

SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

JULY – SEPTEMBER 2022

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

- SEC Enforcement Actions – The Fifth Circuit continues to scrutinize SEC enforcement actions, including (1) the SEC’s authority to seek disgorgement under the Exchange Act and the limitations on that remedy in light of *Liu v. SEC*, 140 S.Ct. 1936, 1949 (2020) and (2) when defendants in enforcement actions are entitled to a jury trial under the Seventh Amendment. In *SEC v. Hallam*, the Fifth Circuit concluded on the facts of the case at hand that the disgorgement remedy was permissible and that the defendant, after stipulating to liability, was not entitled to an evidentiary hearing with respect to the disgorgement and penalties. In *SEC v. Novinger*, the Fifth Circuit affirmed the district court’s denial of defendants’ motion to void the “no deny” provisions in a five-year old consent decree entered in an SEC enforcement action. In *SEC v. World Tree Financial*, the Fifth Circuit held, as a matter of first impression in this circuit, that an investment adviser’s failure to disclose cherry-picking —allocating more profitable trades within a block trade to favored client accounts—violates the Securities Exchange Act, Securities Act, and Investment Advisers Act. Finally, on November 7, 2022, the Supreme Court will hear argument in *SEC v. Cochran*, an appeal from a Fifth Circuit decision that held federal districts have jurisdiction to hear constitutional challenges to ongoing SEC administrative proceedings involving administrative law judges. See FH Newsletter 4Q21, at 4 (discussing the Fifth Circuit’s decision in *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021)).
- Securities Fraud Class Actions – Texas courts issued rulings on motions to dismiss in three securities class actions. Judge Rosenthal granted in part and denied in part defendants’ motion to dismiss the amended complaint in the *Cabot Oil* case, finding Cabot’s statements that it was in “substantial compliance” with environmental consent decrees were not actionable under *Omnicare*, but that plaintiffs adequately pleaded scienter with respect to their other claims. In *McDermott*, Magistrate Judge Edison issued his recommendation that Plaintiffs’ additional claims regarding alleged misrepresentations and omissions relating to the risks and costs of McDermott’s merger with Chicago Bridge & Iron (CB&I) set forth in a

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supplemental complaint be dismissed because (1) the supplemental complaint failed to allege any statements that were factually untrue or misleading at the time they were made and (2) he rejected plaintiffs' new theory that defendants had a duty to disclose McDermott's potential bankruptcy. In *Apache Corp.*, Judge Edison recommended that defendants' motion to dismiss be denied, while conceding it was a "very close call" whether plaintiffs adequately pleaded scienter.

- Texas state law securities claims – Courts reviewed and dismissed securities fraud claims under the Texas Securities Act (TSA) and statutory fraud claims under the Texas Business Organizations Code (TBOC). See *Burback v. Olson* and *Setliff v. Zoccam Technologies*. Courts also affirmed judgment imposing liability under the TSA. See *Christie v. Hahn*.
- Other cases – In *Weller v. Keyes*, the Austin Court of Appeals held that officers and agents of an LLC can be held personally liable for fraud or other tortious conduct performed within the course and scope of their employment notwithstanding the enactment of Section 21.223 of the TBOC, which limits certain veil-piercing liability. In *Control & Applications LLC v. Abdallah*, the Houston First Court of Appeals affirmed a judgment finding that majority owners of an LLC breached their fiduciary duty when they purchased the minority interests at a low valuation without disclosing that they had already negotiated to sell the company to another buyer at a higher valuation. In *Mehta v. Ahmed*, the Houston First Court of Appeals overturned a jury's finding that parties had created a partnership under Section 152.052 of the TBOC.

For convenience, the cases summarized below are hyperlinked to Westlaw.

CASE SUMMARIES

I. FEDERAL CASES

A. Fifth Circuit

1. *Securities and Exchange Commission v. Hallam*, 42 F.4th 316 (5th Cir. 2022) (Smith, J.)

The Fifth Circuit continues to scrutinize SEC enforcement actions, including (1) the SEC's authority to seek disgorgement under the Exchange Act (15 U.S.C. § 78u(d)(3) & (5)) and the limitations on that remedy in light of *Liu v. SEC*, 140 S.Ct. 1936, 1949 (2020)¹ and (2) when defendants in enforcement actions are entitled to a jury trial under the Seventh Amendment.² In

¹ See *SEC v. Blackburn*, 15 F.4th 676 (5th Cir. 2021) (holding that disgorgement remedy was appropriate under *Liu* and 15 U.S.C. § 78u(d)(5) where it satisfied the following two requirements: "Two things keep a remedy aimed at unjust enrichment from becoming punitive: Disgorgement cannot exceed the defendants' 'net profits' and must 'be awarded for victims.'").

² See *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022) (holding that SEC's use of ALJ in administrative action alleging securities fraud and seeking both monetary and equitable relief violated petitioners' Seventh Amendment right to a trial by jury because the SEC's enforcement proceeding was similar to traditional actions at law to which the right to a jury trial attaches).

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a lengthy opinion analyzing *Liu* and the post-*Liu* amendments to the remedy provisions of the Exchange Act, Judge Smith concluded on the facts of the case at hand that the disgorgement remedy was permissible and that the defendant, after stipulating to liability, was not entitled to an evidentiary hearing with respect to the disgorgement and penalties.

Liu and the 2021 Amendments to the Exchange Act

Section 21(d)(5) of the Exchange Act authorizes the SEC to seek equitable relief for violations of the securities laws:

In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.

15 U.S.C. § 78u(d)(5). The SEC utilizes this provision to seek disgorgement as an equitable remedy in enforcement actions. In 2020, the Supreme Court in *Liu* imposed limitations on this remedy: Disgorgement cannot exceed the defendants’ “net profits” and must “be awarded for victims.” *Liu*, 140 S. Ct. at 1940.

In 2021, Congress amended the remedial provisions of the Exchange Act. It did not amend Section 21(d)(5) that authorizes the SEC to seek equitable relief. However, it expanded Section 21(d)(3) to include not only civil penalties but also disgorgement. It did so by adding the italicized language to Section 21(d)(3):

(3) Civil money penalties *and authority to seek disgorgement*.—

(A) Authority of commission.—Whenever it shall appear to the Commission that any person has violated any provision of this chapter . . . the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to—

(i) impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation; and

(ii) *require disgorgement under paragraph (7) of any unjust enrichment by the person who received such unjust enrichment as a result of such violation.*

15 U.S.C. § 78u(d)(3). Congress also added Section 78u(d)(7), titled “Disgorgement,” which provides, “In any action or proceeding brought by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may order, disgorgement.”

The Fifth Circuit’s Ruling in *Hallam*

Without admitting or denying the allegations in the SEC’s complaint, Hallam consented to entry of judgment containing four elements of relief: (1) payment of a civil penalty in an amount to be determined by the district court, (2) allowing the court to determine if he should be

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permanently enjoined from dealing in securities except for his own account, (3) “disgorgement of ill-gotten gains,” and (4) prejudgment interest on those gains. *Hallam*, 42 F.4th at 319.

Hallam argued that the Supreme Court’s ruling in *Liu* negated his prior consent, that disgorgement was inappropriate under *Liu*, and that the 2021 amendments to the Exchange Act did not authorize disgorgement in his case. Judge Smith held that the consent judgment precluded Hallam from challenging the SEC’s ability to get a disgorgement award under any circumstances, but Hallam retained the right to challenge the SEC’s basis for seeking such an award. 42 F. 4th at 327. (Judge Oldham concurred in the ruling except that he would have held that Hallam waived his right to challenge the disgorgement award).

The Court distinguished between (1) “equitable” disgorgement under Section 78u(d)(5), which is subject to the limitations in *Liu*, and (2) “legal” disgorgement under Section 78u(d)(3)(A)(ii), as recently amended. 42 F.4th at 341. Equitable disgorgement arguably requires the SEC to “trace” the funds to be disgorged to the asset in which the SEC has a legal right: “To satisfy the tracing requirement, if there is one, the SEC would need to identify particular funds from the fraudulent business that are still in Hallam’s possession – or assets that he purchased with those particular funds, tracked all the way through the chain of possession. In that context, money isn’t considered fungible.” 42 F.4th at 332.

The Court found that the SEC was entitled to legal disgorgement, which only required the SEC to “reasonably [] approximate the defendant’s ‘unjust enrichment’ attributable to the securities violation.” 42 F.4th at 341. That amount may not include income earned on ill-gotten gains. If the SEC carries its burden, the burden shifts to the defendant to prove the requested amount is “unreasonable,” which is a fact question for the district court. *Id.* The Court found that Hallam failed to rebut the SEC’s reasonable determination of unjust enrichment.

