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SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

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This quarterly newsletter summarizes recent federal and state court decisions 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:

- Supreme Court Whistleblower Decision – In *Murray v. UBS Securities, LLC*, the Supreme Court resolved a circuit split and ruled that under the whistleblower-protection provisions of the Sarbanes-Oxley Act a claimant does not have to show that his employer acted with retaliatory intent to state a claim for an unfavorable personnel action. Instead, a claimant need only show that his protected activity was a contributing factor in the employer's unfavorable personnel decision.

- Securities Fraud Cases – In the ongoing *Cabot Oil & Gas* securities fraud class action, Judge Rosenthal granted plaintiffs leave to amend their complaint to add allegations about the Company's 2019 production guidance as well as consent orders and felony charges the company faced. However, the Court denied plaintiffs leave to assert any claims based on the Company's 2018 production guidance because it was barred by the 5-year statute of repose. In other cases dealing with class certification issues, (a) Judge Rosenthal ruled in *Vertex* that a motion for appointment of lead counsel can be filed in a later-filed action provided (i) the motion is timely and (ii) the original court is notified of the filing; (b) Magistrate Judge Edison recommended narrowing the proposed class period in the soon-to-be-settled *Apache* litigation; and (c) Magistrate Judge Edison recommended separate subclasses for *McDermott* shareholders who acquired their shares directly and those who acquired shares through the merger with Chicago Bridge & Iron.

- Shareholder Derivative Cases – Two district court rulings this quarter showcase different approaches to dealing with shareholder derivative actions when a parallel securities fraud action has survived motions to dismiss. In a case against the board of Six Flags, Judge Pitman dismissed a derivative action after the board refused demand or the grounds that pursuing claims against the company's officers and directors would force the company to take inconsistent positions in parallel securities litigation and plaintiffs did not allege sufficient facts to challenge that business judgment. In the *Cabot Oil & Gas* derivative litigation, Judge Rosenthal dismissed the case for failure to plead demand futility because plaintiffs failed to allege particularized facts showing that at least half of the ten-member board could not impartially consider the shareholders' demand. The *Cabot* ruling highlights the potential evidentiary benefit for defendants when exculpatory documents are produced in response to a books and records demand.

- Enforcement Cases – In *SEC v. Novinger*, the Fifth Circuit declined on procedural grounds to consider a constitutional challenge to the SEC's policy prohibiting defendants from making public denials when they settle on a "neither admits nor denies" basis. The arguments that the SEC policy violates the First Amendment, Due Process Clause, and the Administrative Procedure Act are likely to be presented in future cases. In other cases, federal district courts denied a motion to dismiss claims arising from a pump-and-dump scheme (*Verges*), dismissed an indictment premised on the now-rejected "right to control" theory because it did not sufficient allege a scheme to defraud was intended to deprive victims of their property rights (*Constantinescu*), granted partial summary judgment for the SEC in an options trading scheme (*Jaitley*), and partially granted and partially denied summary judgment in an enforcement action relating to investments in life insurance policies (*Mueller*).

CASE SUMMARIES

I. FEDERAL CASES

A. United States Supreme Court and Fifth Circuit Decisions

1. *Murray v. UBS Secs., LLC*, 144 S. Ct. 445 (Feb. 8, 2024).

The Supreme Court unanimously held that a whistleblower bringing a claim under the whistleblower-protection provision of the Sarbanes-Oxley Act (§ 1514A) (SOXA) must prove that the protected activity was a contributing factor in the employer's unfavorable personnel action but need not also show the employer acted with retaliatory intent. *Id.* at 456. The Court reversed a Second Circuit decision requiring proof of retaliatory intent and resolved a circuit split on the issue.

Background

Murray, formerly a research strategist with UBS, alleged he was fired for informing his supervisor that leaders of the commercial mortgage-backed securities (CMBS) trading desk were pressuring him to skew his research reports in support of their business strategies. SEC regulations required Murray to certify that his research reports were produced independently and accurately reflected his own views. Murray reported the conduct, which he deemed unethical and illegal, to his direct supervisor on several occasions. Shortly after Murray reported that he was being left out of meetings and subjected to constant efforts to skew his research, his supervisor recommended that Murray be fired or transferred to a desk analyst position where he did not have SEC certification responsibilities. The CMBS trading desk declined Murray as a transfer, and UBS terminated him.

Murray filed a complaint with the Department of Labor, alleging that UBS fired him in violation of § 1514A of the SOXA. The agency did not issue a final decision within 180 days, so Murray filed a whistleblower action in federal court.

