FLETCHER | HELD

Main Number: 713-255-0422
Email: sfletcher@fletcherheld.com
Email: kheld@fletcherheld.com

SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

OCTOBER – DECEMBER 2023

This quarterly newsletter summarizes recent federal and state court decisions and other developments of interest to practitioners litigating securities and fiduciary duty claims in Texas.

Court rulings, hyperlinked to Westlaw, and other notable events include:

- Fifth Circuit Review of SEC and Nasdaq Rulemaking – The final quarter of 2023 did not produce as many securities fraud and fiduciary duty rulings as earlier this year, but what it lacked in quantity, it made up for in potential impact. In *Alliance for Fair Board Recruitment v. SEC*, a Fifth Circuit panel upheld the SEC's approval of Nasdaq's new board diversity rule that requires Nasdaq-listed companies to disclose the voluntary, self-identified gender, racial characteristics, and LGBTQ+ status of its directors, including an explanation if it did not have at least two diverse board members. Two weeks later, a different Fifth Circuit panel in *Chamber of Commerce of USA v. SEC*, struck down the SEC's share repurchase (stock buyback) modernization rule that would have required public companies to disclose in quarterly and annual reports (1) day-to-day stock buyback data, (2) the rationale for stock buybacks, (3) the process used to determine the amount of stock buybacks, and (4) any policies relating to insider purchases and sales during a stock buyback. While both cases upheld constitutional challenges to these SEC approved rules, the *Chamber of Commerce* ruling vacated the stock buyback rule as arbitrary and capricious under the Administrative Procedure Act.

- Securities Fraud Cases – In *Utah Retirement Systems v. McCollam*, the Fifth Circuit affirmed the dismissal of securities fraud claims against Weatherford and some of its executives based on certain pre-bankruptcy statements for failure to allege a strong inference of scienter. In *United States v. Greenlaw*, the Court affirmed the convictions of United Development Funding executives for their involvement in a Ponzi-like scheme that used investor funds to pay bank loans and investor distributions. Finally, in *Seybold v. Charter Communications, Inc.*, the Fifth Circuit affirmed dismissal of SOX whistleblower claims for failure to provide sufficient details to show (1) the whistleblower engaged in protected activity and (2) believed the company was violating securities laws.

- SEC Enforcement Cases – In *SEC v. McKnight*, the district court affirmed the magistrate judge's recommendation to deny a motion to dismiss claims against the promoter of a high-yield investment trading program and a two-person law firm accused of aiding and abetting the promoter by accepting investor funds on his behalf without performing due diligence. In *SEC v. Balina*, the Court denied a motion to exclude the testimony of an SEC expert witness regarding transactions on the Ethereum blockchain and the background of initial coin offerings.

808 Travis Street, Suite 1553
Houston, TX 77002

- Other Fraud and Fiduciary Duty Cases – In *Galentine v. U.S. Bank, N.A.*, the district court granted judgment on the pleadings in a foreclosure action that alleged fraudulent statements by the lender, ruling that plaintiffs failed to identify any injury caused by their reliance on the alleged misstatements. In *Toth Enterprises II, P.A. v. Forage*, the district court refused to dismiss fiduciary duty claims filed against the managers of an LLC, ruling that the LLC-member plaintiffs had alleged sufficient facts against the managers to go forward. In *Ray v. Lynass*, the district court denied motions for summary judgment on claims and counterclaims for fraud and breach of fiduciary duty based on disputed facts. Finally, in *Moayedi v. Arabghani*, the Texas First Court of Appeals affirmed a $2,000 judgment on a personal loan made by a restaurant investor but refused to reverse the trial court's judgment that the investor was not entitled to recoup his initial capital investment of $100,000.

CASE SUMMARIES

I. FEDERAL CASES

A. Fifth Circuit

1. *Alliance for Fair Board Recruitment v. SEC*, 85 F.4th 226 (5th Cir. 2023).

On October 18, 2023, the Fifth Circuit denied petitions for review filed by two business associations challenging the Nasdaq Stock Market, LLC's new Board Diversity Proposal (Disclosure Rule) and Board Recruiting Service Proposal (Recruiting Rule) that were approved by the SEC on August 6, 2021.[1] The Court held that Nasdaq, a self-regulatory organization (SRO) under SEC rules, was a private company and not a state actor subject to governmental restrictions under the U.S. Constitution. It further held that the SEC did not exceed its statutory authority or act arbitrarily or capriciously in approving Nasdaq's Disclosure Rule and Recruiting Rule.

Background

On February 26, 2021, Nasdaq filed proposed amended rule changes to address board diversity.

- The Disclosure Rule proposed to require each Nasdaq-listed company to publicly disclose information on the voluntary, self-identified gender and racial characteristics and LGBTQ+ status of its board members. Nasdaq included definitions with the proposed rules for the terms Diverse, Female, Underrepresented Minority, and LGBTQ+. If a company did not identify at least two diverse board members (defined for domestic issuers as one female and one underrepresented minority or LGBTQ+ person), it had to explain why.

- The Recruiting Rule proposed to offer certain Nasdaq-listed companies access to a board recruiting service to identify and evaluate diverse candidates.

During the public comment period, one petitioner submitted comments before the proposed rules were amended, and the other submitted a 78-page opposition after Nasdaq amended the

[1] The panel consisted of Judges Stewart, Dennis, and Higginson.

proposed rules. The SEC considered evidence submitted by Nasdaq, responded to comments by the petitioners, and concluded the proposed rules were consistent with the Exchange Act and approved them. The petitioners promptly asked the Fifth Circuit to review the proposed rules, arguing that they (1) violated the First and Fourteenth Amendments to the U.S. Constitution, and (2) violated the SEC's statutory obligations under the Exchange Act and the Administrative Procedure Act (APA).

Constitutional Challenges

The Constitution only applies to state action. Petitioners argued that (1) Nasdaq is a state actor because it is a creature of federal law, serves federal interests, and is controlled by a federal agency; and (2) the SEC's involvement with and approval of the Nasdaq rules render them subject to constitutional scrutiny. The Court rejected both arguments.

1. Nasdaq is not a state actor.

Nasdaq is a private entity wholly owned by Nasdaq, Inc. Its board is selected by its broker-dealer members and by Nasdaq, Inc. While Nasdaq is heavily regulated by the SEC, the Supreme Court has made clear that a private entity does not become a state actor merely by being regulated. *Manhattan Cmty. Access Corp. v. Halleck*, 139 S. Ct. 1921, 1932 (2019). In similar cases, sister circuits have found that SROs registered with the SEC are private entities, not state actors. *Alliance*, 85 F.4th at 239-41 (citing cases from the 2d, 3d, 4th, 7th, and 9th circuits).

The Fifth Circuit rejected petitioner's argument that other cases required a different result. The opinion in *Intercontinental Indus., Inc. v. American Stock Exch.*, 452 F.2d 935, 941 (5th Cir. 1971) states "the intimate involvement of the Exchange with the [SEC] *brings it within the purview* of the Fifth Amendment." However, the *Alliance* court noted that the law applying this vague "joint participation" test for state action referenced in *Intercontinental Industries* had changed, the portion relied upon by petitioners was *dicta*, and subsequent cases referencing *Intercontinental Industries* were distinguishable and not precedential. *Alliance*, 85 F.4th at 241-43. The Court likewise distinguished several Supreme Court cases involving Amtrak because Nasdaq was not a corporation created by the government, its board members were not appointed or confirmed by government officials, and its board members were not subject to removal by the government. *Id.* at 243-44.

The Court also rejected petitioners' argument that Nasdaq must qualify as a state actor because otherwise its authority to self-regulate would violate the private nondelegation doctrine. Noting that the state-action inquiry and private nondelegation doctrine are distinct inquiries, it chided the petitioners for making this catch-22 argument: "Petitioners fail to explain why Nasdaq cannot be a private entity whose conduct, while subject to governmental regulation, is neither an exercise of the SEC's government authority nor fairly attributable to the SEC." *Id.* at 244.

2. Nasdaq's Rules are not fairly attributable to a state actor.

Petitioners further argued that because there was a close nexus between the State and the challenged action, the Nasdaq rules were fairly attributable to the state. *Id.* at 245. The Court noted that such a close nexus exists "in a few limited circumstances" and was not present here. *Id.* Nasdaq's listing standards were not a traditional, exclusive public function; the NYSE was founded in 1792 and adopted listing rules in 1817. The petitioners presented no evidence that the government compelled Nasdaq to draft the rules, and comments by two SEC commissioners supporting them was not

sufficient to do so. Nasdaq generated the rules itself and submitted them to the SEC for approval as required by statute. The government and Nasdaq did not act jointly and were not intertwined. *Id.* at 245-47. Moreover, since the petitioners challenged the rules and not any enforcement action under the rules, the Court was not required to decide (and did not) whether enforcement would qualify as state action.

Statutory Challenges

Petitioners first argued that the SEC exceeded its authority under the Exchange Act when it approved the rules. They claimed (1) because the Exchange Act requires the SEC to find that an exchange rule is "designed" to meet certain statutory objectives, it can only rely on objective evidence; (2) the Exchange Act prohibits the SEC from approving an exchange act rule that is not "material" for purposes of a securities fraud claim; (3) Congress did not explicitly authorize the SEC to approve a rule that concerns "major policy questions of vast economic and political significance." The Court rejected each of these arguments.