Although the Court did not decide the issue, the Court suggested that a defendant has a Seventh Amendment right to a jury trial in an action seeking legal disgorgement under Section 78u(d)(3) because it was a legal, not equitable, claim. 42 F.4th at 343-44.

2. *Securities and Exchange Commission v. Novinger*, 40 F.4th 297 (5th Cir. 2022) (Stewart, J.)

The Fifth Circuit affirmed the district court’s denial of defendants’ motion to void the “no deny” provisions in a five-year old consent decree entered in an SEC enforcement action.

Novinger and a company he formed settled an SEC enforcement action alleging they fraudulently sold \$4.3 million worth of securities by making false or misleading statements to Texas investors. Following its standard policy, the SEC barred the defendants from denying they engaged in the charged conduct as a condition of settlement (the “no-deny policy”). Five years later, the defendants filed a motion under Rules 60(b)(4) and 60(b)(5) seeking to void the no-deny provisions, arguing that they violated their First Amendment and due process rights.

The Fifth Circuit held the judgment was not “void” under Rule 60(b)(4) because (1) the district court had jurisdiction over the original case; (2) defendants were not deprived of due process because they previously affirmed they voluntarily agreed to the consent judgment, including the no-deny provisions; (3) and the no-deny provisions did not violate their First

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Amendment rights. The Court also rejected defendants' arguments that applying the no-deny provisions of the judgment "prospectively is no longer equitable" under Rule 60(b)(5).

3. *Securities and Exchange Commission v. World Tree Financial, L.L.C.*, 2022 WL 3098058 (5th Cir. 2022) (Higginson, J.)

The Fifth Circuit held, as a matter of first impression in this circuit, that an investment adviser's failure to disclose cherry-picking—allocating more profitable trades within a block trade to favored client accounts—violates the Securities Exchange Act, Securities Act, and Investment Advisers Act.

A block trade, as defined by the district court, "allows a broker to execute a single large trade in its own name for the benefit of its clients and then allocate portions of that trade to particular client accounts." 48 F.4th at 456. The SEC alleged that defendants transmitted trading orders to its broker (Schwab) during the day but 90% of the time waited until after the markets closed to see how they performed to allocate favorable trades to favored clients and to themselves. This practice contradicted defendants' representations to clients in its Form ADV and compliance manuals that it allocated block trades in "in a fair and equitable manner" and based on "individual advice" to each client. Defendants also traded in the same stock as their clients despite telling clients they would not do so.

The SEC filed suit against World Tree Financial, L.L.C. (World Tree) and its principals Wesley Perkins (Perkins) and Priscilla Gilmore Perkins (Gilmore) asserting the following claims:

- Perkins and World Tree carried out a fraudulent cherry-picking scheme, in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act); Section 17(a)(1) of the Securities Act of 1933 (Securities Act); and Sections 206(1) and (2) of the Investment Advisers Act of 1940 (Advisers Act);
- Gilmore aided and abetted the fraudulent cherry-picking, in violation of Section 209(f) of the Advisers Act; and
- Defendants made material misrepresentations about their allocation and trading practices, in violation of Section 10(b) of the Exchange Act; Section 17(a)(2), of the Securities Act; and, with respect to Perkins and World Tree only, Sections 206(1) and (2) of the Advisers Act.

The SEC sought injunctive relief, disgorgement of all ill-gotten gains, and civil penalties.

The trial court credited the SEC's expert testimony based on a statistical analysis of the trades.

The Fifth Circuit held that the failure to disclose cherry-picking is a material misrepresentation or omission under the federal securities laws. Furthermore, cherry-picking occurs "in connection with the purchase or sale of any security" (Rule 10b-5) and "in the offer or sale of any securities" (Section 17(a)). "It is not necessary for a specific trade or a specific purchaser or seller to be identified to satisfy the in-connection-with element." 48 F.4th at 461. The Court also held that statistical analysis was sufficient to prove cherry-picking, and direct evidence

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is not required. Finally, the Court found that “cherry-picking can satisfy the scienter element because it involves the knowing conduct of picking certain accounts over others.” *Id.* At 463.

Defendants also challenged the disgorgement remedy. Citing *Liu v. SEC*, — U.S. —, 140 S. Ct. 1936, 1940 (2020), Defendants argued that “the disgorgement amount is improperly based on the Disfavored accounts’ unrealized first-day losses and thus the amount is larger than actual net profits from wrongdoing and amounts to unjust equitable relief to the victim; [Defendants] also claim that the disgorgement award improperly includes Schwab’s commission fee.” *Id.* at 466. The Fifth Circuit declined to address these arguments because defendants failed to raise them in the trial court, noting they “did not challenge the SEC’s proposed disgorgement amount in their pretrial or posttrial submissions—instead, they argued only that there was no ‘basis for disgorgement.’ Nor did [they] propose specific deduction amounts, either before the district court or to this court.”

B. District Courts

1. Securities Class Actions

(a) *Delaware County Employees Ret. Sys. v. Cabot Oil & Gas Corp.*, 2022 WL 3227584 (S.D. Tex. Aug. 10, 2022) (Rosenthal, J.)

As we reported in our first quarter 2022 newsletter, Judge Rosenthal previously 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. Plaintiffs filed an amended complaint, and in August 2022, Judge Rosenthal granted in part and denied in part defendants’ motion to dismiss the amended complaint.

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.

On August 10, 2022, Judge Lee Rosenthal partially granted and partially denied defendants’ motion to dismiss the First Amended Consolidated Complaint (FAC) in this putative securities class action against Cabot and three of its corporate officers (Individual Defendants).³ The plaintiffs alleged that from February 2016 to June 2020 the defendants told investors Cabot was remediating environmental problems and complying with ongoing legal and regulatory requirements in Pennsylvania when it was not. After reviewing the FAC in detail, the Court dismissed the claims based on “substantial compliance” statements and all allegations against Cabot’s SVP and regional manager for Susquehanna, PA operations. It allowed certain claims against Cabot, its CEO, and its CFO to proceed to the extent based on statements about a 2011 Notice of Violation, a 2016 Consent Order, and a Report on 2017 Notices of Violation.

³ We previously reported on Judge Rosenthal’s March 31, 2022 dismissal of this action giving plaintiffs leave to replead to allege a strong inference of scienter. *See* 1Q22 Newsletter, at 13.

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Cabot's "Substantial Compliance" Statements Were Not Actionable

The Court first addressed whether Cabot's statement made in multiple SEC filings that it "believe[s] that it substantially compl[ies] with the Clean Water Act and related federal and state regulations" was actionable. The Court initially dismissed the claims based on these statements, but plaintiffs argued the statements were actionable because defendants knew Cabot's primary regulator took the opposite view. In addition, plaintiffs performed a forensic analysis showing that 65 noncompliant wells comprised approximately 13% of Cabot's total gas production during the putative class period and generated approximately \$1 billion of Cabot's \$1.5 billion average annual revenue.

Applying *Omnicare*, the Court noted that opinion statements are only actionable if (1) the speaker omitted material facts about the issuer's inquiry into or knowledge concerning the opinion; and (2) those facts conflict with what a reasonable investor would take from the statement itself. *Id.* at *11 (citing *Omnicare*, 575 U.S. at 189). Focusing on the second part of the test, the Court concluded that a 13% noncompliance rate was not sufficiently high to conflict with Cabot's belief that it substantially complied with federal and state regulations. *Id.* at *13 (discussing *Plains*, 777 F. App'x 726, 728 (5th Cir. 2019), which stated that problems in 9-10% of the company's pipelines was only a small percentage of the overall and high-consequence pipeline areas). The Court distinguished a case cited by plaintiffs because in that case, the defendant represented that it had tools and systems in place to prevent noncompliance with environmental requirements when it knew the tools were not working. *Id.* (distinguishing *Meyer v. Jinkiosolar Holdings Co.*, 761 F.3d 245 (2d Cir. 2014)).

Plaintiffs Adequately Alleged Scienter

The Court considered three categories of misstatements that it previously dismissed for failure to adequately allege scienter. The three categories all involved statements that Cabot was working towards completing, or had completed, remediation of various sites where it had received notices of environmental violations. The Court evaluated whether the FAC added sufficient allegations to raise a strong inference of scienter as to the CEO (Dinges), the CFO (Schroeder), and the SVP in Pennsylvania (Stalmaker).