The trial court instructed the jury that Murray had to establish four elements to prove his §1514A claim:

(1) he engaged in whistleblowing activity protected by Sarbanes-Oxley;

(2) his employer knew he engaged in the protected activity;

(3) he suffered an adverse employment action; and

(4) his "protected activity was a contributing factor in the termination of his employment."

The District Court also instructed: "For a protected activity to be a contributing factor, it must have either alone or in combination with other factors tended to affect in any way UBS's decision to terminate [his] employment," and that Murray was "not required to prove that his protected activity was the primary motivating factor in his termination, or that…UBS's articulated reason for his termination was a pretext." Finally, the jury was instructed that if Murray proved each of the four elements by a preponderance of the evidence, the burden would shift to UBS to demonstrate by clear and convincing evidence that it would have fired Murray even if he had not engaged in the protected activity. When the jury asked for clarification of the contributing factor instruction during their deliberations, the District Court responded that the jury "should consider" whether "anyone with th[e] knowledge of [Murray's] protected activity, because of the protected activity, affect[ed] in any way the decision to terminate [Murray's] employment."

The jury found that Murray established his § 1514A claim and that UBS failed to prove that it would have fired Murray even if he had not engaged in protected activity. Following the trial, UBS moved for judgment as a matter of law, with one of its arguments being that Murray failed to produce any evidence that his supervisor had retaliatory animus toward Murray. The District Court denied the motion, and UBS appealed the decision.

The Second Circuit vacated the jury's verdict and remanded for a new trial. It concluded that proof of retaliatory intent was required to establish the contributing factor element of a § 1514A claim. In doing so, the Second Circuit put itself in direct conflict with the Fifth and Ninth Circuits, which had rejected this requirement for § 1514A claims. *See Haliburton, Inc. v. Administrative Review Bd.*, 771 F.3d 254, 263 (5th Cir. 2014) (per curiam); *Coppinger-Martin v. Solis*, 627 F.3d 745, 750 (9th Cir. 2010). The Supreme Court granted certiorari to resolve the circuit split.

Court's Analysis

Justice Sotomayor delivered the opinion of the Court and began by noting that Congress enacted the SOXA in response to the Enron scandal to prohibit publicly traded companies from retaliating against employees who report what they reasonably believe to be criminal fraud or violations of securities laws. SOXA states that employers may not "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of" protected whistleblowing activity. 18 U.S.C. § 1514A(a).

If an employer violates this provision, an employee may seek relief by filing a complaint with the Department of Labor. *Id.* at § 1514A(b)(1)(A). If the agency does not issue a final decision within 180 days, an employee may sue for damages or equitable relief in federal court. *Id.* at § 1514A(b)(1)(B). The potential remedies include reinstatement at the same seniority status, back pay with interest, and special damages, including litigation costs and expert and attorney fees. *Id.* at § 1514A(c)(2).

SOXA directs courts to apply the same burden-shifting framework found in the whistleblower protection provisions for employees who provide air safety information, 49 U.S.C. § 42121(b). The whistleblower bears the initial burden to show that his protected activity "was a contributing factor in

the unfavorable personnel action alleged in the complaint." *Id.* at § 42121(b)(2)(B)(i). The burden then shifts to the employer to show, by clear and convincing evidence, that it "would have taken the same unfavorable personnel action in the absence of" the protected activity. *Id.* at § 42121(b)(2)(B)(ii).

The specific question before the Court was whether the phrase "discriminate against an employee…because of" protected whistleblowing activity requires a whistleblower to also prove that his employer acted with "retaliatory intent." While the Court agreed with the Second Circuit's opinion that "retaliatory intent" is akin to animus or prejudice, it ruled the text of §1514A does not reference or include a "retaliatory intent" requirement, and the mandatory burden-shifting framework cannot be squared with such a requirement.

No Retaliatory Intent Requirement in the SOXA Provision

Both the Second Circuit and UBS relied heavily on the word "discriminate" in § 1514A to impose a "retaliatory intent" requirement. But the placement of the word "discriminate" in § 1514A(a)'s catchall provision suggests it is meant to capture other adverse employment actions not specifically listed there. The word draws meaning from the surrounding terms "discharge, demote, suspend, threaten, [and] harass," rather than giving them new meaning. Further, because there was no dispute that Murray was discharged, the Court questioned whether the "or in any other manner discriminate" clause was even relevant. The Court nevertheless considered whether "discriminate" inherently requires retaliatory intent. UBS argued that "discriminate" relates back to and characterizes "discharge" such that "to be actionable, discharge must be a 'manner' of discriminating."

