regulated by the Securities and Exchange Commission, or commodities regulated by the Commodity Futures Trading Commission. The prevalence of this misunderstanding about U.S. regulatory delineations has grown to a point that I believe requires correction.
>
> . . . . The CFTC does not regulate commodities (regardless of whether or not they are securities); rather, it regulates derivatives—and this is true for digital assets just as for any other asset class. Before considering whether to redesign the regulatory structure in the crypto context, let's get the facts straight about our current system.

Statement of Commissioner Dawn D. Stump on the CFTC's Regulatory Authority Applicable to Digital Assets (Aug. 23, 2021), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement082321.

Whether the SEC, the CFTC, or both will bring more of these enforcement actions in the future remains to be seen, but the jurisdictional debate is likely to continue as Congress considers new legislation. While an early effort to broadly define and tax "brokers" of digital assets failed, other legislation is certain to be introduced, and the playing field for future enforcement actions may change.

[Enforcement: Digital Assets]

6. *CFTC v. EOX Holdings L.L.C.*, 2021 WL 4482145 (S.D. Tex. Sept. 30, 2021) (Lake, J.).

Judge Lake denied competing motions for summary judgment in an action brought by the CFTC against EOX Holdings and one of its affiliated brokers. While the opinion centers around alleged violations of the Commodities Exchange Act (CEA), we include it here for its discussion of the misappropriation theory of insider trading addressed in the Supreme Court's *O'Hagan* decision and the SEC's insider trading case against Mark Cuban. Specifically, the Court discusses when agreements with third parties may impose a duty of trust and confidence sufficient to support the misappropriation theory.

EOX was a wholly owned subsidiary of an inter-dealer broker in OTC energy commodities registered with the CFTC. EOX executed privately negotiated, block trades in futures and options contracts. EOX and its affiliated brokers were required to report their block trades to the Intercontinental Exchange (ICE) within a short period after they were executed.

One of EOX's affiliated brokers with discretionary trading authority over an account executed numerous block trades for his energy trading customer. Before making the trades, the

broker disclosed to his customer non-public information relating to the identities, positions, orders, and trading interests of other EOX customers. EOX did not obtain consent from or disclose to its other customers that the broker was exercising discretionary authority in the same markets and taking positions opposite to them in those trades.

The CFTC brought claims against EOX and the broker for violating the, including Rule 180.1 which is the CFTC equivalent to Rule 10b-5. The CFTC alleged that the broker violated the rule by "misappropriating EOX customers' order information" by (1) trading against other customers' orders, and (2) tipping the energy customer on whose behalf he traded. Defendants moved for summary judgment on this count, arguing that EOX's other customers had consented to allow EOX to broker trades for other customers, including competitors.[5]

The Court reviewed the holdings in the *O'Hagan* and *Cuban* cases and concluded that they generally required the CFTC to establish that the broker (1) misappropriated confidential information in breach of a pre-existing duty of trust and confidence to the source of the information; (2) intentionally or recklessly, i.e., with scienter; (3) in connection with a contract for sale or purchase of a commodity in interstate commerce; (4) for personal benefit. *Id.* at *22. The Court emphasized that "the undisclosed use of confidential information, in breach of a duty not to use it for personal benefit, is what makes conduct deceptive under §10(b) and Rule 10b-5." *Id.* at 23. The Court then applied that standard to analyze the duties imposed on defendants under various agreements it had with other customers.

The Court noted that "a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship." *Id.* at 27 (quoting *Cuban* I, 634 F.Supp.2d at 725). However, the agreement "must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." *Id.* (quoting *Cuban* I, 634 F.Supp.2d at 725). Applying this standard, the Court concluded that only one of the customer agreements imposed both a duty to keep information confidential and a duty to refrain from trading. *Id.* at 28 (quoting from one agreement that required the broker not to "disclose or use such confidential information for the benefit of Broker or any other third parties . . .."). As to the customer agreements that did not expressly restrict EOX from trading, the Court concluded that there was a fact issue about how they were performed and that such evidence might support the misappropriation claim. The Court granted summary judgment on one claim but otherwise denied the motions of both parties.

[Securities Fraud: Insider Trading, Misappropriation]

7. ***SEC v. Gilman*, 2021 WL 4125195 (N.D. Tex. Sept. 9, 2021) (Lindsay, J.).**

Judge Lindsay denied a motion to stay entry of judgment in SEC civil proceedings until after resolution of a parallel criminal case. The case arose out of alleged misstatements made by Paul Gilman in connection with purported development of soundwave technology and two sham

[5] In addition to the customer agreements, the CFTC argued that a duty of trust and confidence was imposed on EOX and its broker by CFTC and ICE rules, and the Court found that both imposed duties sufficient to support the misappropriation claim.

oil and gas ventures. Defendants consented to judgments in the SEC's civil case but did not file a response when to the motion for final judgment filed by the SEC. Instead, defendants moved to stay the entry of final judgment because they had entered into a plea agreement in a criminal case pending in California federal court. The Court granted the SEC's motion for final judgment and denied the defendants' request for additional time.