While the Court previously concluded that it was reasonable to infer Cabot's executives were aware of pervasive and prolonged failures to remediate well sites in a particular area that affected residential homes despite extensive regulations requiring remediation and compliance, it ruled more was needed to link the specific defendants to the alleged misrepresentations. Plaintiffs alleged that (1) Cabot operated in a highly regulated industry requiring vigilant monitoring of compliance with environmental laws; (2) Cabot's Susquehanna County gas operations were "existential" to the company; (3) Cabot received hundreds of Notices of Violation during the class period demonstrating a "sustained course of misconduct"; (4) Cabot "exhibited a pattern of willful violation of applicable environmental laws, regulations, and other obligations" for more than a decade; and (5) Cabot was criminally charged with knowing violations of Pennsylvania's environmental laws. The Court stated these allegations in the prior complaint, standing alone, were not sufficient to raise a strong inference of scienter. *Id.* at *18.

The Court ruled that plaintiffs made the link in the FAC by alleging facts showing that Dinges and Schroeder were regularly apprised of well-site violations and problems with

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remediation. First, as members of the Board, they received reports of investigations, notices of violations, and remediation activities multiple times a year; they also received quarterly updates reporting the number of violations, large spill cleanups, and remediation cases. Second, as officers, they received quarterly update reports from Cabot's Environmental Health & Safety Department. The reports included details about the number of violations, larger spill cleanups, remediation cases with potential for private lawsuits, and gas migration cases and their remediation status. Taken together, the specific allegations about quarterly update reports that Dinges and Schroeder received, combined with plaintiffs' other allegations, give rise to an inference that they acted with scienter that is at least as strong as the inference that they did not.

As for defendant Stalmaker, the SVP in Pennsylvania, the Court quickly disposed of the allegations against him because he was not a "maker" of alleged misstatements. *Id.* (citing *Janus Cap. Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011)). He did not personally make the alleged statements, nor did he have ultimate authority over them, their content, or whether and how to communicate them. Although he was involved in preparing SEC filings, "preparation is not equivalent to the signing and certification done by Dinges and Schroeder." *Id.* at *16. Unlike the defendant in another case who "reviewed and approved" statements, see *In re Solar Winds Corp.*, 2022 WL 958385 (W.D. Tex. Mar. 30, 2022), Stalmaker was not in a position to approve Cabot's Form 10-Ks and 10-Qs.

The Court dismissed the claims against Stalmaker but allowed the claims against Dinges and Schroeder to proceed.

**(b) *In re Apache Corp.*, 2022 WL 4277350 (S.D. Tex. Sept. 15, 2022)
(Edison, M. J.)**

On September 15, 2022, Magistrate Judge Andrew Edison issued a Memorandum and Recommendation (Recommendation) to deny defendants' motion to dismiss this consolidated securities class action complaint (Consolidated Complaint) in what the Court conceded was a "very close call" on scienter. Recommendation, at *6. Relying heavily on the Fifth Circuit's instruction that on a motion to dismiss "a tie favors the plaintiff," the Court rejected defendants' argument that it was illogical and irrational to assume that defendants spent more than \$3 billion on Apache's Alpine High play knowing it would fail miserably. Instead, the Court concluded that the allegations were sufficient to allege that defendants rationally (but recklessly) gambled on the project in the hope they would figure something out.

Allegations

According to the 148-page Consolidated Complaint, Apache engaged in a massive fraud centering on an oil and gas field in the Texas panhandle called Alpine High. Desperate to make a headline-grabbing discovery to improve its languishing stock price, Apache touted Alpine High as a "transformational discovery" and a "world class resource play" conservatively estimated to hold more than three billion barrels of oil and significant amounts of "really rich gas." With "strong well results" and "successful oil tests" representative of Alpine High's 2000 to 3000 future drilling locations, the discovery put Apache "back in the game" after a "rough time keeping up with competitors."

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Plaintiffs alleged these statements were false and misleading because Apache's own production data and analyses of the Alpine Play did not support them. Based in part on statements from 24 confidential witnesses, plaintiffs claimed that

- In 2016 Apache's lead geologist repeatedly told senior management that the company did not have sufficient data to announce the play and would need nine months of consistent production to do so.
- In 2019, Apache conducted an internal investigation called "Project Neptune" that allegedly concluded that "the vast majority of Apache's Alpine High wells had never performed or produced anything like what the Company had represented to the market."
- Apache's CEO allegedly blocked critical Alpine High data from being vetted under the standard peer review processes that were otherwise used at Apache.
- In 2020, Apache took a \$3 billion write down, having produced less than 1% of the oil and gas defendants represented was recoverable.

PSLRA Safe Harbor Does Not Apply

Defendants first argued that most of the alleged misstatements were forward looking and protected by the PSLRA's safe harbor. The Recommendation rejected this argument on two grounds. First, without reciting them, the Recommendation concluded that many of the alleged misstatements were statements of current or historical fact. Second, it determined that the cautionary language accompanying the statements was generic or insufficient because the risks had already begun to materialize when the statements were made. "Accepting Lead Plaintiffs' allegations as true, at the start of the Class Period, Defendants had *years* of data indicating that Apache would not encounter commercially productive oil and gas reservoirs. Accordingly, far more specific warnings were required to bring Apache's statements within the safe harbor." Recommendation, at *5.

Opinion Statements

Defendants next argued that the vast majority of alleged misstatements were non-actionable opinions. Citing *Omnicare*, the Court noted that opinion statements are actionable if the speaker did not sincerely hold the opinion, or if the plaintiffs allege that (1) the speaker omitted material facts about her inquiry into or knowledge concerning a statement of opinion; and (2) those facts conflict with what a reasonable investor would take from the statement itself. *Id.* at *5 (citing *In re BP p.l.c. Sec. Litig.*, No. 4:10-MD-2185, 2016 WL 3090779, at *9 (S.D. Tex. May 31, 2016) (quoting *Omnicare*, 575 U.S. at 189)).

The Court rejected this argument because it was not convinced that many of the alleged misstatements qualified as opinions. Recommendation, at *6. Even assuming they were, the Court concluded they were still actionable because defendants purportedly concealed material facts, including that (1) Apache geologists did not believe the data supported the Company's predictions; (2) Apache's top management shielded Alpine High data from further review; and (3) the underlying data never supported the estimates offered by Apache senior management.

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Scienter

Describing scienter as “a very close call” on which the Court “went back and forth” as to whether the Plaintiffs’ allegations pass muster, the Court noted the Fifth Circuit’s instruction that “where there are competing inferences that establish or negate the scienter requirement, ‘a tie favors the plaintiff’ on a motion to dismiss.” Recommendation, at *6 (citing *Spitzburg*, 758 F.3d at 686).

Defendants argued the Consolidated Complaint failed to raise a strong inference of scienter. Plaintiffs countered that their 24 confidential witness statements demonstrated Individual Defendants were fully aware of the play’s limitations. Specifically, they pointed to the knowledge of the lead geologist who was “intimately aware” of production, drilling and completions at Alpine High from daily and weekly meetings. According to plaintiffs, he routinely updated the CEO and EVP for Operations Support at quarterly review meetings and monthly visits to the corporate headquarters in Houston. In addition, the CFO “closely tracked the status of each Alpine High well” and attended meetings at which Alpine High’s production was discussed.

Defendants also argued that plaintiffs’ scienter theory – that defendants knew Alpine High would never be economic yet continued to invest more than \$3 billion – was illogical, irrational, and nonsensical. The Court was somewhat swayed by this argument but concluded it “goes a bit too far,” noting that “[w]hile it certainly would not have been in the company’s best interest to stick by a strategy doomed from the start, the [Consolidated Complaint]’s allegations are not wholly illogical.” Recommendation, at *7. Defendants supposedly went “all in” on Alpine High, “gambling that they would figure something out, even though the Company’s extensive explorations repeatedly failed to produce scientific support for their broad claims.” Recommendation, at *7. Quoting from Judge Posner’s decision in the *Tellabs* case, the Recommendation states:

The fact that a gamble – concealing bad news in the hope that it will be overtaken by good news – fails is not inconsistent with its having been a considered, though because of the risk a reckless, gamble. It is like embezzling in the hope that winning at the track will enable the embezzled funds to be replaced before they are discovered to be missing.

Recommendation, at *7 (quoting *Makor Issues & Rts. Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 710 (7th Cir. 2008)). Based on these allegations, the Court concluded that “[w]hile the conduct allegedly pursued by Defendants might not have been a wise one, it was rational (though reckless).” Recommendation, at *7.

In addition, the Consolidated Complaint alleged that (1) the lead technical advisor on Alpine High resigned in October 2018, (2) Apache took a \$3 billion write-down and ceased further activity in Alpine High in February 2020, and (3) Apache’s compensation structure incentivized executives to inflate Apache’s stock price. The Court concluded that “[e]ven if I completely discount these additional scienter allegations, I still think Lead Plaintiffs have done enough at the pleading stage to establish a strong inference of scienter.” Recommendation, at *7.