Citing *Bostock v. Clayton County* for the proposition that "discriminate" typically means "[t]o make a difference in treatment or favor (of one as compared with others)," the Court found that an animus-like "retaliatory intent" requirement is absent from the definition of "discriminate." *Bostick v. Clayton County*, 590 U.S. 644, 657 (2020). Thus, when an employer treats someone worse "because of" the employee's protected whistleblowing activity, the employer violates § 1514A, whether the employer was motivated by retaliatory animus or, for example, by the notion that the employee may be happier in a position that did not come with SEC reporting requirements. The only intent required under § 1514A is the employer's intent to take some adverse employment action against the whistleblower "because of" the protected whistleblowing activity.

Retaliatory Intent Inconsistent with the Burden-Shifting Framework

The Court added that requiring proof of retaliatory intent would ignore the statute's mandatory burden-shifting framework, which provides a mechanism for getting at intent. And Congress decided that for § 1514A claims, the employee's burden is simply to show that the protected activity was a "contributing factor in the unfavorable personnel action." 2024 WL 478566 at *7. Once the employee meets that burden, the burden shifts to the employer to show, by clear and convincing evidence, that it would have taken the same unfavorable personnel action absent the protected activity. The Court noted that other statutes dealing with employment discrimination apply a higher bar, requiring the employee to show that the protected activity was a motivating or substantial factor in the adverse personnel action. The contributing-factor burden-shifting framework incorporated in SOXA is meant to be more lenient.

The Court declined to make "retaliatory intent" a requirement for satisfaction of the "contributing factor" element, explaining that evidence showing an employer acted with retaliatory

animus is simply one – but not the only – way to prove that the protected activity was a contributing factor in the adverse employment action.

The Court also rejected the argument that failure to require retaliatory intent could lead to innocent employers facing liability for legitimate, nonretaliatory personnel decisions. By way of example, UBS suggested that an employer could be liable for retaliation—despite a lack of intent to retaliate—where an employee's whistleblowing causes a client to end its relationship with the company, thereby eliminating the whistleblower's work and ultimately the company's need for his position. The Court opined that the statute's burden-shifting framework addresses this issue. The relevant inquiry is whether the employer still would have fired the employee if the client had left for some other reason. If so, the employer should have no trouble prevailing under the statute. Once again, the Court noted that the contributing-factor framework Congress chose for § 1514A claims is by design not as protective of employers as other statutes.

Justice Alito filed a concurring opinion, which Justice Barrett joined. Justice Alito wrote separately to reiterate that the Court's rejection of an "animus" requirement did not read intent out of the statute and that a plaintiff must still show intent to discriminate to be successful on a § 1514A claim. *Id.* at 456.

2. *SEC v. Novinger*, 96 F.4th 774 (5th Cir. Mar. 19, 2024).

When a defendant settles an SEC enforcement action and "neither admits nor denies" the allegations, the settlement agreement also typically includes a provision prohibiting the defendant from publicly denying the allegations. This is the Fifth Circuit's second time addressing this defendant's First Amendment challenge to the SEC's policy that prohibits settling defendants publicly denying the allegations. The Court found that it lacked jurisdiction.

In 2015, the SEC sued Christopher Novinger and his company (collectively, Novinger) for fraudulently offering and selling life settlement interests in violation of the securities laws. After the complaint was filed, the parties agreed to resolve the dispute. As part of "Agreed Final Judgments," the parties executed joint consent orders requiring Novinger to comply with the Commission's policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings." *Id.* at 1. The SEC policy states that settling defendants cannot:

> (i) Take any action or make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the impression that the complaint is without factual basis; [or]
>
> (ii) Make or permit to be made any public statement to the effect that Defendant does not admit the allegations of the complaint, or that this Consent contains no admission of the allegations, without also stating that defendant does not deny the allegations ….

If a defendant violates these provisions, the SEC can petition the Court to vacate a judgment and restore the underlying action to the active docket.

The final judgments against Novinger were entered in 2016, and they incorporated the joint consent provisions referenced above. Five years later, Novinger filed a Rule 60(b) motion to reopen the case and obtain relief from judgment. He alleged that the consent agreements were "gag orders"

that "violate[d] the First Amendment" and were derived from an SEC rule promulgated in violation of the Administrative Procedures Act, making the agreements void. *Id.* at 777. The district court denied the motion, and the Fifth Circuit affirmed in an earlier opinion. However, Judge Jones added a single-paragraph concurrence, joined by Judge Duncan, stating that the SEC's consent policy struck her as a brutally effective prior restraint. *Novinger I*, 40 F.4th at 308 (Jones, J., concurring).

Encouraged by the two-judge concurrence, Novinger filed a motion for declaratory relief under 18 U.S.C. § 2201 and Rule 57. He again asserted that the "gag order" operated as a prior restraint in violation of the First Amendment and added claims that it also violated the Due Process Clause and the Federal Rules of Civil Procedure. He once again claimed the "gag order" was beyond the scope of the SEC's powers.