Relying on the Fifth Circuit's ruling in *SEC v. First Financial Group, Inc.*, 659 F.2d 660 (5th Cir. 1981), the Court outlined the special circumstances in which civil litigation should be stayed:

1. the extent to which the issues in the criminal case overlap with those in the civil case;
2. the status of the criminal case, including whether the defendants have been indicted;
3. the private interests of the plaintiff in proceeding expeditiously, weighed against the prejudice to the plaintiff caused by the delay;
4. the private interests of and burden on the defendants;
5. the interests of the courts; and
6. the public interest.

Id. at *4. Reviewing the first two factors, the Court noted that the civil and criminal cases did not completely overlap and that defendant had in fact pled guilty and was awaiting sentencing. As to the other factors, the Court did not find they supported a stay.

[Procedure: Receivership, Stay of Parallel Civil Proceedings]

8. ***Burback v. Oblon*, 2021 WL 4477607 (E.D. Tex. Sept. 30, 2021) (Jordan, J.).**

This case challenges the old adage: "Fool me once, shame on you; fool me twice, shame on me." Plaintiffs alleged they were the victims of two fraudulent securities schemes: the Promissory Note Fraud Scheme and the CTH Stock-Fraud Scheme.

Promissory Note Fraud Scheme (FOG). Plaintiffs alleged they were defrauded on September 10, 2015, when they invested in FourOceans Global, LLC (FOG). They executed Note Purchase Agreements for securities in this unregistered entity based on alleged misrepresentations by the defendants. In approximately February-March 2016, they were misled again and told that their investment in FOG had been migrated into two other companies. On or about October 9, 2017, they were misled a third time when they were told the two companies to which their investment had "migrated" had been acquired by another entity.

Stock-Fraud Scheme (CTH). In February 2018, the plaintiffs finally asked defendants about their investments, and Defendants "indicated" there were no irregularities with the FOG investments. Defendants also told plaintiffs they had "a plan" to get their ownership and equity interests in FOG converted into stock in another company and asked plaintiffs to transfer and assign their interests in FOG to a company called CTH. Plaintiffs subsequently entered into subscription agreements in CTH. At that time, Defendants told Plaintiffs CTH was about to be

acquired by SHRG, that this was not public knowledge, and they were not supposed to know about it. The planned acquisition never took place, and on June 1, 2019, plaintiffs learned that FOG had been dissolved and their shares were worthless.

Plaintiffs did not file suit challenging either scheme until December 11, 2020 – more than five years after their purchase of FOG shares but less than five years from the CTH transaction.

The Court dismissed the FOG-related claims under the statue of respose because plaintiffs' alleged investments in FOG occurred more than five years before they filed suit. Plaintiffs argued that the defendants migrated their investments into other entities as part of an "ongoing fraud," but the Court flatly rejected that argument citing *SEC v. Mapp*, 240 F.Supp.3d 569, 580 (E.D. Tex. 2017). In *Mapp*, "the court rejected the SEC's argument that a defendant could be liable for communication following an investment because 'statements following a sale of securities are not made in connection with the purchase or sale of securities.'" *Id.* at *4 (quoting *Mapp*, 240 S.Supp.2d at 580).

The Court also dismissed the CTH-related securities fraud claims for failure to plead with particularity under Rule 9(b). The allegation that defendants "indicated" certain things was vague and insufficient to meet the pleading standard. "For example, it is unclear if an indication is an actual statement or mere silence." *Id.* at *6.

Thus, ironically, the original FOG misrepresentation ("shame on you") was dismissed with prejudice under the statute of respose, but the Court granted plaintiffs leave to replead the CTH representation ("shame on me") that was arguably a continuation of the original scheme because it was made later in time.

[Procedure: Limitations, Statute of Repose]

9. ***SEC v. Faulkner*, 2021 WL 39300091 (N.D. Tex. Sept. 2, 2021) (Fitzwater, J.).**

The latest decision in litigation arising out of the bankruptcy of Breitling Energy Corporation centers around whether a settlement agreement between Breitling's court-appointed receiver (Receiver) and its former accounting firm (Rothstein Kass) can bar other shareholder groups from pursuing claims against the accounting firm. In a 17-page opinion, Judge Sidney Fitzwater approved the settlement and granted the Receiver's motion for a settlement bar.