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Based on its conclusions that plaintiffs sufficiently alleged false statements and facts giving rise to a strong inference of scienter, the Court recommended dismissal of defendants' motion to dismiss. The Recommendation is not the final word, and additional briefing is likely before Judge Hanks issues his ruling accepting or modifying the Recommendation.

(c) ***Edwards v. McDermott Int'l, Inc.*, 2022 WL 3927828 (S.D. Tex. Aug. 30, 2022) (Edison, M. J.)**

On August 30, 2022, Magistrate Judge Andrew Edison issued his Memorandum and Recommendation (Recommendation) on defendants' motion to dismiss plaintiffs' Supplemental Class Action Complaint (Supplemental Complaint).⁴ Plaintiffs sought to expand the class period by nearly two years and include alleged misrepresentations and omissions relating to the risks and costs of McDermott's merger with Chicago Bridge & Iron (CB&I). The Recommendation concludes that the Supplemental Complaint failed to allege any statements that were factually untrue or misleading at the time they were made and rejected plaintiffs' new theory that defendants had a duty to disclose McDermott's potential bankruptcy.

The Supplemental Complaint alleged approximately 20 statements made during the period September 17, 2019 through McDermott's bankruptcy filing on January 23, 2020 (the "Supplemental Class Period"). The alleged misstatements and omissions included the following:

- McDermott could overcome its liquidity problems by obtaining short-term financing (misstatement);
- McDermott might sell its Lummus technology business and pipe fabrication business (misstatement); and
- McDermott planned to file for bankruptcy (omission).

The Court reviewed the allegations in detail and concluded that (1) the statements merely identify strategic alternatives McDermott pursued in an effort to address its serious liquidity concerns; and (2) plaintiffs "cannot point to a single statement in which Defendants affirmatively denied the possibility that [McDermott] would file for bankruptcy protection." Recommendation, at *4. The Recommendation specifically rejected plaintiffs' new theory that defendants had a legal obligation to disclose their plans to file for bankruptcy once they chose to speak about efforts to combat McDermott's liquidity issues:

The reason district courts almost universally reject the notion that a public company must disclose when it is contemplating bankruptcy proceedings is grounded in "public policy justifications for allowing a company operating near insolvency to make careful deliberations about its future free from any obligation to disclose potential bankruptcy."

⁴ We previously reported on three related cases filed against McDermott. *See* 2Q21 Newsletter, at 8 (reporting on the April 14, 2021 denial of defendants' motion to dismiss three cases); 4Q21 Newsletter, at 6 (reporting on the decision to require disclosure of confidential witness names, granting the request to file a supplemental complaint, and denying Lead Plaintiffs' request to add another class representative and additional class counsel).

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Recommendation, at *6 (quoting *Beleson v. Schwartz*, 599 F.Supp.2d 519, 527 (S.D.N.Y. Feb. 24, 2009)). Requiring disclosure of bankruptcy plans would put an unacceptable burden on corporation and their officers, might prematurely foreclose other options to restore financial viability, and would raise substantial practical challenges in defining the proper moment at which the obligation to disclose would take effect. *Id.*

The Recommendation distinguished cases cited by the plaintiffs because each “affirmatively paint[ed] a rosy, misleading picture of a company’s financial status and then [failed to] disclose underlying liquidity problems.” Recommendation, at *6. By contrast, McDermott expressly acknowledged its fragile liquidity position and outlined steps it considered in an effort to escape from its crippling debt. “It is hard to argue with a straight face that a reasonable investor would be surprised to learn that McDermott faced the real possibility of seeking bankruptcy protection.” Recommendation, at *6.

Because the Court recommended that the Supplemental Complaint alleged no actionable misstatements, it did not address whether it also failed to allege a strong inference of scienter. The decision recommended dismissal of the additional claims alleged in the Supplemental Complaint but notably did not recommend eliminating the additional partial corrective disclosures in the Supplemental Complaint or extension of the class period to January 23, 2020.

2. Other Cases

(a) ***360 Security Partners, LLC v. Hallam*, 2022 WL 3159274 (N.D. Tex. Aug. 08, 2022) (Boyle, J.)**

This case involves a dispute between the owner of a privately held Delaware limited liability company and its former CEO. The former CEO claimed he was promised equity in the company, even though the parties could not come to agreement on terms. The owner of the company asserted claims for breach of fiduciary duty against the former CEO for (1) refusing to disclose information relevant to the company’s operation, (2) breaching his duty of loyalty by ignoring instructions from the board of directors and by continuing to enter into contracts against the board’s will, and (3) breaching his duty of care by unilaterally appointing a CFO with no financial expertise and allowing employees to use company checks and credit without sufficient controls. Plaintiff alleged that the former CEO sought leverage in his negotiations to obtain equity in the company.

Judge Boyle found these allegations stated a claim for breach of fiduciary duty under Delaware law and denied the CEO’s motion to dismiss these claims. The Court found, however, that Plaintiff failed to state a claim for conversion through improper check management and credit card use but granted Plaintiff leave to amend these claims.

(b) ***Burback v. Oblon*, 2022 WL 2841482 (E.D. Tex. July 20, 2022) (Jordan, J.)**

As we reported in our third quarter 2021 newsletter, Judge Jordan dismissed fraud claims arising from the issuance of promissory notes, finding that the claims were time-barred under the applicable statute of repose. Judge Jordan allowed plaintiffs’ leave to replead the claims based on

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a later stock fraud scheme. Judge Jordan found that the amended complaint, however, failed to state a claim for securities fraud.

On July 20, 2022, Judge Sean Jordan dismissed this action with prejudice, including all fraud and securities-related claims. In their First Amended Complaint (FAC), Plaintiffs alleged they were defrauded in two securities-related transactions: a promissory note fraud scheme and a stock-fraud scheme.

Promissory Note Fraud Scheme (PNFS). Plaintiffs initially alleged they were defrauded on September 10, 2015, when they invested in Four Oceans Global, LLC (FOG). They executed Note Purchase Agreements for securities in this unregistered entity based on alleged misrepresentations by the defendants Jordan Brock, a FOG manager, and Robert Oblon, the founder of FOG. In approximately February-March 2016, it became apparent to plaintiffs that FOG was a failure, and Oblon told plaintiffs that FOG's business had been migrated into two other companies. The two other companies were acquired by a Sharing Services Global Corporation (SHRG) on or about October 9, 2017, but plaintiffs received no compensation.

CTH Stock-Fraud Scheme (CTH). In February 2018, the plaintiffs 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 they purchased FOG shares but less than five years after the CTH transaction. The Court initially dismissed the PNFS claims under the status of repose and dismissed the CTH claims with leave to amend.

In the FAC, the plaintiffs alleged eight causes of action against Brock, Oblon, and various entity defendants, including (1) securities fraud; (2) statutory fraud under Texas Business & Commerce Code § 27.01; (3) common-law fraud; (4) fraud by nondisclosure; (5) unjust enrichment; (6) civil conspiracy; (7) breach of fiduciary duty; and (8) knowing participation in fraud.

In addition to the general allegations above, plaintiffs alleged in the FAC that Brock made additional false statements in March 2018 about PFNS and a plan to recover their monies. They claimed that Brock knew the statements were false because of his roles at FOG and SHRG and his receipt of shares in another company that took over FOG's business.

The Court dismissed the securities fraud claims against defendants relating to PFNS because the scienter allegations were conclusory and insufficient. Neither Brock's position at various companies nor his receipt of shares in the company that acquired FOG's business raised a

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strong inference of scienter. The FAC failed to contain sufficient allegations linking Oblon to the entity defendants.

The Court also dismissed the statutory fraud, the common-law fraud, and breach of fiduciary duty claims. The PFNS-related claims against Brock were dismissed on limitations grounds because they were filed more than four years after the alleged misstatements. Plaintiffs argued the discovery rule applied, but the Court ruled the Plaintiffs' awareness of the alleged fraud, admitted in the amended complaint, refuted their attempt to invoke the exception. The CTH-related claims against Brock were dismissed because plaintiffs failed to allege sufficient facts to show that Brock knew about the fraudulent scheme or that his statements were false when made.

The claims against the other defendants were dismissed for similar reasons.

(c) ***Setliff v. Zoccam Techs., Inc.*, 2022 WL 4240893 (N.D. Tex. Sept. 13, 2022) (Boyle, J.)**

As reported in a previous newsletter, Judge Boyle dismissed the bulk of the claims in this closely held company dispute, with leave to replead. Judge Boyle reviewed the amended complaint and dismissed the fiduciary duty and fraud claims, leaving only the breach of contract claims, claims under the Texas Business Organization Code (TBOC), and certain declaratory judgment claims.