1. The SEC did not exceed its authority under the Exchange Act in approving the Nasdaq rules.

First, the Exchange Act does not limit the SEC to considering "objective evidence." It simply states that "the findings of the [SEC] as to the facts, if supported by *substantial evidence*, are conclusive." *Id.* at 249 (quoting 15 U.S.C. § 78y(a)(4) and noting that courts have defined "substantial evidence" as more than a scintilla and less than a preponderance). Since the text requires "substantial evidence" not "objective evidence," it was only required to conduct an independent review of the evidence. To the extent it considered the subjective opinions of investors, that "may be relevant evidence and sufficient to meet the substantial evidence standard." *Id.* at 250.

Second, petitioners' argument that information about directors' race, gender, and sexuality is not material and, therefore, outside of the SEC's authority, was not supported by the statutory language in the Exchange Act. "The fundamental purpose of the Exchange Act is implementing a philosophy of full disclosure." *Id.* at 251 (quoting *Basic v. Levinson*, 485 U.S. 224, 230 (1988)). A disclosure rule can be "'related to the purposes of the Exchange Act,' 15 U.S.C. § 78f(b)(5), even if the SEC does not find that the disclosure rule is limited to information that would be 'material' in the securities fraud context." *Id.* The Court held that an exchange disclosure rule does not have to be limited to what would be material to a securities fraud claim. *Id.* at 252.

Even assuming materiality were required, substantial evidence supports the SEC's finding that Nasdaq's rule would provide information that would contribute to investors' investment and voting decisions. *Id.* (citing statements from Vanguard, BlackRock, Goldman Sachs, Microsoft, asset managers, and investors). "This evidence is sufficient to support the SEC's determination that regardless of whether investors think that board diversity is good or bad for companies, disclosure of information about board diversity would inform how investors behave in the market." *Id.* at 252-53. "The SEC did not need to find that there is empirical or scientific basis about the effects of board diversity or that these effects are beyond debate to conclude that a 'reasonable investor' could find board diversity 'important.'" *Id.* at 253.

Third, Nasdaq's disclosure rules do not regulate corporate governance, an area reserved for the states, because they do not impose demographic quotas. The disclosure rules do not mandate that

companies meet certain diversity objectives; they simply require a company to explain if it does not have at least two diverse board members. Nasdaq's rules expressly state that it "would not assess the substance of the company's explanation" and offered several *de minimus* explanations for companies to consider (*e.g.*, the company does not believe Nasdaq's listing rule is appropriate; the diversity objectives are not feasible given the company's current circumstances). *Id.* at 254. Only if a company refuses to give any explanation at all may it be sanctioned. Since the SEC made a reasonable finding on sufficient evidence that the proposal does not impose a diversity quota, the Court adhered to the SEC's "conclusive determination." *Id.* at 255.

Fourth, the SEC's approval of the Nasdaq rules does not implicate the requirement that Congress must make its intention unmistakably clear in the language of the statute to alter the constitutional balance between the states and the federal government. Disclosure rules do not interfere with the role of state corporate law. *Id.* at 255 (citing *Bus. Roundtable v. SEC*, 905 F.2d 406, 411-12 (D.C. Cir. 1990). Nor do the rules invoke the "major question doctrine" because the disclosure rules are not significant in that context. *Id.* at 257 (citing cases involving major questions such as banning tobacco, imposing a nationwide eviction moratorium, and regulating greenhouse gas emissions from millions of small sources).

2. The SEC did not act arbitrarily or capriciously in violation of the APA.

Under the arbitrary and capricious standard, the SEC "must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." *Id.* at 258 (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983)). The Court does not substitute its judgment for the agency's but considers whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. *Id.* (citing *Sierra Club v. U.S. Dep't of Interior*, 990 F.3d 898, 904 (5th Cir. 2021)). The petitioner has the burden of proof.

First, petitioners challenged the SEC's finding that the Disclosure Rule would "contribute to the maintenance of fair and orderly markets" and is designed to remove impediments to and perfect the mechanism of a free and open market and a national market system. The SEC found that board-level diversity statistics are currently not widely available even though Nasdaq and many commenters argued the information was important to investors. Citing numerous comments, the Court concluded the SEC had substantial evidence to support this conclusion.

Second, the SEC concluded that the rule is not designed to permit unfair discrimination. Petitioners challenged this conclusion because domestic and foreign issuers are subject to different definitions and standards.[2] The SEC explained that to the extent foreign issuers choose to meet the diversity objectives, it was "not unreasonable for [Nasdaq] to take into account the differing demographic compositions of foreign countries and to provide Foreign Issuers flexibility …." *Id.* at 262 (citing 86 Fed. Reg. at 44,435). Since both domestic and foreign issuers had to disclose the number

[2] For foreign issuers, the proposed Disclosure Rule was slightly different. First, instead of defining Underrepresented Minority to include specific ethnicities (e.g., Black or African American, Hispanic or Latinx), it referred to "an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious, or linguistic identify in the country of the company's principal executive offices." *Id.* at 261. Second, instead of requiring one female member and one member who was an Underrepresented Minority or LGBTQ+, it allowed foreign issuers to list two female board members to avoid providing an explanation. *Id.* Finally, it asked foreign issuers to disclose whether disclosure of diversity data was prohibited by the laws of its home country. *Id.*

of board members who self-identify as underrepresented, the challenge failed and the SEC's conclusion was supported by substantial evidence.

Third, the Court rejected the argument that the SEC failed to adequately consider the "tremendous costs for firms that dare to defy the quotas" and failed to show the asserted benefits outweighed those costs. The Court noted that the SEC must consider whether the proposed rules impose any burden on competition not necessary or appropriate under the purposes of the Exchange Act, but it need not "measure the unmeasurable." *Id.* at 263. A discussion of unquantifiable benefits is sufficient so long as the SEC articulates a rational connection between the facts found and the choice made. *Id.* (citing *Linden v. SEC*, 825 F.3d 646, 658 (D.C. Cir. 2016)). In this case, the SEC adequately considered the potential burdens on competition and addressed the petitioner's concerns that the Disclosure Rule would create a target for activists and shareholder lawsuits. If some companies chose not to list on Nasdaq to avoid certain costs, they could do so. The SEC weighed the burdens on competition against the "difficult-to-quantify, intangible benefits" of the Disclosure Rule and considered and accounted for petitioners' argument that the SEC underestimated the costs of non-compliance for Nasdaq-listed companies. On balance, the Court concluded that the petitioners failed to meet their burden to show that the SEC's decision was arbitrary or capricious.

Finally, the Court noted that the SEC reviewed the supporting and contrary evidence in the record and reached its own independent decision to approve the rules. Indeed, the SEC rejected the extensive body of empirical evidence that Nasdaq submitted to support its view that diverse boards are positively associated with improved corporate governance and company performance. The SEC found the studies submitted by Nasdaq were inconclusive and not a reliable basis for evaluating the overall effects of the Disclosure Rule. As the Court stated: "This is not the work of an agency taking an SRO's 'word for it.'" *Id.* at 265.

2. ***Chamber of Commerce of USA v. SEC*, 85 F.4th 760 (5th Cir. 2023) (main opinion), and *Chamber of Commerce of USA v. SEC*, 88 F.4th 1115 (5th Cir. 2023) (vacating rule).**

On October 31 and December 19, 2023, the Fifth Circuit issued related opinions that vacated the SEC's share repurchase disclosure modernization rule.[3] The amended rule, which was adopted by the SEC in May 2023, required public companies to report day-to-day share repurchase data and disclose the reasons for the repurchases. The Fifth Circuit rejected petitioners' arguments that the amended rule violated the First Amendment and that the SEC did not provide enough time for public comments. The Court, however, agreed with the petitioner's argument that the SEC acted arbitrarily and capriciously in violation of the Administrative Procedure Act (APA) by failing to quantify the expected costs and benefits of the amended rule and ignoring quantitative data submitted by business groups.

[3] *Final Rule: Share Repurchase Disclosure Modernization*, SEC Release No. 34-97424 (May 3, 2023) ("Final Rule").

Background

Stock buybacks have been the focus of public and media scrutiny in recent years.[4] Since the late 1990s, buybacks have outpaced dividends due to their tax benefits and financial flexibility.[5] After Trump-era tax cuts reduced the corporate tax rate, the value of share buybacks in the S&P 500 surged from a record $600 billion in 2017 to $800 billion in 2018 and more than $1 trillion in 2022. Some were concerned that stock buybacks enabled executives to sell shares at inflated prices or manipulate the market by increasing earnings per share. Others suggested that corporations should be using the windfall from tax cuts to reinvest in the business or increase worker pay. To discourage the use of buybacks, the Inflation Reduction Act of 2022 imposed a 1% federal excise tax on share repurchases.