Rothstein Kass provided audit services to three Breitling entities in connection with a reverse merger in which two private companies controlled by Christopher Faulkner, Breitling Oil & Gas Company (BOG) and Breitling Royalties Corporation (BRC), merged into a public entity, Bering Exploration, Inc. (Bering). After the merger, Bering changed its name to Breitling Energy Corporation (BECC) (collectively, with BOG and BRC, the "Breitling Entities'). Rothstein Kass was hired by BOG and BRC in anticipation of the transaction and hired again to audit the Breitling Entities after the reverse merger was completed. Rothstein Kass issued unqualified audit opinions on the financial statements of the Breitling Entities in 2014. Subsequently, the Breitling Entities were put into receivership.

Following an investigation of the audit services, the Receiver filed suit against Rothstein Kass alleging claims for negligence and participation in breaches of fiduciary duties. After 18

months of pretrial proceedings, the parties entered into a settlement agreement in which Rothstein Kass' insurer agreed to pay $7 million to the Receiver (for distribution to bankruptcy claimants) and the Receiver agreed to release of all claims against Rothstein Kass and to seek a settlement bar enjoining others from directly or indirectly continuing or commencing claims against Rothstein Kass.

A group of officers, directors, and shareholders of Bering, the public entity involved in the reverse merger, sued the accounting firm prior to the settlement and objected to the settlement bar proposed by the Receiver. In a separate action that was stayed by the Court, they brought six counts against Rothstein Kass: aiding and abetting and conspiring to breach fiduciary duties; aiding and abetting and conspiring to violate the Texas Securities Act; negligent misrepresentation; common law fraud and aiding and abetting common law fraud; fraud by nondisclosure; and statutory fraud. The Bering Plaintiffs argued that their claims were independent and non-derivative, not part of the receivership estate, and that the Receiver lacked standing to bring (and did not bring) their claims.

The Court analyzed whether the Receiver's claims belonged to the estate, using the Fifth Circuit's two-part test set out (in dicta) in *Sharp Capital*: (1) the cause of action alleges only an indirect harm to the plaintiff – one that derives from harm to a receivership entity, and (2) a receivership entity could have raised the claim for its own direct injury, then the claim belongs to the receivership estate. *SEC v. Sharp Capital*, 315 F.3d 541, 544 (5th Cir. 1993).

Addressing the first part of the test, the Court noted that the Bering Plaintiffs alleged two injuries resulting from the accounting firm's audits: (1) loss of their recission rights, and (2) the lost value of their stock in Bering. It ruled that both were direct injuries to Bering, which by virtue of its name change, was one of the receivership entities. The Bering Plaintiffs were not parties to the asset purchase agreement used to effect the reverse merger, and the Court ruled their loss of recission rights derived from the harm to Bering. Since they had "no separate and independent right of action for injuries suffered by the corporation," they were only injured indirectly. Thus, the first part of the *Sharp Capital* test was satisfied.

Addressing the second part of the test, the Court found that the Receiver "could have brought all of the remaining claims" alleged by the Bering Plaintiffs. The Court rejected the Bering Plaintiffs' argument that under *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App. 1986, *writ ref'd n.r.e.*), that the accounting firm owed them a separate and independent legal duty to make no negligent misrepresentations. The Court did not decide whether such a duty was owed by the accounting firm, but it refused to entertain the argument because no such claim was alleged and the injury alleged was still not independent of Bering.

In support of the settlement bar, the Court further noted that allowing the Bering Plaintiffs to proceed with their claims would interfere with assets claimed by the Receiver because any amount they recovered would reduce the Receiver's recovery. It also rejected the Bering Plaintiffs' argument that *Reneker v. Offil,* 2009 WL 804134, at *4 (N.D. Tex. Mar. 26, 2009), prohibited the Receiver from asserting claims for individualized losses to investors. The Court read *Reneker* to stand for the general (and uncontested) rule that a receiver cannot pursue independent and non-derivative claims.

After rejecting other arguments, the Court stated:

> But the bar order is a *sine qua non* of the settlement because "without a Bar Order, there will be no settlement between the Receiver and Rothstein Kass. This is not unusual. As the Fifth Circuit explained in *Zacarias*, '[the brokers] negotiated for the bar orders as preconditions of their respective settlements. The brokers' incentives to settle are reduced – likely eliminated – if each … investor retains an option to pursue full recovery in individual satellite litigation. Such resolution is no resolution."