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.⁵

TBOC Claims. TBOC § 21.914 authorizes a court to declare the “validity and effectiveness” of any “defective corporate act.” Plaintiff sought a declaration that the 2019 Filed Restatement to the certificate of incorporation was a defective corporate act. The Court found the restatement was a “fundamental action” under TBOC § 21.364(a) that required approval by a two-thirds majority of the shareholders. The 2019 Restatement was properly approved by the shareholders, but the board failed to properly adopt the restatement because, although it voted unanimously to approve it, it did not approve a “resolution stating the proposed amendment” as required by TBOC § 21.052. The Court, therefore, declined to dismiss Plaintiff’s claim that the 2019 Restatement was defective.

⁵ The Court previously denied Defendants’ motion to dismiss the breach of the contract claims, and Defendants did not move to dismiss these claims in the amended complaint. The Court previously dismissed the state securities fraud claims [Tex. Rev. Civ. Stat. art. 581-33], and Plaintiffs re-asserted them only to “preserve error.” The Court, therefore, dismissed these claims again without discussion. *Id.* at *13.

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The Court also found that whether the 2019 Restatement was properly ratified by shareholders per TBOC § 21.914(d) raised fact questions that could not be resolved on a motion to dismiss.

Declaratory Judgment Claims. The Court found that most, but not all, Plaintiff's claims for declaratory judgment under the Federal Declaratory Judgment Act, 22 U.S.C. § 2201, were duplicative of Plaintiff's other claims. The Court dismissed the duplicative claims but allowed the claims declaring the redemption of shares invalid, as well as certain claims regarding the validity of the 2019 Restatement.

Fiduciary Duty Claims. Plaintiff asserted claims for breach of fiduciary duty derivatively on behalf of Zoccam against its CEO, Cook. Federal Rule of Civil Procedure 23.1 requires that a derivative plaintiff verify its complaint. Plaintiff filed an unverified complaint and then later filed a verification. The Court refused to consider the late filed verification, which it treated as an unauthorized filing of an amendment to the complaint. Also, many of the paragraphs in the complaint were pleaded "on information and belief." The Court, therefore, dismissed the derivative claims.

Securities Fraud Claims. The Court analyzed the 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 claims together and ultimately dismissed all the fraud claims.

Plaintiff alleged the following misrepresentations and omissions:

- Cook failed to disclose that Cook had filed an IRS Form 8832 electing to have Zoccam taxed as a corporation (the 8832 Omission);
- Zoccam misrepresented it had previously filed tax returns on an S-Corp basis (the S-Corp Misrepresentation);
- Cook failed to disclose that the S-Corp Misrepresentation was untrue (the S-Corp Omission);
- Defendants misrepresented that the impropriety of Zoccam's prior S-Corp filings could be retroactively cured by the elimination, "in name Setliff v. Zoccam Technologies, Inc., only," of the Series A Preferred Shares (the Name Only Misrepresentation);
- Cook misrepresented that she had agreed to all of Setliff's proposed changes to the Restated Certificate (the Cook Misrepresentation);
- Defendants concealed that they had unilaterally increased the number of authorized shares in the 2019 Filed Restatement (the Share Increase Omission);
- Holmes (on behalf of Zoccam) misrepresented that the 2019 Filed Restatement had been filed with the Texas Secretary of State on August 27, 2019 (the Filing Date Misrepresentation); and
- Defendants failed to disclose that the 2019 Filed Restatement would be filed with the Texas Secretary of State without the required Board and Shareholder approvals (Filing Omissions).

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Claims Against Cook

The Court dismissed all the fraud claims against Cook because (1) Plaintiff failed to plead that Cook had a duty to disclose for the 8832 Omission, S-Corp Omission, or Share Increase Omission, (2) Plaintiff failed to support the Cook Misrepresentation with allegations to support an inference that Cook knew about the changes to the 2019 Filed Restatement, and (3) Plaintiff impermissibly group pleaded the Defendants for the Filing Omissions.

Claims Against Zoccam

Zoccam argued that the economic loss rule barred Plaintiff's fraud claims because such claims are encompassed by Plaintiff's claims for breach of the settlement agreement. The Court, however, found that Plaintiff alleged that the 2019 Filed Restatement was fraudulently induced and that "the legal duty not to fraudulently procure a contract is separate and independent from the duties established by the contract itself." *Id.* at *18 (quoting *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 46 (Tex. 1998)). The Court further explained, "Any breach of the Settlement Agreement does not then encompass the duty to not induce [Plaintiff] into agreeing to the 2019 Filed Restatement, which underlies the remaining fraud claims. They are separate and distinct duties; therefore, the economic loss rule does apply." *Id.*

The Court nonetheless dismissed all the fraud claims against Cook because (1) Plaintiff's vote was superfluous and therefore he cannot make a claim of fraud for the S-Corp Misrepresentation and Name Only Misrepresentation, (2) Zoccam did not have a duty to disclose for the Share Increase Omission, (3) the Filing Omissions insufficiently group pleads the "who," and (5) Plaintiff failed to plead that Zoccam intended for Plaintiff to act or refrain from acting for the Filing Date Misrepresentation and the Filing Omissions.

II. STATE COURT CASES

A. Texas Appellate Courts

1. ***Weller v. Keyes*, 2022 WL 3638204 (Tex. App.—Austin [459th Dist.] Aug. 24, 2022)(Baker, J.)**

Reversing the trial court's grant of summary judgment, the Austin Court of Appeals held that officers and agents of an LLC can be held personally liable for fraud or other tortious conduct performed within the course and scope of their employment notwithstanding the enactment of Section 21.223 of the TBOC, which limits certain veil-piercing liability.⁶

⁶ Section 21.223 provides:

(a) A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate of such a holder, owner, or subscriber or of the corporation, may not be held liable to the corporation or its obligees with respect to:

...

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David Weller and his consulting company IntegriTech Advisors, LLC (collectively, Weller) sued MonoCoque Diversified Interests LLC (MDI) and its officers Mary Keyes and Sean Nadeau for fraud and other claims. Weller alleged that Keyes and Nadeau fraudulently induced him to turn down other opportunities to work for MDI and then failed to pay Weller for his work after the parties failed to come to agreement on employment and related contracts. Keyes and Nadeau moved for summary judgment on the grounds that Section 21.223 barred personal liability for actions they undertook as agents of MDI. The trial court agreed and granted summary judgment. The appeals court reversed.

The appeals court noted: “Texas has long had two methods for holding individual corporate agents or officers personally liable when they are acting within the course and scope of their employment or role as corporate agents—piercing the corporate veil or direct individual liability.” *Id.* at * 3. (quoting *Bates Energy Oil & Gas v. Complete Oilfield Servs.*, 361 F. Supp. 3d 633, 669–70 (W.D. Tex. 2019)). Although Section 21.223 curtailed veil-piercing liability, the Court held it did not affect direct liability:

The second longstanding method of holding corporate agents personally liable for actions performed within the course and scope of their employment or role as corporate agents—direct individual liability for tortious conduct—remains alive and well under the common law. The supreme court recently reaffirmed this longstanding rule, albeit without mentioning Section 21.223. *See Transcor Astra Grp. S.A. v. Petrobas Am., Inc.*, — S.W. 3d —, No. 20-0932, 2022 WL 1275238, at *11 (Tex. Apr. 29, 2022) (“the fact that an individual was acting in a corporate capacity does not prevent the individual from being held personally—or ‘individually’—liable for the harm caused by those [tortious] acts”);

Id. at *3. The Court concluded: “Section 21.223 is ‘aimed [solely] at traditional veil piercing theories, which seek to hold shareholders and beneficial owners liable merely based on their status as an owner or shareholder’ and is not to be used as a mechanism to ‘shield a corporate officer or agent who commits tortious conduct merely because the officer or agent also possesses an ownership interest in the corporation.’” *Id.* at *4 (quoting *Bates*, 361 F. Supp. 3d at 667).

2. ***Christie v. Hahn*, 2022 WL 3572690 (Tex.App.—Dallas Aug. 19, 2022) (Reichek, J.)**

Affirming a verdict entered after a bench trial on a claim for offering or selling a security by means of an untrue statement of material fact or omission, the Dallas Court of Appeals held (1)

(2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, beneficial owner, subscriber, or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory[.]

Tex. Bus. Orgs. Code § 21.223. Although Section 21.223 refers only to corporations, Section 101.002(a) extends its applicability to LLCs. *See id.* § 101.002(a) (noting that subject to § 101.114, § 21.223 applies to LLC and its members, owners, assignees, affiliates, and subscribers)

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the note constituted a security and (2) defendant was liable for statements made by his brother/business partner under both an agency theory and an aiding and abetting theory.