Against this backdrop of public and congressional skepticism about share repurchases, the SEC conducted a study on buybacks and why issuers repurchase their shares. While the study concluded that repurchasing shares could be an efficient use of capital and could indicate an issuer's shares were undervalued, the SEC concluded that investors would still benefit from additional disclosures. *Chamber of Commerce*, 85 F.4th at 766. Since 2003, issuers had been required under the existing rules to report aggregate monthly share repurchase data in their quarterly and annual reports. Under the SEC's December 2021 proposal, issuers would have been required to (1) report quantitative repurchase data on a separate form within one business day, and (2) provide additional detail regarding the structure of an issuer's repurchase program and its share repurchases. Final Rule, at 4-5. The SEC received public comments on the proposal for 45 days and then reopened the comment period for 30 days after the Inflation Reduction Act passed.

The final rule modified the December 2021 proposal in several respects. First, instead of requiring data to be reported within one business day on a separate form, the SEC maintained the requirement to include the repurchase data in quarterly and annual reports. Second, it insisted on disclosure of day-to-day repurchase data rather than aggregate monthly data. Third, it required issuers to disclose "the objectives or rationales for its share repurchases," "the process or criteria used to determine the amount of the repurchases," and "any policies and procedures relating to purchases and sales of the issuer's securities during a repurchase program by its officers and directors." (collectively, the rationale-disclosure requirement). Final Rule, at 12.

The stated purpose of the amendments was to "improve the information investors receive to better assess the efficiency of, and motives behind, an issuer repurchase." Final Rule, at 21. While the SEC acknowledged that "many, perhaps even most, share repurchases are not undertaken solely or primarily to benefit managers or to achieve targets," additional disclosures would "'help investors gauge whether … repurchases may be motivated by price support for insiders' sales of their securities,

[4] *See, e.g.,* W. Lazonick, M. Sakinc, and M. Hopkins, *Why Stock Buybacks Are Dangerous for the Economy*, Harvard Bus. Rev. (Jan. 7, 2020); J. Zweig, *Stock Buybacks Aren't Bad. They Aren't Good Either.*, Wall St. J. (Feb. 17, 2023) (citing study "Share Repurchases on Trial" that concluded the stock returns of companies that did large or frequent buybacks were slightly lower in the year of repurchase but indistinguishable from others in the long run); N. Guest, S. Kothari, & P. Venkat, *The Case Against Restricting Buybacks*, MITSloan Mgmt. Rev. (July 17, 2023).

[5] While investors are taxed on dividends as ordinary income, buybacks are generally taxed at the lower rate for capital gains. And, unlike dividends, corporations can choose when to repurchase their shares and decline to do when there is financial uncertainty. For example, during the COVID crisis in 2020, buybacks sharply declined.

rather than conveying a true signal of undervaluation.'" Final Rule, at 23-24 (quoting proposing release).

As required by the Exchange Act and the Investment Company Act, the Final Rule analyzed the costs and benefits of the new requirements; the potential impact on efficiency, competition, and capital formation; and reasonable alternatives. Final Rule, at 120-157. Notably, the Final Rule included the following statement:

> We have considered the economic effects of the amendments, including their effects on competition, efficiency, and capital formation. Many of the effects discussed below *cannot be quantified*. Consequently, while we have, wherever possible, attempted to quantify the economic effects expected from these amendments, much of the discussion remains qualitative in nature. Where we are unable to quantify the economic effects of the final amendments, we provide a qualitative assessment of the potential effects.

Final Rule, at 99 (emphasis added).

On May 12, 2023 – nine days after the final rule was adopted – three business associations filed an original petition for review with the Fifth Circuit.[6] They argued that (1) the rationale-disclosure requirement violated the First Amendment by impermissibly compelling speech; (2) the SEC acted arbitrarily and capriciously in adopting the final rule by not considering their comments or conducting a proper cost-benefit analysis; and (3) the SEC did not provide the public with a meaningful opportunity to comment on the proposed rule. The Court rejected the first and third arguments but accepted the second.

1. The rationale-disclosure requirement did not violate the First Amendment.

The First Amendment includes both the right to speak freely and the right to refrain from speaking. *Id.* at 768 (quoting *Woley v. Maynard*, 430 U.S. 705, 714 (1977)). While strict scrutiny applies to non-commercial speech, "lesser scrutiny applies when the government compels disclosures in the context of commercial speech" because of the "value to consumers of the information such speech provides." *Id.* (quoting *Zauderer v. Off. Disciplinary Couns. Sup. Ct. Ohio*, 471 U.S. 626, 651 (1985)). This means:

> "[S]tates may require commercial enterprises to disclose 'purely factual and uncontroversial information' about their services" so long as those disclosures are "reasonably related to a legitimate state interest" and not "unjustified or unduly burdensome."

Id. at 768 (quoting *Net Choice, L.L.C. v. Paxton*, 49 F.4th 439, 485 (5th Cir. 2022) (quoting *Zauderer*, 471 U.S. at 651)).

The SEC argued the rationale-disclosure requirement was governed by *Zauderer* and that the government satisfied the lesser scrutiny test. The petitioners argued that *Zauderer* did not apply because

[6] Fed. R. App. P. 15 authorizes a petition for review of agency action to be filed with "the clerk of a court of appeals authorized to review the agency order."

the compelled disclosure of the issuer's subjective opinion about the business benefits of its actions was not a purely factual disclosure and the subject matter (share repurchases) was one of the most controversial decisions a corporation can make. The Court disagreed, noting that this argument was foreclosed by its ruling in *NetChoice*. In that case, the Fifth Circuit ruled that a Texas statute requiring large social media platforms to explain their content removal decisions was both a purely factual disclosure and not controversial. The Court added: "If a social media company's reason for removing user content was uncontroversial in *NetChoice*, then an issuer's reason for repurchasing its own shares is uncontroversial here." *Id.* at 770.

The Court then reviewed the rationale-disclosure requirement to determine if it was reasonably related to a legitimate government interest and not unjustified or unduly burdensome. It concluded that the SEC has a legitimate interest in promoting the free flow of commercial information and the rule "reaches no broader than necessary" to address the harm of information asymmetry claimed by the SEC. However, the Court added that "[t]hese rationales may not be enough to survive APA review" and "[w]e need not be persuaded by the SEC's reasoning to hold that the benefits of the rationale-disclosure rule are more than purely hypothetical." *Id.* at 771. It then quickly dispensed with the undue burden prong, reasoning that the requirement did not burden issuers' protected speech or drown out their message. "The issuer is free to speak (or not) however and whenever it wishes apart from a privately crafted explanation of its reasons for repurchasing shares." *Id.* at 772.

2. The Final Rule violated the APA.

The petitioners argued the SEC acted arbitrarily and capriciously in adopting the rule because it failed to (1) quantitatively analyze the economic implications of the proposed rule whenever feasible; (2) respond adequately to petitioners' comments about the agency's economic analysis; and (3) substantiate the proposed rule's benefits adequately.

The Court agreed with the SEC that it was not, as a general matter, required to undertake a quantitative analysis to determine the economic implications of every proposed rule. The Exchange only requires the agency to "consider" economic implications, and a rigorous quantitative economic cost-benefit analysis is not the only way to determine whether a proposed rule promotes efficiency, competition, and capital formation. It is within the agency's discretion to determine the economic implications of the rule it proposes.

The SEC cited the Supreme Court's decision in *FCC v. Promethus Radio Project*, 141 S. Ct. 1150, 1158 (2021), for the proposition that the APA imposes no obligation on agencies to conduct their own empirical or statistical studies. *Id.* at 775. The Court distinguished *Prometheus* from the present case, noting that the FCC in that case had "repeatedly asked for data" but "received no data" other than the materially incomplete data set it already had. *Id.* at 776. By contrast, in the present case, the SEC (1) invited commenters "to provide data and information that would help quantify the benefits, costs, and the potential impacts" of the proposed amendment, (2) received three suggestions from the petitioners on how to quantity the effects, (3) ignored the petitioner's suggestions; and (4) then claimed it could not quantify the effects. As the Court stated: "It is hard to fault petitioners for giving the SEC exactly what it had asked for. *And that factual distinction makes all the difference*." *Id.* (emphasis added). In light of its failure to consider the petitioner's suggestions after expressly inviting them, the Court ruled the SEC had "failed to demonstrate that its conclusion that the proposed rule 'promote[s] efficiency, competition, and capital formation' is 'the product of reasoned decisionmaking.'" *Id.* at 776 (cite omitted).

The Court then considered whether the SEC adequately substantiated the rule's benefits and costs. It concluded the SEC did not substantiate (1) that improperly motivated buybacks are a problem; or (2) that the rule promotes price discovery at a relatively modest cost for issuers.[7]

3. The SEC provided adequate opportunity for notice and comment.

The Court rejected the petitioner's third argument, noting that the APA generally requires only a minimum thirty-day comment period. Since the SEC provided 45 days for public comments, that was sufficient.

Based on the foregoing, the Court granted the petition for review but initially remanded the case and gave the SEC 30 days to remedy the deficiencies in the rule. *Id.* at 780. Twenty-two days later, the SEC filed an opposed motion requesting to extend the 30-day cure period for an indefinite period of time. The Court denied the SEC's motion. After the 30th day passed, the SEC admitted it was not able to correct the defects in the rule in the allotted time, and the Court granted petitioners' motion to vacate the agency rule. *Chamber of Commerce*, 88 F.4th at 1117-1118.[8]

The Fifth Circuit's ruling may not be the final word in this matter. The SEC could file a petition for certiorari with the Supreme Court, restart the rulemaking process and quantify the costs and benefits of the amended rule, or propose a new rule to address the perceived asymmetric information about share repurchases. However, given legislative calls to increase the excise tax on share repurchases to 4% and the significant reduction in stock buybacks in 2023 after interest rates increased and stock market prices declined, the SEC may well do nothing in the near term.