Faulkner, 2021 WL 3930091, at *16 (quotation omitted).

[Procedure: Settlement Bar]

II. STATE COURT CASES

A. Texas Appellate Courts

1. *Ashby v. Kern*, 2021 WL 2963750 (Tex. App. – Dallas July 14, 2021) (Reichek, J.)

The Fifth Circuit Court of Appeals in Dallas addressed district court rulings on two motions to compel arbitration, one filed by individual defendants and one filed by a title insurance company. The dispute arose out of an alleged scheme to fraudulently induce plaintiffs into purchasing unregistered securities in real property. The district court denied both motions to compel arbitration. The Court of Appeals reversed the ruling as to the officers of Rockwell Debt Free Properties (Rockwell), ruling that broad language in the purchase and sale agreement (PSA) between Rockwell and the plaintiffs required arbitration of "any dispute" and the individual defendants were covered as Rockwell's agents. But the Court upheld the district court's ruling that First American Title Insurance Company could not compel arbitration because the title insurance company failed to prove it had complied with a Texas Department of Insurance requirement offering insureds the opportunity to opt out of its arbitration provision.

Plaintiffs claimed Rockwell persuaded them to invest in commercial property that was leased to Noah Corporation and that all defendants failed to disclose that Rockwell had a financial interest in the property and that Noah was in financial distress. According to the petition, Rockwell used First American to give the sales a "stamp of legitimacy." Plaintiffs asserted claims against First American, Rockwell, and various principals of Rockwell for securities violations, fraud, breach of contract, fraudulent transfer, aiding and abetting, and violations of the Business and Commerce Code. The district court denied motions to compel arbitration, and defendants appealed. During the interlocutory appeal, Rockwell filed for bankruptcy protection, so the appeal continued on behalf of the individual defendants and First American.

The Individual Defendants' Motion to Compel Arbitration

The Court began by reviewing the arbitration provision in the PSA that was signed by each of the plaintiffs and on behalf of Rockwell. It stated that "[a]ny dispute between the parties will be submitted to binding arbitration …." The Court noted that arbitration provisions using terms like "any dispute" create a presumption of arbitrability for any claims that "touch matters, have a significant relationship with, or are inextricably enmeshed or factually intertwined with the

contract" and "only the most forceful evidence of a purpose to exclude the claims" will prevent them from being arbitrated. *Id.* at *4 (quoting *Barantas Inc. v. Enter. Fin. Grp. Inc.*, 2018 WL 3738089, at *7 (Tex. App. – Dallas Aug. 7, 2018, no pet.).

Plaintiffs made two arguments to avoid arbitration. First, they argued that another provision of the PSA, in which plaintiffs acknowledged they were buying the property "as is," contained an exclusion from arbitration for fraud claims. The provision stated that "except in the case of fraud, no law suit [sic] or cause of action shall ever be commenced …" The Court rejected Plaintiffs' reading of the provision, noting that "causes of action" was not limited to claims filed in court and was routinely used to refer also to arbitration claims. Second, plaintiffs argued that the individual defendants could not compel arbitration because they did not sign the PSA. The Court cited numerous cases ruling that broad agreements to arbitrate all disputes include the actions of agents of the parties, particularly "[w]hen all the agents' allegedly wrongful acts relate to their conduct as agents of the signatory company." *Id.* at *5 (citing *In re Merrill Lynch Trust Co. FSB*, 235 S.W.3d 185, 188 (Tex. 2007)). Since the petition's allegations were sufficient to show an agency relationship between Rockwell and the individual defendants and the claims against the individual defendants were all based on work they allegedly performed on behalf of Rockwell, the Court concluded the trial court abused its discretion in denying the individual defendants' motion to compel.

First American's Motion to Compel Arbitration

First American raised two arguments in support of its motion to compel arbitration: (1) an arbitration provision in its title insurance policies; and (2) the arbitration provision in the PSA under the equitable doctrines of intertwined claims or direct benefits estoppel.

Plaintiffs did not dispute that the title policy required arbitration but argued it did not apply because First American failed to comply with a Texas Department of Insurance requirement that they be given an opportunity to opt out of the arbitration provision before the title policy issued. *See* Title Insurance Basic Manual, Procedural Rule 36 (2021) (requiring that a title insurance company "shall notify" its proposed insured of its right to delete the arbitration provision). Based on evidence submitted by First American, seven of the ten title commitments had an issuance date after the policy date. The only evidence First American presented that it informed Plaintiffs of their right to delete the arbitration provision was an email sent to one plaintiff referencing her title commitment. Since the evidence was, at best, conflicting, the Court ruled the district court did not abuse its discretion in refusing to compel arbitration.