The district court denied the motion, ruling that a motion for declaratory relief was not an appropriate pleading. It further found that despite its inherent authority to modify a decree, there was no change in the law or facts that suggested modification was needed.

Although neither party disputed the Fifth Circuit's jurisdiction, the Court *sua sponte* considered whether it had appellate jurisdiction to review the district court's denial of a procedurally improper motion. It concluded that it did not have jurisdiction because the district court's order was not a final decision disposing of Novinger's claim. And, while the district court ruling prevented Novinger from pursuing his claim through the wrong procedural vehicle, the district court remained capable of modifying the consent decree if a different motion were filed. *Id.* at 779.

In response to Novinger's argument that he was constrained by a "procedural straight jacket" after his Rule 60(b) motion failed, the Court rejected the request to make an exception for Novinger in this case. As the SEC pointed out, Novinger had an opportunity to seek relief under Rule 60(b) and failed; that does not entitle him to some other form of relief. The Court rejected Novinger's other procedural arguments as well.

3. *Talarico v. Johnson*, 2024 WL 939738 (5th Cir. Mar. 5, 2024) (not designated for publication).

In a short, per curiam opinion the Fifth Circuit affirmed the dismissal of securities fraud and breach of fiduciary duty claims brought against Ultra Petroleum Corporation and other defendants by a pro se plaintiff with 20 years' experience investing in the oil and gas sector. The Fifth Circuit affirmed for the reasons stated in the district court's 60-page opinion and the long-standing doctrine that investors who merely hold, but do not purchase or sell, securities lack standing to assert securities fraud claims.

Ultra was an exploration and development company that operated primarily in Wyoming. Ultra was not initially successful and filed for bankruptcy. After emerging from bankruptcy in 2017, Ultra shifted from vertical drilling to horizontal drilling of gas wells. In January 2018, it disclosed some positive results from three test wells and announced plans to drill additional horizontal wells. The additional wells were not successful and by August 2018, Ultra announced it was scaling back its horizontal well drilling. By March 2019, the company announced it would not drill any horizontal wells for the rest of the year. By September 2019, Ultra suspended all drilling operations due in part to low gas prices. By May 2020, Ultra filed again for bankruptcy protection.

Plaintiff purchased Ultra common stock and entered into several options contracts between March 2 and April 23, 2018. He claimed several misrepresentations were made to him *after those dates*. On December 4, 2019, he was allegedly told by Ultra's financial advisor that other investors viewed Ultra as having "significant equity value." On December 9, Ultra's CEO allegedly made additional representations to Plaintiff that were contradicted by later statements in the company's 2020 bankruptcy filing. Based on these alleged misrepresentations, Plaintiff brought claims against Ultra, its former employees, former chairman, minority owners, and financial advisor for (a) securities fraud; (b) common law fraud; and (c) breach of fiduciary duty.

The Court rejected Plaintiff's securities fraud claim because he was a "holder" of securities rather than a "purchaser" or "seller." Under long-standing precedents, holders of securities do not have actionable claims for securities fraud because Section 10 of the 1934 Act is limited to claims arising from the purchase or sale of securities. *Id.* at *3 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) and other cases). The Court noted that the holder doctrine applied to both Plaintiff's common stock and his option contracts, and it rejected his arguments that dicta in *Blue Chip Stamps* suggested a different result. The Court also affirmed the district court's other rulings, noting that Plaintiff had not made convincing arguments to overturn the well-reasoned, 60-page opinion.

B. District Courts

1. Securities Fraud Actions

(a) *Delaware Cty. Employees Ret. Sys. v. Cabot Oil & Gas Corp.*, 2024 WL 83503 (S.D. Tex. Jan. 8, 2024) (Rosenthal, J.).

In this long-running securities fraud lawsuit, the court previously denied motions to dismiss and certified a class of purchasers for the period February 22, 2016 to June 12, 2020.[1] The original and first amended complaints alleged that defendants misrepresented the extent to which the company was complying with environmental laws and regulations and remediating defective wells and contaminated waters. The plaintiffs sought leave to file a second amended complaint that added allegations about the Company's 2018 and 2019 production guidance, and the consent orders and felony charges the company faced. The Court granted the plaintiffs' motion with one exception, denying leave to assert any claims based on the Company's 2018 production guidance because it was barred by the 5-year statute of repose.