Background Facts and Verdict. Two brothers, Cheston and Ashton Christie, worked at their parents' sports bar and decided to buy it from them. To fund a portion of the purchase price, Cheston solicited an investment from Terry Hahn by telling him "(1) both he and Ashton were buying the bar, which was important to Hahn because he knew Cheston better than he knew Ashton, trusted Cheston more, and knew Cheston ran the financial end, and (2) Hahn's money would be used to purchase the bar." *Id.* at *2. Hahn invested \$100,000 in the form of a note, which contained the following terms: (1) the Note did not require the Christie brothers to make monthly principal payments or pay interest; instead, Hahn was to receive quarterly payments of 20% of the bar's profits until his initial investment was repaid and (2) after that, Hahn would receive 10% of profits in perpetuity and 2% of the gross sales price in the event Christies was sold. Hahn had no role in managing the bar.

Hahn brought this suit solely against Ashton asserting that Ashton violated the TSA by selling an unregistered security, without a license, and under false pretenses. Hahn alleged the Note was a security under the TSA and Cheston acted as Ashton's agent in soliciting funds from Hahn. Hahn alleged Ashton:

- violated TSA § 33(A)(1) by offering or selling a security without registering as a seller under the TSA and by offering or selling a security that was not registered with the Texas State Securities Board (the registration violations); and
- violated § 33(A)(2) by offering or selling a security by means of an untrue statement of material fact and/or by an omission to state a material fact necessary to make the statements made not misleading (the fraud violations). *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(A). 2

The alleged basis for the fraud violations were Ashton's representations that both brothers were going to purchase the bar and that Hahn's money would be used to make the purchase. In addition, Hahn alleged Ashton was liable for the registration and fraud violations because (1) he directly or indirectly controlled his brother Cheston (§ 33(F) (1)), and (2) he aided and abetted Cheston's violations of the TSA (§ 33(F)(2)).

After a bench trial, the trial court entered a verdict in favor of Hahn

Appeals Court Ruling. The appeals court affirmed the verdict.

First, the Court found that the Note was an "investment contract" and, therefore, met the TSA definition of a security (Article 581-4(A)).⁷ 2022 WL 3572690 at * 3-4 (citing *Life Partners*,

⁷ This section states, "The term 'security' or 'securities' shall include any limited partner interest in a limited partnership, share, stock, treasury stock, . . . note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, . . . or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, *investment contract*, or any other instrument commonly known as a security, whether similar to those herein referred to or not." (emphasis added).

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Inc. v. Arnold, 464 S.W.3d 660, 666 (Tex. 2015) and *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)).

Citing *Life Partners*, the Court noted that “the TSA's definition of ‘securities’ must be broadly construed to maximize the protection it provides to investors, while focusing on the economic realities of the transaction at issue regardless of any labels or terminology the parties may have used. *Id.*, at * 4. An “investment contract” for purposes of the TSA means

(1) a contract, transaction, or scheme through which a person pays money (2) to participate in a common venture or enterprise (3) with the expectation of receiving profits, (4) under circumstances in which the failure or success of the enterprise, and thus the person's realization of the expected profits, is at least predominantly due to the entrepreneurial or managerial efforts of others, rather than merely ministerial or clerical efforts of others.

Id. (citing *Life Partners*, 464 S.W.3d at 662). The Court found the Note was an investment contract based on the following facts: (1) the purpose of the Note was to finance the purchase of the bar, (2) Hahn was to receive a percentage of the bar's profits rather than interest payments, and (3) Hahn had no role in managing the bar.⁸

Next, the Court found Ashton could be held liable for the conduct of Cheston. The Court found the evidence was sufficient to “demonstrate that Ashton had primary liability under § 33(A)(2) because Cheston acted as his agent in his dealings with Hahn. A principal is liable for the fraudulent acts and misrepresentations of his authorized agent.” *Id.* at *16.⁹

Because the Court found liability for fraud under Section 33(A)(2), it did not address whether Ashton also violated Section 33(A)(1) for selling an unregistered security or whether the Note was exempt from registration under Section 5 of the TSA.

3. *Carriere v. O'Brien*, 2022 WL 3649364 (Tex.App.—Houston [1st Dist.] Aug. 25, 2022) (Rivas-Molloy, J.)

The Houston First Court of Appeals partly affirmed and partly reversed the trial court's summary judgment ruling in this securities-related case. The procedural issue on appeal was whether, under a fair-notice pleading standard, plaintiff's petition alleged a claim for securities fraud under the TSA in addition to claims for fraud, breach of fiduciary duty, and negligence.

Plaintiff Linda Carriere sued her financial advisor, Daniel O'Brien. He allegedly assisted her in purchasing an annuity, a life settlement policy, and five life insurance policies on which she

⁸ Because the Court found the Note was an “investment contract” and, therefore, a “security,” it did not consider Ashton's additional argument that the Note was not a security under the “family resemblance” test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

⁹ The Court did not address Ashton's argument that the evidence was insufficient to demonstrate secondary liability as an aider and abettor under Section 33(F)(2).

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lost money. Carriere suggested, but did not directly allege, that O'Brien also forged her name on a power of attorney used to complete these purchases.

O'Brien filed traditional and no evidence motions for summary judgment seeking a ruling on Carriere's claims for fraud, breach of fiduciary duty, and negligence. He argued the claims were barred by limitations, that he did not owe her any fiduciary duty, and that she had not produced any evidence showing fraud, damages, or causation. In response, Carriere stated that her case also "clearly falls under the Texas Securities Act" and that its limitations period was applicable. The trial court granted O'Brien's hybrid summary judgment motion but treated its order as interlocutory until the defendant moved for summary judgment on other claims.

Instead of moving for summary judgment on Carriere's TSA claim, O'Brien filed a second traditional motion for summary judgment, arguing that plaintiff only alleged three causes of action (which did not include any TSA claim) and that the Court's prior ruling addressed them all. In her response, Carriere asked the trial court to take judicial notice of her earlier filing in which she stated that her case fell under the TSA. The trial court instead granted O'Brien's second motion for summary judgment and dismissed the case with prejudice.

The Court of Appeals affirmed the trial court's dismissal of the common-law fraud, fiduciary duty, and negligence cases for failure to raise a fact issue, but it reversed the dismissal of plaintiff's TSA claim. Noting that Texas follows a fair-notice standard for pleading, the Court ruled that the petition set forth sufficient details to put the defendant on notice of a TSA claim. While the petition did not specifically mention the TSA, it specifically tracked several of the civil liability requirements in §33(F)(2) of the TSA and requested attorney fees under the TSA. In addition, because O'Brien failed to move for summary judgment on Carriere's TSA claim after she raised it in her initial response, the trial court erred by granting summary judgment on that claim.

4. *Control & Applications LLC Houston v. Abdallah*, 2022 WL 3650133 (Tex.App.—Houston [1st Dist.] Aug. 25, 2022) (Amparo Guerra, J.)

The plaintiffs, Raed and Ali Abdallah (Raed and Ali), were minority shareholders in vMonitor LLC (vMonitor). They alleged they were the victims of an orchestrated scheme to obtain their interests in vMonitor at a low price (\$2.75 million) shortly before it was sold for four times as much. They sued the defendants for fraud, conspiracy, and breach of fiduciary duty. After a bench trial, the trial court awarded Raed and Ali \$7.2 million in actual damages and \$1.4 million in exemplary damages. The Court of Appeals affirmed the trial court's judgment.

Factual Background

Brothers Raed and Ali were minority owners of vMonitor. Raed developed the technology and ran vMonitor for 10 years. The company was acquired by an entity owned by Rashed Saif Jaber Al Suwaidi (Rashed). Rashed served as Chairman of vMonitor. The company's CEO was Carlos Marques Montejano (Carlos), and its COO was Hussan Suheil (Sami). Rashed owned 51% of the company; Carlos owned 18%; and Sami owned 25%. However, Sami's interest included an 8.33% interest for each of Raed and Ali that he held in trust.

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In March 2012, Carlos approached one of the company's customers (Shiera), about buying an interest in vMonitor. Carlos later told Raed that Shiera wanted to invest and that Carlos and Sami had decided to sell. Carlos proposed that plaintiffs join with them to sell their interests for \$1.1 million each based on Shiera's calculation that vMonitor was worth \$13.2 million. When the Shiera sale did not occur, Carlos offered to buy plaintiffs' shares through Rashed's company, Horizon, for the same price. Since Raed understood that Carlos and Sami also planned to sell their interests to Horizon at the same price, he and Ali agreed.