The outcomes in the *Alliance* and *Chamber of Commerce* cases are quite different. While both cases involved disclosure rules adopted or approved by the SEC and both cases rejected constitutional challenges to those rules, the *Alliance* court rejected the petitioner's challenge under the APA and the *Chamber of Commerce* upheld an APA challenge. Litigants and commentators will try to harmonize or distinguish the two decisions in the future, but one key difference appears to be that in *Chamber of Commerce* the SEC stated during the rulemaking process that it was unable to quantify the costs and benefits of the rule, specifically requested quantitative data from commenters, then ignored petitioners' suggestions on how the SEC could quantify the costs and benefits. By contrast, in *Alliance*, the SEC did not request quantitative data, acknowledged during the rulemaking process that the intangible benefits of the rule were difficult to quantify, considered evidence submitted by Nasdaq, responded to comments by the petitioners, and reached its own independent conclusion on approving the rule. In short, *Chamber of Commerce* identified flaws in the SEC's process that the Court found persuasive whereas the Court in *Alliance* was not persuaded that the SEC's process was flawed.

---

[7] Curiously, the *Chamber of Commerce* decision makes no reference to the Fifth Circuit's *Alliance* opinion issued approximately two weeks earlier.

[8] The first decision was made by a three-judge panel consisting of Judges Smith, Southwick, and Higginson. The second decision was made by Judges Smith and Southwick. The Court noted that this quorum of two judges made the decision because Judge Higginson, who authored the *Alliance* decision, "now stands recused." *Chamber of Commerce*, 88 F.4th at 1116. No further explanation for the recusal appears in the opinion or the Court's orders in the case.

3. ***Utah Retirement Systems v. McCollum*, 2023 WL 8649878 (5th Cir. 2023).**

The Fifth Circuit upheld the dismissal of a putative securities fraud class action filed against Weatherford International, P.L.C. (Weatherford) and some of its executives. Plaintiff alleged that the defendants made materially false or misleading statements about a "Transformation Plan" to buy time so they could negotiate a pre-bankruptcy Management Incentive Plan (MIP) to obtain 5% of the Company. The district court held the plaintiff failed to allege sufficient facts to raise a strong inference of scienter, and the Fifth Circuit affirmed on that ground.

In July 2018, after several years of financial distress, Weatherford announced a "Transformation Plan" that would impose severe cost-cutting measures and divest non-critical business units so the Company could avoid restructuring. Weatherford attempted but failed to implement that plan. In February 2019, Weatherford's then-CEO Mark McCollam was asked if Weatherford was considering bankruptcy, and he responded: "I don't waste a lot of time thinking or planning how to fail." Three months later, Weatherford announced it had executed a restructuring support agreement with a group of senior noteholders, and its stock price plummeted. Weatherford formally initiated bankruptcy proceedings on July 1, 2019.

In a short per curiam opinion, the Fifth Circuit affirmed dismissal of the case for failure to allege a strong inference of scienter. The Court rejected plaintiff's theory that defendants "knew" bankruptcy was inevitable, ruling that plaintiff's proposed inference was not as compelling as the inference that "Weatherford was 'trying to fix its issues but was continually stymied by a weak oil market.'" *Id.* at *3.

The Court also rejected plaintiff's argument that defendants were motivated to make misrepresentations about the Transformation Plan and delay the bankruptcy filing so they could negotiate the MIP. The Court stated that incentive compensation "can hardly be the basis on which an allegation of fraud is predicated" because "the vast majority of corporate executives" receive this type of compensation. *Id.* at *4 (quoting *Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 544 (5th Cir. 2008)). In addition, the MIP merely gave the new board *discretion* to award management equity compensation up to 5% but did not guarantee any concrete benefit to anyone. *Id.* Finally, the complaint failed to allege facts that tied together its fraud theory with the asserted motive: "Plaintiff argues that Defendants needed to delay bankruptcy to negotiate the MIP, but Plaintiff does not allege how the MIP would have been different – or not existed at all – had the company gone under sooner." *Id.*

4. ***United States v. Greenlaw,* 84 F.4th 325 (5th Cir. 2023).**

The Fifth Circuit affirmed the convictions of United Development Funding (UDF) executives for conspiracy to commit wire fraud affecting a financial institution (18 U.S.C. § 1343), conspiracy to commit securities fraud (18 U.S.C. § 1348 & 1349), and aiding and abetting securities fraud (18 U.S.C. § 1348). These statues require an "intent to defraud," which the Court defined as "an intent to (1) deceive, and (2) cause some harm to result from the deceit." *Id.* at 339. The securities counts prohibit execution of a "scheme to defraud," which the Court defined as "any false or fraudulent pretenses or representations intended to deceive others in order to obtain something of value, such as money, from the [entity] to be deceived." *Id.* at 339.

The Government's Allegations. UDF ran a group of investment funds (UDF III, UDF IV, and UDF V) that lent investor money to real estate developers. The Government alleged that UDF was a "classic Ponzi-like scheme" because it "used investor money from UDF IV and UDF V to pay distributions to UDF III investors and to repay loans from banks, and then lied about it to the investing public and the SEC." This allegation was based on two central alleged misrepresentations:

- Defendants represented on UDF III's quarterly and annual filings that the source of distributions to UDF III investors and lenders would be "cash ... from operations," *i.e.*, the "interest the developers were paying back on [their UDF III loans]." But the source of the funds was really "cash from investors in UDF IV and UDF V."

- Defendants represented in their UDF V filings and advertised in marketing presentations to brokers, dealers, and financial advisors that UDF V would not engage in affiliate transactions. But the money movements from UDF V to UDF III to pay distributions and a bank loan constituted affiliate transactions because UDF controlled both sides of the transaction.

Defendants' Arguments on Appeal. Defendants argued that there was insufficient evidence of (1) any material misrepresentations and (2) intent to deprive of money or property. The Fifth Circuit rejected both arguments.

Misrepresentations. Defendants argued that because a developer would take out a loan from all three funds, when money was moved from UDF IV and V to UDF III, it was actually paying down the developer's existing loan with UDF III. The Court found that there was overwhelming evidence – including testimony from the Government's forensic accountant and emails among the Defendants stating that the purpose of the money transfers was to pay distributions to UDF III investors – that the cash used to pay UDF III investors was not cash from operations as reported in UDF's SEC filings, but rather was cash from investors in UDF IV and V. The Court also found that the money transfers from UDF IV and V to UDF III were transactions with "affiliates," which rendered false UDF V's statement in its SEC filings that it wouldn't engage in affiliate transactions.

Intent. The Court also found there was sufficient evidence that Defendants intended to deprive investors of money or property. The Court agreed with Defendants that there is "no cognizable property interest in the ethereal right to accurate information." *Id.* at 346. However, the Government was not required to show that any investors actually lost money. The Court found sufficient evidence that Defendants "intended to conduct a scheme to deprive investors of their money," noting that (1) "they purposefully advertised a desired rate of return to brokers and continued to solicit investors to invest their money into UDF III despite knowing that UDF III did not have enough money to sustain its current investors" and (2) "they purposefully did not invest UDF IV and UDF V investors' money into the business or otherwise use the money to further fund developer's projects." Thus, a rational trier of fact could readily infer from this evidence that new investor money was the object of [Defendants'] operation because it was only after the money was transferred that they were able to pay distributions to UDF III investors." *Id.* at 345. The Court found that Defendants "exposed investors to risks and losses that, if publicly disclosed, would have decreased its value and investment power. That is enough to support a fraud conviction."

Jury Instructions. Defendants also argued that the Fifth Circuit Criminal Pattern Jury Instruction on "intent to defraud" used by the trial court was flawed because it did not require the jury to find

that Defendants intended to deprive investors of money or property. The jury instruction stated: a "'specific intent to defraud' means a conscious, knowing intent to deceive *or* cheat someone." *Id.* at 349 (quoting Fifth Circuit, Pattern Jury Instructions (Criminal Cases) § 2.57 (2019) (emphasis added)). The Court agreed that the "disjunctive 'or' makes it a misstatement of law" because the jury could find an intent to defraud without finding that Defendants intended to deprive another person of their property interests. *Id.* at 350. However, the Court found the erroneous instruction was harmless error.[9]

5. *Seybold v. Charter Communications Inc.*, 2023 WL 7381438 (5th Cir. 2023) (per curiam).

A Fifth Circuit panel of Judges Southwick, Engelhardt, and Wilson affirmed the judgment of the district court, holding that an ex-employee claiming he was terminated for reporting to his supervisors several instances of alleged securities and shareholder fraud failed to plausibly plead both his whistleblower claim and his breach of contract claim against his employer. Order at *1.

Darrell Seybold was employed by Charter Communications, Inc. (Charter) as a sales manager for eight years until he was terminated in February 2020. Charter's stated reason for the termination was Seybold's unprofessional conduct and communication, but Seybold contended that Charter fired him for reporting Charter's unlawful or unethical corporate behavior.