Plaintiffs sought leave to file a second amended complaint asserting the following additional misrepresentations and omissions:

- Defendants publicly announced production guidance in 2018 and 2019 they knew they could not meet;

[1] For general factual background, see pages 16-21 of this newsletter discussing a companion shareholder derivative action filed against Cabot's officers and directors. For details about prior rulings in the Cabot securities litigation, see FH 1Q22 Newsletter, at 13-15 (securities litigation – motion to dismiss); FH 3Q22 Newsletter, at 6-8 (securities litigation – motion to dismiss amended complaint); and FH 3Q23 Newsletter, at 7-11 (securities litigation – class certification).

- Defendants knowingly failed to disclose that the company had reduced its 2018 production guidance because of a gas migration investigation by the Pennsylvania Department of Energy (Pennsylvania DOE);

- Defendants knowingly failed to disclose the company would soon be charged with felonies by the Pennsylvania Attorney General; and

- Defendants knowingly failed to disclose a proposed consent decree it had received from the Pennsylvania DOE.

The defendants argued that leave should be denied on three grounds: (1) the production guidance statements were protected by the safe harbor for forward-looking statements; (2) the 2018 production guidance claims were time-barred; and (3) the second amended complaint failed to satisfy the PSLRA's heightened pleading standards.

The Court rejected the safe harbor argument for two reasons. First, the pleading contained numerous allegations supporting scienter – *i.e.*, that Cabot's officers knew when the statements were made the company would not be able to meet the production guidance numbers. *Id.* at 10 & 12 (discussing repeated warnings defendants received from Cabot managers). Second, the production guidance statements were not accompanied by "meaningful cautionary language" but just "a boilerplate litany of generally applicable risk factors." *Id.* at 12 (quoting *Southland Sec. Corp. v. INSpire Ins. Sols., Inc.*, 365 F.3d 353, 372 (5th Cir. 2004)). The same disclaimers appeared in each press release and were not "tailored to Cabot's circumstances at the particular time." *Id.*

The Court agreed that the 2018 production guidance statements were made more than five years before the motion for leave to amend was filed. Applying the 5-year statute of repose in 28 U.S.C. § 1658(b), the Court ruled any claims relating to those purported misstatements or omissions were time barred. *Id.* at *13. The Court rejected plaintiffs' argument that the amendment "relates back" to the original complaint. Although the prior complaints alleged that "environmental compliance issues were reasonably likely to, and would, adversely impact Cabot's ability to achieve its financial and operational projections," they did not allege that Cabot's 2018 production guidance was a material misrepresentation, nor did they allege the facts that are the basis for that theory. *Id.* at *15.

Finally, with respect to the alleged omissions regarding proposed consent orders and felony charges, the Court ruled that while Cabot disclosed some of the proposed consent orders, it did not disclose them all. "[O]nce the defendants addressed the proposed consent orders and agreements, they were obligated to do so accurately." *Id.* at 17. As to disclosure of the criminal charges filed against the Company by the Pennsylvania Attorney General, the Court ruled they were not "ordinary routine litigation incidental to the business" and therefore, were subject to more detailed federal disclosure requirements, which Cabot did not meet. *Id.* at *17.

(b) *Bender v. Vertex Energy,* Inc., 2024 WL 459081 (S.D. Tex Feb. 6, 2024) (Rosenthal, J.).

In this consolidated securities fraud class action, Judge Rosenthal decided a number of novel issues regarding appointment of lead counsel and lead plaintiff under the PSLRA.

The litigation began with two cases filed in Alabama and a third case filed in Texas. The Alabama plaintiffs filed and published notice of the proposed class action, starting the 60-day clock for lead plaintiff motions to be filed.[2] The Texas plaintiffs filed their motion to be appointed lead counsel/plaintiff by the deadline, but they filed it in the Texas court rather than the Alabama court where the first action was filed. The Texas plaintiffs later filed a document in the Alabama cases notifying the court and parties that they had filed a lead plaintiff motion in the Texas case. The Alabama cases were later transferred to and consolidated with the Texas case.

The Alabama plaintiffs argued the Texas plaintiffs' motion to be appointed lead counsel was untimely because it was not filed by the deadline in the first-filed action in Alabama. Judge Rosenthal disagreed, holding that courts can consider "motions for appointment as lead plaintiff filed in actions other than the first filed action, particularly where, as here, the actions have been consolidated, the motion was filed within 60 days of the notice, and the movant filed a notice of the motion in the first filed action." Moreover, the Court ruled that even if the motion filed in the Texas case was improperly filed, "the timing of [the Texas plaintiffs'] motions in the Alabama actions is excusable. [They] filed a notice 12 days after the deadline for motions for appointment, requesting the Southern District of Alabama to 'consider' their motion for appointment filed with [the Texas] court." The Court also noted that allowing consideration of the Texas plaintiffs' motion would further the goals of the PSLRA because they had the largest financial stake in the outcome of the case, which made them the presumptively most adequate plaintiff under the PSLRA. *See* 15 U.S.C.§ 78u-4(a)(3)(B)(iii)(I)(bb). Finally, the Court found the Texas plaintiffs' counsel were adequate representatives and appointed them lead counsel.