Plaintiffs stopped working actively for vMonitor by August 2012 and signed purchase agreements for the sale to Rashed's company in October 2012. Although the purchase agreements were effective as of October 1, 2012, Carlos and Rashed did not sign them until October 12, and plaintiffs did not sign them until October 14 and October 15. In addition to the \$1.1 million for their shares, which was paid out over the next year, plaintiffs also received \$275,000 each in December 2013 as an earn-out payment. In total, the brothers received \$2,750,000 for their interests in vMonitor. In return, they agreed to release all claims and causes of action they had against vMonitor through the date of the Purchase Agreement.

Before the Purchase Agreements were fully executed and without the knowledge of plaintiffs, Sami began discussions with Rockwell Automation (Rockwell) about a potential acquisition of vMonitor. Carlos and Sami had prior discussions with other potential buyers, including Honeywell in April 2011 and Lime Rock Partners in May 2011. When Carlos and Sami learned that Lime Rock assigned a value of \$25-\$30 million to the company, they argued it was worth twice as much (i.e., \$50 - \$60 million). Neither Raed nor Ali was present for the discussions with Honeywell and Lime Rock, and they were not told of Sami's discussions with Rockwell prior to signing the purchase agreements.

The discussions with Rockwell progressed, and Rockwell signed a nondisclosure agreement in November 2012. By May 2013, Carlos, Sami, and Rashed had negotiated a \$60-million valuation of the company from Rockwell – four times the valuation used for the sale of plaintiffs' interests. All these events occurred while Raed and Ali were still beneficial owners of their interests in vMonitor. Ultimately, vMonitor was sold to Rockwell for \$59,762,000. When Raed learned of the sale, Carlos falsely told him that the purchase price was the same as the "exit price" Raed and Ali had received for their interests. Carlos acknowledged this statement was a lie.

The Lawsuit and Trial

Raed and Ali filed suit, alleging breach of fiduciary duty and fraud based on an alleged scheme to obtain their membership interests at an artificially low price. They specifically alleged that Rashed (as majority owner of vMonitor) and Sami (as the holder of their membership interests) breached their fiduciary duty of loyalty to the brothers. They alleged that Rashed, Carlos, and Sami also engaged in fraud by failing to disclose Carlos and Sami's opinion that vMonitor was worth between \$50 and \$60 million in May 2011 and by fabricating an offer from Shiera to persuade them to sell at a low price. They also pleaded that defendants were jointly and severally liable as conspirators and for aiding-and-abetting breaches of fiduciary duties.

After a six-day bench trial, the court rendered judgment for Raed and Ali on all their claims. The court awarded them \$7.2 million in actual damages based on their interests in the company at

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a value of \$59 million and awarded an additional \$1.4 million each in exemplary damages against Rashed.

Appeal

Defendants challenged the legal and factual sufficiency of the trial court's judgment and damages awards. The Court of Appeals limited its discussion to the evidence supporting fraud, civil conspiracy, and damages.

Fraud Claims. The trial court identified seven false statements in its fact findings, and defendants challenged all of them. The most interesting points raised concerned whether statements were inactionable because they were forward looking, statements of opinion, or not justifiably relied upon.

The Court noted that statements regarding future events typically are not actionable in fraud, but there are exceptions. *Id.* at *8 (citing *Trenholm v. Ratcliff*, 646 S.W.2d 927, 930 (Tex. 1983) and *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 48 (Tex. 1998)). The Court nevertheless dissected the statements and concluded that most related to past or present facts (e.g., "Shiera had valued vMonitor in the \$13 million range"; "Carlos and Sami had agreed to sell their ownership interests to Shiera at the \$13 million valuation.").

With respect to opinion statements, the Court again dissected the statements to focus on the factual portions (e.g., "Rashed had no intention of selling his interest" was factual in nature, but "the sale of the company would not happen anytime soon" was an opinion statement).

With respect to justifiable reliance, the Court reiterated that a defendant has no burden to negate the reliance element, and the burden remains on the plaintiff to establish reliance. *Id.* at *9-10. Defendants argued that Raed and Ali knew Shiera had reneged on his offer to purchase an interest in vMonitor and could not have relied on that alleged misrepresentation. The court stated that was not the question; the misrepresentation was that Carlos and Sami were willing to sell based on Shiera's \$13 million valuation when they told Lime Rock the company was worth \$50-\$60 million.

Civil Conspiracy. Defendants claimed the conspiracy claim failed because (1) there was no underlying tort and (2) there was no evidence of a meeting of the minds. The court quickly dispensed of both arguments. First, it concluded that defendants had not adequately briefed their conspiracy challenge in their opening brief, so it was waived. Second, it noted that defendants' argument rested on the notion that there were separate negotiations with Raed and Ali for the Shiera transaction and the sale to Rashed's company, but the trial court could reasonably have concluded they were all part of the same scheme.

Damages. Defendants argued the only evidence of actual damages was presented by their expert who opined that Raed, and Ali each received a reasonable and fair price for their shares. The Court rejected that position because the trial court had a rational basis for its calculation of actual damages because Carlos and Sami stated their view that the company was worth \$50-\$60 million in May 2011, and Carlos agreed in trial testimony that nothing changed from that time to the date of the Rockwell sale. Accordingly, the trial court judge could reasonably have rejected the expert's enterprise value estimate in favor of his own calculation based on the evidence presented.

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With respect to exemplary damages, the Court noted that the evidence supported the underlying claims met the clear and convincing standard necessary for exemplary damages. Even assuming the evidence against Rashed were not clear and convincing, he could still be held liable for exemplary damages under the civil conspiracy claim.

5. *Mehta v. Ahmed*, 2022 WL 3720181 (Tex.App.—Houston [1st Dist. Aug. 30, 2022])

The Houston First Court of Appeals reversed a trial court judgment after a jury trial, concluding that there was insufficient evidence to support the jury finding that plaintiff Mohammed Ahmed (Ahmed) and defendant Sunil Kumar Mehta (Mehta) formed a partnership to acquire a shopping mall. While there was some evidence to support some of the five factors for partnership formation set forth in §152.052 of the TBOC, the Court concluded it was not legally sufficient in its totality to support the judgment. For similar reasons, the Court reversed the judgment on the unjust enrichment and fraud claims. Although fact intensive, the opinion provides a useful summary of how courts analyze the five factors to determine whether a partnership was formed.

Background

In June 2017, Mehta learned that the West Oaks Mall was listed for sale. On June 22, he submitted a letter of intent to acquire the property. On June 28, Mehta submitted a revised \$10 million offer contingent on financing and a 60-day closing period. The broker told him he would need to make an all-cash offer with a 30-day closing period if he wanted to be the successful bidder.

Mehta did not have \$10 million available in immediate funds, so he spoke with Morag McInnes, a broker at Community Bank. McInnes told him he did not qualify for the loan, but McInnes offered to contact Ahmed, one of the bank's customers, to see if he would loan Mehta the money. Ahmed told McInnes that he would be interested only if the deal involved some form of equity ownership.

The same day Mehta called Ahmed directly. Ahmed testified that he told Mehta he was only interested in being a partner not a lender. He claimed Mehta told him "So you can do the partnership?" and that he responded positively. Mehta then asked if he could send an offer to the seller, and Ahmed said: "If you do the joint venture, if you do a partnership agreement with me to acquire the [West Oaks Mall], my money is available." Mehta, on the other hand, testified that he told Ahmed that he wanted to buy the mall himself and only wanted to borrow money from Ahmed. He also testified that was uninterested in partnering with Ahmed because Ahmed was involved in "big business" lawsuits with his previous business partners, which Mehta viewed that as a red flag.

On June 29, Mehta told the seller's broker that he had just spoken with his son, and together they had enough cash to make a cash bid. He then submitted "a cash offer" for \$10 million with a 20-day closing period. Mehta did not mention Ahmed in either the revised offer or his communication with the seller's broker. The next day, the seller preliminarily accepted Mehta's offer, subject to proof of "available cash" and a walk-through of the site.

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Mehta then met with Ahmed to discuss the deal and tour the mall. Ahmed testified that he again told Mehta he did not want to be a lender and that, after some haggling, the parties agreed to a partnership with a 65/35 split. Mehta, on the other hand, testified that they agreed to enter into a partnership or any split.

On July 5, Mehta asked McInnes for a proof-of-funds letter (POF letter) to send the seller stating that he personally had \$10 million in available cash. McInnes refused, saying that was not true. However, because McInnes believed Mehta and Ahmed were entering into a partnership, she suggested that the POF letter be sent on behalf of the “Mehta Group,” which she understood suggested that both Mehta and Ahmed would be the source of funds. Mehta agreed to the revised POF letter but did not tell McInnes that he did not plan to partner with Ahmed. Nor did he tell her that he and his son were planning to fund the deal instead. Later that day, Mehta sent the POF letter to the seller’s broker, but he did not reference Ahmed.