Seybold asserted that he made four reports to his supervisors via email regarding (1) Charter's policy of retagging circuits to make old Ethernet customers appear new, (2) a policy change to senior home accounts resulting in overreporting, (3) unattainable standards for sales personnel, and (4) miscalculation of sales commissions. According to Seybold, these acts constituted securities fraud and shareholder fraud by Charter.

Following his termination, Seybold pursued a Sarbanes-Oxley (SOX) complaint with the Occupational Safety and Health Administration (OSHA), but OSHA dismissed his complaint. Thereafter, Seybold filed suit against Charter alleging violations of the SOX whistleblower protections and breach of contract relating to unpaid commissions.

Charter filed a 12(b)(6) motion to dismiss Seybold's first amended complaint. The district court agreed with Charter and dismissed Seybold's SOX claim with prejudice, finding that the first amended complaint "provide[d] zero new, meaningful detail" and that Seybold failed to provide "specificity regarding the report's contents, Seybold's state of mind, and the causal link between the…report and Seybold's termination." Further, the district court denied Seybold leave to file a second amended complaint after he disregarded prior instructions regarding the errors in his initial complaint.

The district court granted a Rule 12(c) motion for judgment on the pleadings as to the breach of contract claim and dismissed that claim with prejudice, finding that Seybold's contract claim failed under Texas law due to a disclaimer in the Commission Plan explicitly stating that the plan was not a contract.

---

[9] Defendants also challenged the trial court's instruction on "scheme to defraud," which stated a "'scheme to defraud' means any plan, pattern, or course of action intended to deprive another of money or property *or* bring about some financial gain to the person engaged in the scheme." The Court declined to decide whether this instruction was erroneous because it found that even if it were, it was harmless error. *Id.* at 352.

Seybold timely appealed, arguing that the district court improperly dismissed his SOX claim under Rule 12(b)(6) and his breach of contract claim under Rule 12(c), and abused its discretion by denying him leave to amend his complaint under Rule 15(a).

The Court noted that like a Rule 12(b)(6) motion to dismiss for failure to state a claim, it reviews a Rule 12(c) dismissal on the pleadings *de novo*, "accepting all well-pleaded facts as true and viewing those facts in the light most favorable to the plaintiff." (citing *Bustos v. Martini Club Inc.*, 599 F.3d 458, 461 (5th Cir. 2010)). Further, the Court noted that whether to grant leave to amend a complaint under Rule 15(a) is within the discretion of the district court and can only be reversed on appeal where there is an abuse of discretion. (citing *U.S. ex rel. Willard v. Humana Health Plan of Tex., Inc.*, 336 F.3d 375, 387 (5th Cir. 2003)).

Failure to State a SOX Claim

Under SOX, an employee must prove by a preponderance of the evidence that: (1) the employee engaged in protected activity; (2) the employer knew that the employee engaged in the protected activity; (3) the employee suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action. (citing *Allen v. Admin. Rev. Bd.*, 514 F.3d 468, 475 (5th Cir. 2008)).

The "protected activity" forming the basis of Seybold's SOX claim against Charter was his filing of four reports with his supervisors via email. The district court identified errors in the complaint related to this "protected activity" that Seybold failed to cure in his first amended complaint, including whether Seybold knew he was engaging in protected activity at the time he emailed his supervisors; whether Charter knew Seybold was engaging in protected activity at the relevant time; and whether Seybold pled with sufficient particularity the content of the reports to determine whether they amounted to protected activity.

The Court agreed with the district court's ruling that Seybold's SOX claim failed as a matter of law. Order at *4. Seybold did not demonstrate that he engaged in protected activity or that Charter believed Seybold was engaging in protected activity. *Id.*

As to Seybold's first three reports, the pleadings lacked any concrete detail regarding what Seybold reported to his supervisors and whether he thought the reported conduct was illegal at the time. *Id.* at *3. Summarizing his actions as "reporting," "opposing," and "disputing" Charter policies without providing the detail requested by the district court was not sufficient to show Seybold had a reasonable belief that Charter's conduct violated securities laws. *Id.* The Court stated that physical copies of Seybold's email reports were not required, but Seybold needed to describe the contents of the emails with particularity to show that he was engaging in protected activity under SOX at the time he emailed them. *Id.* He failed to do so. And, although Seybold provided copies of emails related to his fourth report regarding unpaid commissions, they did not contain any allegations of wrongdoing and, at most, reflected a disagreement over a paycheck.

The Court determined that Seybold's vague allegations fell short of pleading requirements and did not bring his dispute within the scope of SOX's whistleblower protections. *Id.* at *4. Seybold's pleadings failed to show that he actually blew the whistle by alerting Charter of his belief that its actions were unlawful such that his SOX claim failed as a matter of law. *Id.*

The Court also held that the district court did not abuse its discretion in denying Seybold leave to file a second amended complaint where such an amendment likely would not have cured the fatal problems in Seybold's case. *Id.* at *5. Although the district court "explicitly pointed out each discrete issue with the original complaint, Seybold failed to cure any of his pleading deficiencies and ultimately ignored the district court's clear instructions." *Id.* The Court agreed with the district court's assessment that allowing Seybold a second chance to amend would have been futile.

Failure to State a Breach of Contract Claim

The "contract" underlying Seybold's breach of contract claim for unpaid commissions was the Commission Plan, which stated that "nothing in this Plan shall constitute a contract of employment or contract of any other kind" and that the sales participant "will remain at all times employed at the will of Charter." Seybold argued that under Texas law, an at-will employment relationship is still contractual in nature such that Charter was obligated to pay the agreed-upon commissions and could not claw back advanced commissions.

The Court disagreed with Seybold's characterization of the Commission Plan and found there was no valid contract due to the Commission Plan's explicit disclaimer. *Id.* at *4. The Court pointed out that the district court correctly noted other instances where courts have found such disclaimers binding and have prevented similar commission plans from forming the basis of a breach of contract claim. Further, Seybold failed to present any Fifth Circuit case in which the Court ignored a clear disclaimer like this one to allow a breach of contract claim to proceed. Accordingly, the Court found that the district court correctly dismissed Seybold's breach of contract claim. *Id.* at *5.

B. Federal District Courts

1. SEC Enforcement Actions

(a) ***SEC v. McKnight,*** **2023 WL 8000294 (N.D. Tex. Oct. 17, 2023) (Toliver, Mag. J.); and *SEC v. McKnight*, 2023 WL 8097078 (N.D. Tex. Nov. 21, 2023) (Lindsay, J.).**

Magistrate Judge Renee Toliver considered defendants' motion to dismiss the SEC's complaint against an investment promoter and a law firm, and she recommended the motion be denied. Recommendation at *1. Judge Sam Lindsay adopted the recommendation.

Factual and Procedural Background

The SEC filed a complaint against Aaron McKnight, his associates, and various entities under his control alleging that they defrauded investors out of millions through various fraudulent schemes, including a "high-yield investment trading program" scheme (the HYIP Scheme). The SEC also sued Frost & Miller, LLP (F&M), a two-person New York law firm, and Kenneth Miller, an attorney and principal at F&M (collectively, the F&M Defendants). The SEC alleged the F&M Defendants aided and abetted McKnight in the HYIP Scheme by (1) recklessly funneling over $2 million in investor funds through their law firm accounts directly to McKnight and (2) allowing the accounts to be used in furtherance of McKnight's fraudulent investment scheme.

More specifically, the complaint alleged:

- McKnight raised over $2 million from three investors for his fictitious HYIP trading program via an entity named Heaven's Way Investment Trust (HWIT). The HWIT investors executed written agreements with HWIT instructing them to deposit their investment money into an escrow account with F&M and promising certain returns on their investments. However, no investment profits were paid to the HWIT investors. Instead, McKnight used the money to make Ponzi-scheme payments and pay unrelated legal bills to F&M, among other things.

- The F&M Defendants accepted four wires totaling $2.045 million from HWIT investors into their firm accounts. They accepted a $200,000 deposit into F&M's operating account from HWIT Investor 1. Next, they accepted a $345,000 deposit into F&M's operating account from Investor 2, of which they transferred $140,000 back to HWIT Investor 1. This induced HWIT Investor 1 to make a subsequent $500,000 investment, which the F&M Defendants received in their operating account. Lastly, they received a $1 million deposit from HWIT Investor 3 into the firm's IOLTA account, from which they transferred $140,000 back to Investor 1. Almost immediately upon receipt of the investors' funds, the F&M Defendants transferred the money directly to McKnight and others, as McKnight instructed. The only exception was $76,000 McKnight directed the F&M Defendants to keep for themselves.

- Instead of performing any degree of diligence, Miller "blindly followed McKnight's instructions" thereby abdicating control over the firms' bank accounts to McKnight and knowingly or recklessly facilitating transactions that furthered McKnight's fraud.

- The F&M Defendants misappropriated investor funds when they retained $76,000 in HWIT Investors' funds at McKnight's direction.

- The F&M Defendants "ignored a myriad of red flags and recklessly followed McKnight's instructions to disburse over $2 million in investor funds, including to themselves, despite recognizing that the investors were taking comfort in the fact that they had sent their money to a law firm rather than to McKnight directly," which gave McKnight's scheme an air of legitimacy.