(c) *In re Apache Corp. Secs. Litig.*, 2024 WL 532315 (S.D. Tex. Feb. 9, 2024) (Edison, M.J.).

In this securities litigation arising out of alleged misrepresentations about Apache Corporation's Alpine High play,[3] Magistrate Judge Andrew Edison issued a Memorandum and Recommendation (M&R) on plaintiff's motion for class certification. While Plaintiffs sought to certify a three and one-half year class period ending on March 13, 2020, the M&R recommended a one and one-half year class period from September 7, 2016 to February 22, 2018. The Court did so because defendants demonstrated there was no front-end or back-end price impact attributable to 15 alleged misrepresentations made after February 22, 2018. Plaintiffs objected to the Court's M&R, but before the district court ruled on the objections, the parties announced they had agreed to settle the matter.

The M&R provides a useful roadmap of the legal standards to certify a securities class action, beginning with Rule 23's prerequisites (numerosity, commonality, typicality, and adequacy) and the court's obligation to undertake a "rigorous analysis" of the claims, defenses, relevant facts, and law. *Id.* at *2-4. It also provides a good summary of (a) the presumption of reliance under *Affiliated Ute* and *Basic*; and (b) how defendants can rebut the *Basic* presumption with evidence that the alleged misrepresentations had no price impact as explained in the U.S. Supreme Court's *Goldman* decision. *Id.*

[2] The PSLRA requires the plaintiff in the first-filed case to file a notice of the action within 20 days of filing suit, and it imposes a 60-day deadline from publication of that notice to file motions to be appointed lead plaintiff. 15 U.S.C. § 78u-4(a)(3)(A).

[3] For discussion of the factual allegations, see FH Newsletter 3Q22 at 8-11.

As noted above, plaintiffs sought to certify a lengthy class period from September 7, 2016 to March 13, 2020. Defendants conceded that classwide issues predominate and a presumption of reliance was appropriate for the period September 7, 2016 to February 22, 2018, but they challenged the presumption of reliance during the later period of February 23, 2018 to March 13, 2020. (the "Focus Period"). Defendants argued (1) there was no front-end price impact attributable to the 15 alleged misrepresentations during the Focus Period; (2) there was no back-end price impact attribute to the three corrective disclosures made in that period; and (3) the market's perception of Alpine High's oil and gas prospects was unchanged during the Focus Period further supporting defendants' position.

No Front-End Price Impact

Both party's experts found no statistically significant increase in price on 12 of the 13 trading days after the 15 alleged misrepresentations during the Focus Period, and the one trading day with a significant increase was attributable to an unrelated issue. Plaintiffs then argued that since defendants conceded there was *some* price impact from misrepresentations made between September 7, 2016 and February 22, 2018, defendants had the burden to show this earlier impact was entirely dissipated before they could argue that later misrepresentations had no price impact. Judge Edison disagreed.

Describing plaintiffs' argument as "extraordinary" and one that would render the Supreme Court's opinion in *Goldman* meaningless, the M&R noted that in securities fraud class actions, "a class period ends when the truth has been disseminated to the market." *Id.* at *7 (quoting *Carpenters Pension Tr. Fund of St. Louis v. Barclays PLC*, 310 F.R.D. 69, 97 (S.D.N.Y. 2015)). Defendants are not required to affirmatively demonstrate total dissipation of the price impact of earlier misrepresentations before they can challenge the price impact of later misrepresentations. *Id.* The standard clearly stated in *Basic* is that "any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." *Id.* (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 248 (1988)).

No Back-End Price Impact from Corrective Disclosures

The M&R then reviewed three allegedly corrective disclosures made during the Focus Period to see if price impact for the earlier misrepresentations could be inferred. Defendants argued there was no statistically significant impact from the corrective disclosures or there was a mismatch because the disclosures were attributable to something other than the alleged misrepresentations.

- March 16, 2020 *Seeking Alpha* Post – plaintiffs claimed this article was a corrective disclosure, but defendants argued that it did not report anything that was not disclosed earlier in February 2020. Judge Edison agreed, noting "the market had known for weeks that these statements were false because Apache had already taken a $3 billion write down and ceased all exploration and funding of Alpine High." *Id.* at *9.

- October 25, 2019 Keenan Resignation – while experts found a statistically significant drop in Apache's stock price after this announcement, defendants argued it was unrelated to Alpine High. They noted that analysts were concerned the resignation related to Apache's Suriname exploration activities and did not change their reserve estimates for Alpine High after Keenan resigned. Judge Edison agreed and found that defendants had presented compelling evidence that the market reacted "for a reason wholly unrelated to Alpine High." *Id.* at *10.