The Court rejected First American's argument that arbitration could be compelled under the PSA based on equitable doctrines. The equitable doctrine of intertwined claims has been referenced by several Texas courts but never adopted by the Texas Supreme Court. It provides that a non-signatory to a contract with an arbitration provision may be permitted to compel arbitration when (1) the non-signatory has a close relationship with a signatory, and (2) the claims are intimately founded on, and intertwined with, the underlying contract obligations. *Id.* at *9 (citing *Natgasoline LLC v. Refractory Constr. Servs. Co. LLC*, 566 S.W.3d 871, 888 (Tex. App. – Houston [14th Dist.] 2018, pet. denied)). The relationship must be more than an "entangled business relationship," *Jody James Farms, JV v. Altman Group, Inc.*, 547 S.W.3d 624, 633 (Tex. 2018), and typically requires some corporate affiliation between the signatory and the non-signatory party. *Id.* Because the record showed that First American was independent and distinct from Rockwell and nothing in the

PSA would have led plaintiff investors to anticipate being forced to arbitration on their claims against First American, the Court rejected the argument.

The doctrine of direct benefits estoppel precludes a plaintiff from taking inconsistent positions about a contract with an arbitration provision, e.g., seeking to hold a non-signatory liable under the contract while simultaneously arguing that the non-signatory cannot compel arbitration because it did not sign the agreement. *Id.* (citing *Jody James*, 547 S.W.3d at 637). The Court found it did not apply to First American because plaintiffs did not assert any claims against First American based on the PSA; rather, it sued First American for various torts and statutory violations. "The fact that the claims would not have arisen but for the existence of the PSA is not enough to establish direct benefits estoppel." *Id.* at *10 (citing *G.T. Leach Builders, LLC v. Sapphire V.P., LP*, 458 S.W.3d 502, 528 (Tex. 2015)).

[Procedure: Arbitration]

2. *In re J. Kyle Bass*, No. 05-21-00102-CV, 2021 WL 3276879 (Tex. App.-Dallas July 30, 2021) (Schenck, J.).

The Dallas Court of Appeals overturned a trial court ruling requiring production of privileged documents in a long-running securities fraud case. The appeals court found that Plaintiffs failed to establish a *prima facie* case for the crime-fraud exception.

Plaintiff United Development Funding, L.P. (UDF) sued Kyle Bass and Hayman Capital entities (Hayman) for business disparagement, tortious interference, and conspiracy. Plaintiffs alleged that Hayman engaged in a "short and distort" – acquiring short positions in UDF stock then spreading false information about UDF to drive down its stock price.

Hayman produced a privilege log and asserted attorney-client privilege for hundreds of documents. UDF challenged the assertion for 318 documents under the crime-fraud exception. A visiting judge reviewed the documents *in camera* and concluded that UDF made a prima facie showing that each document related to and had a nexus with the alleged fraudulent or criminal conduct. Hayman sought mandamus relief.

To establish a prima facie case for the crime-fraud exception, a party must offer evidence establishing (1) the elements of crime or fraud, and (2) that the crime or fraud was ongoing or about to be committed when the privileged communications occurred. *Id.* at *3 (citing *In re Tex. Health Res.*, 472 S.W.3d 895, 905 (Tex. App. – Dallas 2015, orig. proceeding). Once a *prima facie* case is established, the court must find some valid relationship between the document in question and the alleged crime or fraud. *Id.*

Hayman argued that UDF failed to establish a *prima facie* case, and the Court focused on UDF's arguments.

First, UDF argued the "law of the case," claiming the appellate court had previously ruled UDF made a *prima facie* case in connection with its claims under the Texas Citizen's Participation Act (TCPA). The Court disagreed, noting that the prior appeal concerned only tort claims for disparagement and tortious interference and that the crime-fraud exception only applies to claims of fraud. "While both fraud and business disparagement may involve a misstatement, the

exception to the privilege does not extend to all torts that may involve alleged misstatements." *Id.* at *3. The Court declined to take an expansive view of the crime-fraud exception as UDF urged.

Second, although UDF alleged that Hayman engaged in a "short and distort," it "did not set forth the elements of a securities-fraud claim and did not attempt to attribute specific evidence to elements of the same." *Id.* at 4.

The Court ultimately concluded that the trial court abused its discretion in ordering production of the materials. It also noted that the Hayman statements UDF contended were false were public and not concealed. Because the statements were about UDF, it had the ability to determine whether they were in fact false and did not need access to privileged information to prove its case.

[Procedure: Crime-Fraud Exception]

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