The SEC brought claims against the F&M Defendants for aiding and abetting McKnight's violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. The F&M Defendants moved to dismiss the SEC's complaint under Federal Rules of Civil Procedure 12(b)(6) and 9(b).

<u>Aiding and Abetting</u>

Under Section 20(e) of the Exchange Act, the SEC can bring an aiding-and-abetting action against "any person that knowingly or recklessly provides substantial assistance" to a primary violator of the securities laws. 15 U.S.C. §78t(e). The SEC must show that:

(1) the primary party committed a securities violation;

(2) the aider and abettor had "general awareness" of its role in the violation; and

(3) the aider and abettor knowingly or recklessly rendered "substantial assistance" in furtherance thereof.

S.E.C. v. Big Apple Consulting USA, Inc., 783 F.3d 786, 794 (11th Cir. 2015).

For purposes of their motion to dismiss, the F&M Defendants assumed the SEC adequately alleged that McKnight committed an underlying securities violation. However, they challenged the second and third elements, arguing that the complaint did not plausibly allege that they had knowledge of McKnight's violation or offered substantial assistance to further McKnight's scheme.

The SEC responded that the F&M Defendants' motion applied an incorrect standard that would require the SEC to allege that the F&M Defendants actually knew of the underlying violation and were effectively actively participating in the scheme. The SEC contended that under the correct recklessness standard, it more than adequately alleged sufficient facts to satisfy the second and third elements of aiding-and-abetting liability.

General Awareness

The F&M Defendants argued that the complaint relied on conclusory allegations and failed to establish their "general awareness" of their participation in an improper activity. Citing *Woodward v. Metro Bank*, the Court noted that the SEC must adequately allege the F&M Defendants had a "general awareness that [their] role was part of an overall activity that is improper." 522 F.2d 84, 95 (5th Cir. 1975).[10] Allegations regarding "red flags" or "suspicious events creating reasons for doubt" that should have alerted an aider and abettor to the improper conduct of the primary violator may show severe or extreme recklessness. *See S.E.C. v. Morris*, No. H-04-3096, 2005 WL 2000665, at *9 (S.D. Tex. Aug. 18, 2005).

The Court concluded that the SEC sufficiently pled facts demonstrating that the F&M Defendants had a "general awareness" that their role was part of an overall activity that was improper. Recommendation at *5.

The Court found that the complaint adequately alleged the F&M Defendants acted with at least extreme recklessness by ignoring numerous "red flags" and suspicious circumstances indicating that the transactions associated with the HYIP Scheme were not legitimate, including: (1) McKnight, a client with drug-related convictions and $150,000 in unpaid legal bills, suddenly informed Miller that investors would be wiring over $2 million to the firm's escrow account; (2) the F&M Defendants knew nothing about the investors or what they expected F&M to do with the funds; (3) the F&M Defendants knew they were handling investor funds unrelated to any underlying legal work; (4) the F&M Defendants did not review or possess the transaction documents related to the investments; and (5) the F&M Defendants knew McKnight preferred to involve law firms in his financial deals because he believed investors were more comfortable sending money to a reputable law firm.

Further, the Court pointed out that the complaint also alleged "red flags" related to the transactions themselves, including that: (1) none of the wire confirmations referred to McKnight or

[10] The Court noted that while the *Woodward* decision includes a now statutorily abrogated narrower view of scienter in aiding-and-abetting cases, its standard for "general awareness" remains good law. The Court also noted that both parties relied on *Woodward* for this standard.

otherwise indicated the funds belonged to him; (2) although the wire confirmations contained similar transaction codes starting with "HWIT," Miller did not know about or ask about HWIT; (3) F&M paid HWIT Investor 1 out of deposits made by HWIT Investors 2 and 3; and (4) at the instruction of McKnight, the F&M Defendants kept $76,000 of the HWIT Investors' funds as payment for his unrelated legal bills. In addition, the complaint alleged that by exercising basic due diligence, the F&M Defendants would have learned that they were facilitating Ponzi payments.

The Court found that the SEC's allegations were sufficient to satisfy the "general awareness" element for purposes of Rule 9(b) and Rule 12(b)(6).

Substantial Assistance

The F&M Defendants also argued that the complaint failed to adequately allege that they provided "substantial assistance" in McKnight's fraudulent scheme. The F&M Defendants contended the wire transfers from the HWIT investors "wound up" in F&M's operating account solely because of HWIT's and McKnight's fraudulent conduct and McKnight's lies about the funds, such that the F&M Defendants could not have rendered substantial assistance in furtherance of the unlawful scheme.

The Court noted that "the SEC must allege facts showing that Defendants' conduct was a substantial causal factor in the perpetration of the primary party's fraud" to satisfy the substantial assistance requirement. *S.E.C. v. Shapiro*, No. 4:05-CV-364, 2008 WL 819945, at *7 (E.D. Tex. March 25, 2008). The Court also referenced the finding in *Stack* that an attorney had "knowingly or recklessly provided substantial assistance" by, among other things, controlling accounts to which investors sent money, wiring investor funds to the primary violator, and misappropriating investor funds. *S.E.C. v. Stack*, No. 1:21-CV-00051-LY, 2021 WL 4777588, at *8 (W.D. Tex. Oct. 13, 2021).

The Court found the allegations were sufficient to support the SEC's claim that the F&M Defendants knowingly or recklessly provided substantial assistance to McKnight in committing the primary violation. Recommendation at *6.

Judge Sam Lindsay adopted the magistrate judge's findings and conclusions and denied defendants' motion to dismiss.

(b) *SEC v. Balina,* 2023 WL 8040767 (W.D. Tex. Nov. 20, 2023) (Hightower, Mag. J.).

Magistrate Judge Susan Hightower denied defendant's motion to exclude the testimony of the SEC's designated cryptocurrency expert witness, Dr. Shimon Kogan, finding that his opinions were sufficiently relevant and reliable.

The SEC alleged that defendant Ian Balina's distribution of a crypto asset security called SPRK Tokens through an investment pool was an unregistered offering of securities in violation of the Securities Act. The SEC designated Dr. Kogan to provide expert testimony on Balina's transactions on the Ethereum blockchain and on the background of initial coin offerings (ICO), cryptocurrency, and blockchain technology. The SEC contended that the testimony was necessary because Balina denied controlling the investment pool and claimed he was unable to interpret the publicly available

data on the blockchain about his transactions with the pool. Balina moved to exclude Dr. Kogan's opinions under Federal Rule of Evidence 702.

Legal Standards

Federal Rule of Evidence 702 provides that:

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

(a) The expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

(b) The testimony is based on sufficient facts or data;

(c) The testimony is the product of reliable principles and methods; and

(d) The expert has reliably applied the principles and methods to the facts of the case.

Citing *Kumho Tire Co. v. Carmichael*, the Court noted that the analysis under Rule 702 and *Daubert* applies to all proposed expert testimony, including scientific, technical, and other specialized knowledge. 526 U.S. 137, 141 (1999). In *Daubert*, the Supreme Court held that trial judges must ensure that scientific evidence is both relevant and reliable. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579, 589 (1993). Because the *Daubert* test focuses on the underlying theory on which the opinion is based, the proponent of expert testimony need not prove that the expert's testimony is correct, but that it is reliable. (citing *Moore v. Ashland Chem. Inc.*, 151 F.3d 269, 276 (5th Cir. 1998)). The proponent of expert testimony bears the burden of establishing reliability. (citing *Sims v. Kia Motors of Am., Inc.*, 839 F.3d 393, 400 (5th Cir. 2016)).

Under *Daubert*, trial courts apply four factors when considering the reliability of scientific evidence: (1) whether the technique can be or has been tested; (2) whether it has been subjected to peer review or publication; (3) whether there is a known or potential rate of error; and (4) whether the relevant scientific community generally accepts the technique. *Daubert*, 509 U.S. at 593-94. The test of reliability is flexible, and *Daubert's* list of factors "neither necessarily nor exclusively applies to all experts or in every case." *Id.* (citing *Kumho Tire*, 526 U.S. at 141). Trial judges are given broad discretion to determine whether *Daubert's* specific factors are reasonable measures of reliability in a particular case. *Id.* (citing *U.S. v. Simmons*, 470 F.3d 1115, 1123 (5th Cir. 2006)). The Court noted that when conducting a *Daubert* analysis, the trial court's main focus should be on determining whether the expert's opinion will assist the trier of fact. Further, the Court acknowledged that the "helpfulness threshold is low: it is principally…a matter of relevance." *Id.* (citing *E.E.O.C. v. Boh Bros. Const. Co.*, 731 F.3d 444, 459 n.14 (5th Cir. 2013)).

Analysis

A. First Opinion

Dr. Kogan's first opinion was that Balina controlled the smart contract used by the investment pool. Balina argued this the opinion should be excluded because it was not relevant or reliable. The Court found Dr. Kogan's opinion was relevant under *Daubert* because the SEC alleged Balina's distribution of SPRK Tokens through his investing pool was an unregistered offering of securities, and Dr. Kogan's planned testimony that Balina controlled the pool would help the trier of fact evaluate that claim. Order at *3.