- April 23, 2019 Press Release – plaintiffs claimed the Company's announcement that it was temporarily deferring production at Alpine High caused the stock to decline 11% over four days. Defendants countered that the decline was not statistically significant, and the deferral related to declining prices at the local gas hub. The M&R discusses this issue in some depth but ultimately applies a commonsense judgment that investors expected the temporary deferral and any decline in price was due to gas prices generally, not Alpine High specifically.

In sum, because no front-end price impact or back-end price impact was shown, the M&R recommended narrowing the class period to 1 ½ years from the original proposed 3 ½ years.

(d) *Edwards v. McDermott Int'l, Inc.*, 2024 WL 873054 (S.D. Tex. Feb. 29, 2024) (M&R) (Edison, M.J.) and 2024 WL 1256293 (S.D. Tex. Mar. 25, 2024) (adopting M&R) (Edison, M.J.).

In this long-running securities fraud action, Judge Andrew Edison issued a Memorandum & Recommendation (M&R) denying plaintiff's motion to certify a single class of purchasers of McDermott common stock. After addressing various arguments concerning plaintiff's standing and adequacy to be class representative, Judge Edison reasoned that there was a fundamental conflict between potential class members who acquired McDermott stock as a result of the merger with Chicago Bridge & Iron (CB&I) and those who owned McDermott stock before the merger. Accordingly, he recommended the district court deny certification of a single class of purchasers but grant a future motion to certify two subclasses. He also recommended narrowing the class period and rejecting plaintiff's arguments about certain "corrective disclosures" that did not match any of the alleged misrepresentations. After making slight modifications to clarify the subclass definitions, Judge Hanks adopted the M&R as the opinion of the Court.[4]

The M&R provides a useful roadmap of the legal standards to certify a securities class action, beginning with Rule 23's prerequisites (numerosity, commonality, typicality, and adequacy) and the court's obligation to undertake a "rigorous analysis" of the claims, defenses, relevant facts, and law. *Id.* at *3-*4. It provides a good summary of several securities-related issues such as (a) the "forced seller" doctrine; (b) the presumption of reliance under *Affiliated Ute* and *Basic*; and (c) how defendants can rebut the *Basic* presumption with evidence that the alleged misrepresentations had no price impact as explained in the U.S. Supreme Court's *Goldman* decision. *Id.* at *4-*6.

Factual Background[5]

In this §10(b) class action against McDermott and its former officers, plaintiff alleged that defendants made misrepresentations before and after the 2018 merger of McDermott and CB&I. The alleged misrepresentations related to (1) the value of four, large challenging CB&I projects known as the "Focus Projects," (2) the importance of CB&I's Lummus technology business; and (3) the strength and financial health of McDermott after its merger with CB&I. According to the §10(b) complaint, the CB&I assets were significantly inflated because of undisclosed losses on the Focus Projects.

[4] Unless otherwise noted, all citations are to the M&R.

[5] For additional details, see FH Newsletter 1Q21, at 8-12 (describing denial of motions to dismiss two separate class actions alleging violations of §14(a) and §10(b)); FH Newsletter 4Q21, at 6 (describing recommendation to allow supplemental complaint but not additional class representative in §10(b) action); FH Newsletter 3Q22, at 11-12 (describing recommendation on motion to expand the class period for the §10(b) action).

McDermott allegedly knew the CB&I assets were overly inflated and that it needed to sell the Lummus business to maintain adequate cashflow but hid this information from shareholders.

Pontiac General Employees' Retirement System was appointed lead plaintiff in June 2019. Pontiac claimed it spent $517,825 to "purchase" 25,052 shares of McDermott stock during the proposed class period. *Id.* at *2. After defendants' motions to dismiss the §10(b) claims were denied, Pontiac moved for class certification, appointment of class counsel, and appointment of itself as class representative. During the course of discovery on the class certification motion, the parties learned that Pontiac had not actually purchased any McDermott shares; rather, it acquired its interest in McDermott through conversion of CB&I shares into McDermott shares at the time of the merger.

Standing and Adequacy of Proposed Class Representative

Defendants challenged class certification by arguing Pontiac lacked standing to sue and was not an adequate representative of the proposed single class. Defendants argued that CB&I shareholders like Pontiac were not damaged but received a benefit when they exchanged CB&I shares for McDermott shares in the merger. Specifically, Pontiac received a benefit because (1) CB&I shares were significantly inflated at that time of the merger, and (2) CB&I would have gone bankrupt without the merger. Defendants argued that Pontiac lacked standing to bring securities fraud claims because it had no damages and that Pontiac was not an adequate class representative because it was subject to an affirmative defense (no damages) that did not apply to other members of the proposed class.