Shortly after the POF letter was submitted, Ahmed admitted that he became concerned Mehta did not intend to be his partner. Things came to a head on July 17, when Ahmed said Mehta told him they would not be partners. On cross examination, Ahmed admitted that he never actually formed a partnership with Mehta and was motivated to “teach him a lesson” by putting him through litigation.

Mehta ultimately funded the deal from other sources, and the mall purchase closed on August 15, 2017.

After closing Ahmed sued Mehta for breach of fiduciary duty, unjust enrichment, and fraud. The jury found that Ahmed and Mehta had formed a partnership to acquire and develop the West Oaks Mall and awarded Ahmed \$1 million on his breach of fiduciary duty claim and \$586,000 for his unjust enrichment and fraud claims. Mehta appealed.

Appellate Opinion

The Court reiterated the standards on appeal from a jury verdict, noting that “[i]f there is more than a scintilla of evidence to support the challenged finding, we must uphold it.” The Court then reviewed the evidence supporting each of the claims.

Partnership Formation

The Court analyzed the evidence supporting formation of a partnership using the five factors set forth in Section 152 of the TBOC and listed below. The Court noted that a partnership could be express or implied and that a party seeking to establish the existence of a partnership “is not required to provide evidence of all factors.” *Id.* at *9 (citing *Ingram v. Deere*, 288 S.W.3d 886, 896 (Tex. 2009)). Rather, the statute’s “less formalistic and more practical approach” is based on a totality-of-the-circumstances test that requires the Court to evaluate evidence on a continuum. *Id.* (citing *Ingram*, 288 S.W.3d at 896 and other cases).

1. Right to receive a share of profits.

Because there was no written agreement memorializing the terms of any partnership nor any profits to divide, the Court looked to testimony about the parties’ conduct and any oral

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agreement between them. *Id.* at *10 (citing *Malone v. Patel*, 397 S.W.3d 658, 674-75 (Tex. App. – Houston [1st Dist.] 2012, pet. denied)). The Court found Ahmed’s testimony that the parties agreed to a 65/35 split was some evidence on the issue, but the testimony did not specifically reference profits or explain what the parties agreed to split (e.g., profits? ownership of the property? gross revenue from rental payments?). Nor did the Court find any record evidence with details of the alleged split agreement. Accordingly, the Court found Ahmed’s testimony about a 65/35 split “conclusory and no evidence of a right to receive a share of the profits” of the mall. *Id.* at *11 (citing *Windrum v. Kareh*, 581 S.W.3d 761, 770 (Tex. 2019) (“When the evidence presented to the jury is conclusory, it is considered no evidence.”)).

Ahmed argued that lack of profits was not the same as lack of a profit-sharing agreement, citing *Houle v. Casillas*, 594 S.W.3d 524 (Tex. App. – El Paso 2019, no pet.). The Court quickly distinguished this case. It involved a partnership to renovate and lease apartments that ended before any profits were realized, but the undisputed evidence showed that the parties had an agreement to share equally in profits after the renovations were completed. In contrast, the alleged Ahmed-Mehta partnership was not undisputed.

2. Expression of intent to be partners.

The Court noted that evidence of this factor must be “separate and apart from the review of other factors” and that “the terms used by the parties do not control” the outcome. *Id.* at *11 (citing *Ingram*, 288 S.W.3d at 899-900 and other cases). Much of Ahmed’s evidence concerned his own understanding that the parties had become partners, but “Ahmed’s mere belief there may be a partnership is not probative evidence of a partnership.” *Id.* The Court noted that the term “partner” is regularly used in the common vernacular and may be used in a variety of ways. *Id.* at *12 (citing *Ingram*, 288 S.W.3d at 900). While the jury was free to believe Ahmed’s testimony and not Mehta’s on this point, the testimony did not show a “mutual expression of intent to be partners.” *Id.*

The Court focused on Mehta’s statements to third parties for evidence of mutual intent. It found none. First, Mehta never mentioned Ahmed to the seller’s broker, referencing only his individual interest in acquiring the property and funding from him and his son. Second, while Mehta’s act of obtaining the POF letter from McInnes at Community Bank was some evidence of Mehta’s intention to be partners, it was weak and self-contradictory when considered in context. The POF letter identified the Mehta Group, not Ahmed, and McInnes drafted it based on her understanding that Ahmed and Mehta would be partners. She admitted that Mehta had asked her not to include Ahmed’s name in the letter and that neither Ahmed nor Mehta ever told her they had actually formed a partnership. Third, it was not reasonable for the jury to infer from the discussions between Ahmed and Mehta after the offer was preliminarily accepted that they intended to be partners. Mehta testified that he was exploring other financing at this time, and Ahmed admitted that he knew they would not be partners well before the deal closed.

Based on this weak and self-contradictory evidence, the Court did not find much evidentiary support for this factor.

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3. Participation or right to participate in control of the business.

The Court found no more than a scintilla of evidence supporting this factor. Ahmed admitted that he never had any control over West Oaks Mall but claimed (1) he and Mehta discussed that Ahmed had experience franchising restaurants and could do whatever he wanted with the food business at the mall, and (2) they agreed on a 65/35 split. The Court found the testimony about the food business was no more than a scintilla and could have referred to another project they were considering (i.e., acquiring the Macy's near the West Oaks Mall which Mehta did). As for the 65/35 split, the Court noted it was vague and there was no testimony about whether it would be a general partnership, a limited partnership, or a limited liability partnership so it was not clear Ahmed would have any right to control the business.

4. Agreement to share losses of the business.

Ahmed acknowledged the evidence supporting this factor was slight but pointed to the alleged 65/35 split agreement. For the same reasons the Court found this testimony insufficient to show agreement to share profits, it ruled it was insufficient to show any intent to share losses.

5. Agreement to contribute or contributing money or property to the business.

Since Ahmed did not actually contribute any money or property toward the acquisition and development of the mall, the Court looked to see if there was any agreement for him to do so. *Id.* at *16. It found some evidence based on (1) Ahmed's agreement to allow Mehta to use his financial standing with Community Bank to obtain the POF letter and (2) Ahmed's agreement to contribute money towards the acquisition.

Balancing these five factors, the Court ruled there was no conclusive evidence supporting any of the statutory factors, and the evidence presented to support the second and fifth factors was weak and self-contradictory. On the two most important factors – an agreement to share profits and a right to control the business – there was no evidence. Accordingly, the Court held “the evidence is legally insufficient to support the jury’s finding that the parties formed a partnership to acquire and develop the West Oaks Mall.” *Id.*

Unjust Enrichment

Ahmed argued that he provided a benefit to Mehta by allowing his available cash to be considered for the proof-of-funds letter. The Court discounted this argument because the seller's agent testified Mehta was picked as the winning bidder *five days before* the proof-of-funds letter was submitted. She testified that the selection was made based solely on her due diligence into his financial statements and personal references, and the proof-of-funds letter did not influence the seller's decision. The Court stated that even if the jury did not believe the testimony of the seller's broker, the proof-of-funds letter was no more than an incidental benefit to Mehta. The evidence was legally insufficient to establish that Mehta wrongfully secured or passively received a benefit – an element necessary to support Ahmed's unjust enrichment claim. *Id.* at *18 (citing *Ahmed v. Shah*, 2015 WL 222171, at *5-6 (Tex. App. – Houston [1st Dist.] Jan. 15, 2015, no pet.)).

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Fraud

Although Ahmed did not elect to accept any award based on the jury’s finding of fraud, the parties briefed the issue and the Court reviewed it to see if there was an alternative basis to support the jury’s award. The Court quickly concluded that Ahmed failed to demonstrate detrimental reliance or causation linked to any material misrepresentations or omissions by Mehta. “Ahmed’s fraud theories rest on the evidence he agreed to let his Community Bank assets be considered for the proof-of-funds letter ...” *Id.* While that is some evidence that he relied upon a misrepresentation or undisclosed material fact, it is no evidence that he suffered injury as a result. Ahmed’s own testimony confirmed that he did not contribute any monies, that none of his assets were tied up, and that he could have bid to purchase the mall himself but chose not to do so.

**N. Scott Fletcher
Kenneth P. Held
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Securities and Commercial Litigation, Internal Investigations, and Enforcement Defense

808 Travis Street, Suite 1553
Houston, TX 77002

(713) 255-0422

www.fletcherheld.com

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