The Court also found the methods used by Dr. Kogan to cross-check public information and information provided by the SEC were sufficiently reliable. The Court did not use the *Daubert* reliability factors in this instance. Citing *Kumho Tire*, the Court noted that the factors are meant to be helpful, not definitive. 526 U.S. at 151. Dr. Kogan checked the public pool data to confirm that administrative changes were marked as performed by Balina's Ethereum address. The Court determined that Kogan's methods were sufficiently reliable because Balina's Ethereum address was undisputed, and the record of transactions on the Ethereum blockchain enabled the analysis of past transactions with a high degree of confidence they actually occurred. *Id.* at *4.

Balina also argued that Dr. Kogan's opinion should be excluded because Kogan did not personally obtain the public blockchain data, did not create the tables summarizing the data, and received assistance from Integra, a forensic data analytics and litigation consulting firm. Federal Rule of Evidence 703 provides that "an expert may base an opinion on facts or data in the case that the expert has been made aware of or personally observed." Under Rule 703, "experts are not required to prepare all the documents that support an opinion as long as the information is of the type reasonably relied on by experts in his field." (citing *Imperial Trading Co. v. Travelers Prop. Cas. Co. of Am.*, No. 06-4262, 2009 WL 2408412, at *2 (E.D. La. July 28, 2009)). Dr. Kogan testified that his report was "a collaborative work" with Integra and that he reviewed and edited the entire report. The Court found that Integra's assistance did not render Kogan's opinions inadmissible.

Last, Balina argued that Dr. Kogan's first opinion did not rest on sufficient facts or data, but he failed to specify what facts were missing. The Court pointed out that if other facts contradict those identified by Kogan, then they affect the weight of Kogan's opinion rather than its admissibility and should be left for the jury to consider.

B. Second Opinion

Kogan's second opinion that Balina's control of the investment pool was consistent with documentary and blockchain evidence of his control was an extension of his first opinion. Therefore, the Court denied Balina's motion to exclude Kogan's second opinion.

C. Third Opinion

Balina moved to exclude Kogan's third opinion that Balina invested at least $104,883 in the investment pool and received a 30% bonus on his investment on the basis that the $104,883 figure was not in dispute. Balina also moved to exclude Kogan's opinion because Kogan's statement that he

could not rule out the possibility that Balina invested more money in the pool amounted to speculation. The Court found the SEC met its burden to show that Kogan's testimony regarding Balina's $104,883 investment was reliable.

The parties disagreed as to whether Kogan could opine that Balina may have invested more than $104,883 because five of the contributing Ethereum addresses were unidentifiable. Balina argued that Kogan provided no methodology for determining that the unidentified addresses could possibly be Balina's account. The SEC responded that Kogan offered no opinion as to who owned the five addresses and argued it was not inappropriate for an expert to note the facts uncovered by his investigation and explain the limitations of what he can say based on that evidence. The Court agreed with the SEC, noting that Kogan did not speculate as to who owns the five unidentified Ethereum addresses and that Kogan's third opinion resulted from his analysis of the blockchain evidence, including public Ethereum data and documents provided by the SEC.

D. Fourth Opinion

Balina moved to exclude Dr. Kogan's fourth opinion that promoters played a significant role in ICOs between 2016 and 2018 on the basis that it is an abstract opinion designed to confuse or prejudice the jury. Balina also asked the Court to exclude any testimony related to the "Background" section of Kogan's report, which included topics such as "Ethereum blockchain and ETH," "Ethereum Addresses and Wallets," and "Smart Contracts and ERC-20 Tokens." Balina argued that testimony regarding these terms and topics should be excluded because they are common in today's world and could be defined by agreement.

If Rule 702 is satisfied, experts may offer testimony on the background or "general principles" of their fields. The Court found the background information on terms and topics in Kogan's fourth opinion and the Background section of his report may be helpful to the jury.

For these reasons, the Court denied defendant Balina's motion to exclude the testimony of Dr. Kogan.

2. <u>Other Cases</u>

(a) *Galentine v. U.S. Bank, N.A.*, 2023 WL 6930729 (S.D. Tex. Oct. 19, 2023) (Lake, J.).

Judge Sim Lake granted Defendant U.S. Bank's motion for judgment on the pleadings in a declaratory judgment action brought by the plaintiffs, the Galentines, to prevent a foreclosure and quiet title on their home in Humble. The case is included in this newsletter because the plaintiffs alleged fraud claims.

According to their petition, which was removed to the district court, the Galentines fell behind on their mortgage in 2019 because of "personal hardship from their health issues and then subsequent loss of employment during the coronavirus pandemic." 2023 WL 6930729, at *1. The Galentines applied for loss mitigation in January 2022 but were offered only a deed in lieu of foreclosure. They were invited to reapply for loss mitigation if their circumstances changed and did so. Then a different agent told the Galentines that their application would not be considered because the loan was delinquent for more than three years. The Galentines asserted a common law fraud claim based on

allegations that by "telling Plaintiffs that they had an option of filling out a loss mitigation application, letting them fill one out, denying them any relief other than a deed in lieu of foreclosure … and then inviting Plaintiffs to re-apply…When Plaintiffs attempted to re-apply just months after being denied and invited to re-apply …Plaintiffs were told that Defendants would not offer any loss mitigation because the loan was 3 years delinquent." *Id.* at *2 (cleaned up).

In addressing the Galentines' common law fraud claim, Judge Lake narrowed the issue to a single point: detrimental reliance. Reading the Galentines' complaint liberally, the fraud claim identified two possible misrepresentations: first, that Plaintiffs had an option of filling out a loss mitigation application; and second, that Defendants invited Plaintiffs to reapply after denying their first application if Plaintiffs' circumstances had changed. The Court noted that the first misrepresentation did not allege a false statement, and as such, could not support a fraud claim. *Id.* at *4. The second statement at best implied that the Defendants would consider a second application but had no intention to do so. Assuming without deciding that the Galentines' allegations adequately alleged a false statement and reliance, the Court determined that the Galentines did not allege that their second application or new employment contributed to U.S. Bank's decision to foreclose. Because they failed to identify any injury caused by their reliance, their claim for common law fraud failed. *Id.*

(b) *Toth Enterps. II, P.A. v. Forage*, 2023 WL 8723199 (W.D. Tex. Dec. 18, 2023).

Judge Pitman granted in part and denied in part defendants' motion to dismiss RICO and fiduciary duty claims. Plaintiffs formed an LLC to provide medical lab services to rural hospitals and entered into a service agreement with another company. The defendant company, with the knowledge of the LLC's managers, allegedly underreported revenues, falsified reports, and failed to share monies as required by the service agreement. Plaintiffs then sued the LLC managers and the other company for RICO violations, fraud, conversion, and breach of fiduciary duty. Defendants moved to dismiss, and the district court held that Plaintiffs could pursue their RICO and breach of fiduciary duty claims against the LLC managers in their individual capacities but denied their right to proceed derivatively.[11]

With respect to the fiduciary duty claim, the Court first considered whether Plaintiffs could bring claims against the LLC managers if they only owed fiduciary duties to the LLC. The Court acknowledged that "Texas courts have generally held that fiduciary duties of a corporate director 'run to the corporation, not to the individual shareholders.'" *Id.* at *8 (quoting *Straehla v. AL Glob. Servs., LLC*, 619 S.W.3d 795, 805 (Tex. App.—San Antonio 2020, pet. denied)). However, the Texas LLC Act and the LLC-related provisions of the Texas Business Organizations Code do not directly address the fiduciary duties of members and managers of LLCs but suggest they exist because LLCs are expressly authorized to expand or restrict the fiduciary duties of managers and members. Noting that other courts had found relationships of trust between LLC managers and members and that Plaintiffs alleged (1) the managers ran the LLC's day-to-day operations, and (2) the LLC managers actively

[11] Plaintiffs did not move to dismiss the fraud claim.

worked to mislead the Plaintiffs, the Court refused to dismiss the fiduciary duty claims against the LLC managers.[12]

(c) *Ray v. Lynass*, 2023 WL 7238682 (W.D. Tex. Nov. 2, 2023) (Howell, Mag. J.).

Magistrate Judge Dustin Howell denied summary judgment on (1) plaintiffs' claims for fraud and breach of fiduciary duty, and (2) defendant's counterclaims for breach of fiduciary duty. The Court found fact issues precluded summary judgment on all these claims.

In 2015, defendant Patrick Lynass and plaintiff Michelle Ray formed AFS, a Texas-based company specializing in information management consulting. Lynass's contribution to AFS was seventeen years of sales and new business development experience. Ray and AFS terminated Lynass in November 2020, alleging that from the inception of AFS, Lynass "failed to close a single deal from any lead derived on his own" as director of sales. 2023 WL 7238682, at *1. After his termination, Lynass allegedly refused to return AFS property and misappropriated confidential information to thwart AFS client relationships. Based on these allegations, Ray and AFS asserted ten causes of action against Lynass, including breach of fiduciary duty and fraud. Lynass asserted counterclaims for breach of formal fiduciary duty, breach of informal fiduciary duty, breach of the company agreement, and for declaratory relief.

Breach of Fiduciary Duty. The AFS Company Agreement required Lynass "to act with integrity of the strictest kind, deal fairly and honestly with AFS, and to act in obedience to the best interests of AFS." *Id.* at *5. Based on the Company Agreement, plaintiffs alleged a breach of fiduciary duty for Lynass's duty not to compete with AFS by using confidential trade secrets and Lynass's coopting of AFS's domain name and account information. *Id.* Lynass argued that he owned the domain name at the pertinent times and transferred ownership of the domain name after the commencement of litigation, and therefore could not have breached his fiduciary duty by coopting it. The Court rejected Lynass's argument, finding that the summary judgment evidence presented a fact issue as to the ownership of the domain name because the AFS Company Agreement indicated that the domain name was part of Lynass's initial capital contribution and no subsequent amendments conclusively changed that contribution. *Id.* at *4-5. Lynass also argued that he could not be liable for breach of fiduciary duty because he was no longer a manager or officer of AFS at the time of the alleged coopting of the domain name. The Court rejected this argument, finding that the Company Agreement and Certificate of Formation created a fact issue as to the existence of a fiduciary duty between the parties. *Id.* at *6.

Fraud. The plaintiffs also asserted fraud claims against Lynass based on allegations that Lynass misrepresented his knowledge, skill, and experience with the intent to induce Ray to form AFS and make Lynass a manager. *Id.* at *8. Lynass argued these alleged misrepresentations were made outside of the statute of limitations, and Ray failed to plead the discovery rule under Texas law. The Court ruled Ray alleged sufficient facts to give notice that she might assert the discovery rule. *Id.*

[12] The Court did not state whether the LLC provisions sought to eliminate the liability of managers for breach of fiduciary duty. Since Texas does not allow LLCs to eliminate the fiduciary duty of loyalty and the Plaintiffs alleged the managers defrauded them, it is unlikely any restriction of duties in the LLC Agreement would have changed the outcome.

Fiduciary Duty Counterclaims. Lynass separately moved for summary judgment on his counterclaims of breach of formal fiduciary duty, breach of informal fiduciary duty, and related declaratory relief. *Id.* at *11. Lynass "derivatively on behalf of AFS" asserted a breach of fiduciary duty claim against Ray, arguing that Ray owed AFS a fiduciary duty, breached this duty by firing Lynass, failing to make distributions, and failing to respond to Lynass's demand for books and records of AFS. *Id.* AFS allegedly suffered injury in the form of loss of significant client accounts and attorney fees associated with the litigation. While the parties agreed that Ray owed AFS a fiduciary duty and that AFS lost a significant client account, the Court found fact issues that precluded summary judgment as to Ray's purported breach and whether the breach caused the damages Lynass alleged. *Id.*

Regarding Lynass's breach of informal fiduciary duty claim, the Court found that Lynass's summary judgment evidence fell short of proving the type of longstanding personal relationship that would support a finding of an informal fiduciary duty. Specifically, Lynass proffered a declaration that he and Ray had known each other for multiple years through professional conferences, and that he helped Ray get a job. *Id.* at *12. Lynass also claimed that after he and Ray formed AFS, he would stay at Ray's home in Austin, and when they traveled for AFS business, they would stay in one-room Airbnbs to save money. *Id.* The Court found that Ray's declarations related directly to the parties' relationship in forming AFS and their subsequent conduct, and that when the AFS-related conduct was stripped away, the only remaining statement was that Lynass and Ray knew each other for years and that he helped her get a job. Such evidence was insufficient to establish the type of relationship or any justified reliance on Ray to act in Lynass's best interest that would give rise to an informal fiduciary duty. *Id.* Because Lynass failed to meet his summary judgment burden for both of his fiduciary duty claims, the Court denied his related request for declaratory relief. *Id.* at 14.

C. State Court Cases

1. *Moayedi v. Arabghani*, 2023 WL 6977815, (Tex. App.—Houston [1st. Dist.] Oct. 24, 2023) (Hightower, J.).

The First Court of Appeals affirmed the trial court's rendered judgment in favor of plaintiff Massoud Moayedi for $2,000 in damages plus attorney's fees. Moayedi appealed, arguing that he should have been awarded additional damages based on additional causes of action of breach of fiduciary duty, conversion, and assault.

Factual Allegations. Behzad Arabghani wanted to open the Shiraz Café, a Mediterranean restaurant, and sought financing from Moayedi. Along with another partner who ultimately sold his interest to Moayedi, the gentlemen formed a closely held corporation called Shiraz Café, Inc. and agreed to a pro-rata monthly share of profits. Arabghani agreed to run the restaurant, while Moayedi agreed to provide approximately $100,000 in capital. Moayedi conditioned his investment upon his installment as treasurer of Shiraz Café, and pursuant to the company's bylaws, he retained the right to control the company's finances. Despite having drafted a resolution to open two business accounts with Wells Fargo, neither Moayedi nor Arabghani opened any business account for Shiraz Café. Instead, Arabghani deposited the $100,000 capital contribution into his own personal bank account and used those funds to build out the space rented for the restaurant. The build-out, equipment, and rent exceeded $100,000. Arabghani used the restaurant's meager income to pay operating expenses,

including employees' wages. Arabghani did not use any of the initial capital contribution for his own personal benefit.

Shiraz Café did not make enough money to cover its expenses and was locked out by its landlord for failure to pay rent. Moayedi asserted claims for breach of contract, breach of fiduciary duty, conversion, and assault against Arabghani and sought the following damages: (1) $100,000 for the initial capital contribution paid to Arabghani; (2) $2,000 for the balance of the personal loan; and (3) $6,185.44 for delinquent sales tax paid on behalf of Shiraz Café. He also sought $12,500 in attorney's fees. At the bench trial, Arabghani admitted that he did not allow Moayedi to control or access Shiraz Café's finances because Moayedi was a "thief." 2023 WL 6977815, at *3. Moayedi testified that he did not believe the build-out of the restaurant had cost $100,000, but he offered no evidence of costs or other expenses incurred to open or operate the restaurant. Moayedi also failed to offer evidence that Arabghani used the initial capital contribution for his own personal benefit or for anything other than opening and operation expenses associated with the restaurant. After the Shiraz Café opened, Moayedi gave Arabghani a personal loan of $5,000, of which Arabghani repaid only $3,000. There was further testimony regarding minor mishandling of Shiraz Café income, an actual slap in the face, and unpaid wages of restaurant staff.

Trial Court Ruling. The trial court ruled Moayedi could recover from the company delinquent sales tax paid on the company's behalf. However, from Arabghani, Moayedi could only recover $2,000 for the balance of his personal loan and $12,500 in attorney's fees. Regarding the $100,000 initial capital contribution, the trial court found no evidence that "those funds were used for anything other than the benefit and maintenance of the corporation and specifically the running of Shiraz Café" or that the funds were used for Arabghani's personal benefit. *Id.* at *4.

Appellate Court Ruling. On appeal, the First Court of Appeals held that the evidence was factually sufficient to support the trial court's take-nothing judgment on Moayedi's breach of contract and conversion claims. Specifically, Moayedi offered no evidence that the parties had agreed that Moayedi would recoup his initial capital contribution nor any evidence that Arabghani used the corporate funds for his own personal benefit. In fact, other evidence showed that Arabghani used the funds to open and operate the Shiraz Café. Similarly, the Court upheld the take-nothing judgment for Moayedi's breach of fiduciary duty claim. Moayedi pointed to the operating agreement to show a fiduciary relationship with Arabghani, and he argued that Arabghani breached his fiduciary duty by refusing to give Moayedi access to the corporation's records, taking possession of the capital contribution, and restaurant revenue, and placing those funds into accounts not accessible by Moayedi. Assuming for purposes of argument that a fiduciary relationship existed and was breached, the Court held that "Moayedi did not provide evidence proving that Arabghani used the money for his own personal benefit rather than for the benefit of Shiraz Café." *Id.* at *9. The testimony was consistent with other evidence showing that Arabghani prepared the restaurant for opening and operated it for several months. The Court noted Moayedi's reliance on *Flanary v. Mills*, 150 S.W. 3d 785, 793 (Tex. App.—Austin 2004, pet. denied), where a business partner had taken thousands of dollars from the company to pay for personal expenses, but found that "*Flanary* highlights the lack of evidence offered by Moayedi to prove that Arabghani used the corporation's funds for his personal benefit … and also supports our conclusion that the trial court's implied finding – that Arabghani's alleged breach of

fiduciary duty did not cause an injury to Moayedi or benefit Arabghani—was not against the great weight and preponderance of the evidence." *Id.*

N. Scott Fletcher
Kenneth P. Held

FLETCHER | HELD

Securities and Commercial Litigation, Internal Investigations, and Enforcement Defense

808 Travis Street, Suite 1553
Houston, TX 77002

(713) 255-0422

www.fletcherheld.com

Fletcher Held, PLLC quarterly newsletters are only intended to provide general information and should not be construed as legal advice on any specific facts or circumstances. Transmission of this publication is not intended to create an attorney-client relationship. This newsletter may not be quoted or referenced in other publications or proceedings without prior written consent of the Firm. The views expressed in this newsletter are the personal views of the authors and do not necessarily reflect those of the Firm or its clients.