The M&R addressed defendants' standing and adequacy arguments. As to standing, it stated: "Defendants assume that CB&I's stock was inflated and McDermott's stock was not inflated at all. If true, Plaintiff (and all other CB&I shareholders) would have only benefitted from the exchange of their shares and would not have suffered any economic injury. But—and this is a big 'but'—this argument is based on nothing more than the conclusory assertion of Defendant's expert …." *Id.* at *8. The Court refused to "knock out an entire group of plaintiffs" based on this conclusory assertion, particularly when plaintiff's expert rebutted the defense expert by noting that the stock prices of CB&I and McDermott "traded in lockstep." *Id.* at *9.

As to adequacy, the Court reviewed cases cited by the parties, including *In re Vivendi Universal, S.A. Secs. Litig.*, 242 F.R.D. 76 (S.D.N.Y. 2007), *aff'd sub nom. In re Vivendi, S.A. Secs. Litig.*, 838 F.3d 223 (2d Cir. 2016), but found them distinguishable. While rejecting the arguments raised by the parties, the Court nevertheless concluded that Pontiac had a fundamental conflict:

> It is too early to say whether former CB&I shareholders derived a net economic benefit from the alleged fraud…. If CB&I's stock was less inflated than McDermott's stock, then former C&I shareholders may prove an economic injury. This possibility is why Plaintiff has standing. But it is also *possible* that CB&I's stock was more inflated than McDermott's stock, and that former CB&I shareholders derived a net economic benefit from exchanging their shares. *This* possibility represents a fundamental conflict. This is not a "merely speculative or hypothetical" conflict. Plaintiff's own expert has already conceded that 'Defendants' alleged misstatements and omissions were clearly incorporated in CB&I's … stock price prior to the Merger."

Id. at *12 (cleaned up). The Court concluded: "It is fundamentally unfair for absent class members who never held CB&I shares to be represented by Plaintiff and its counsel, who may yet expend considerable time – as they did during the class certification hearing – on this issue." *Id.*

Reliance and Price Impact

An issue in almost every securities class action is the intersection between Rule 23(b)(3)'s predominance requirement and §10(b)'s reliance requirement. *Id.* at *4. In securities class actions alleging public misrepresentations, plaintiffs often invoke the *Basic* presumption of reliance. *Id.* at *5. The presumption can be rebutted if defendants prove by a preponderance of the evidence that an alleged misrepresentation did not affect the market price of the stock. *Id.* at *6. The court's task is to assess the evidence of price impact – direct and indirect – and determine whether it is more likely than not that the alleged misrepresentations had a price impact. *Id.*

When plaintiff's theory is that the stock price was artificially inflated by misrepresentations, this artificial inflation (front-end price impact) may be inferred when the stock price later falls (back-end price impact) after a corrective disclosure matching the earlier misrepresentation. *Id.* The alleged misrepresentation and the corrective disclosure need not mirror each other, but they should be related or relevant to each other. When there is a "mismatch" between the alleged misrepresentation and the corrective disclosure (e.g., when a misrepresentation is generic and a corrective disclosure is specific), then any inference of price impact is weaker. *Id.*

Applying these principles, plaintiffs proposed a three-year class period from December 18, 2017 to January 23, 2020, and alleged that defendants made eight corrective disclosures during that time. *Id.* at *17. Defendants argued there was a mismatch between the last five corrective disclosures and the alleged misrepresentations, thereby defeating evidence of price impact and rebutting any presumption of reliance. The M&R reviewed the parties' arguments on these points as well as each of the corrective disclosures.

First, the M&R rejected plaintiff's argument that price impact arguments require expert testimony or evidence from an economist. It noted that plaintiff did not cite any cases for this point and did not attempt to articulate the link between the alleged misstatements and corrective disclosures in its reply brief. It further noted that the U.S. Supreme Court in *Goldman* instructed courts to use their "common sense" in evaluating price impact.

Second, the M&R evaluated the last five corrective disclosures and concluded that three of them (September 24 and September 27, 2019, and January 21, 2020) did not reveal any new information regarding the alleged misrepresentations. *Id.* at *18-21. Defendants thus rebutted the evidence of price impact, and the M&R narrowed the class period to slightly less than three years, from December 18, 2017 to November 5, 2019.

After reviewing the parties' objections to the M&R, the district court revised the wording of the subclass definitions to make clear that (1) the CBI Subclass is only for those who converted CB&I stock into McDermott stock as part of the merger, and (2) the MDR Subclass is only for those who purchased or otherwise acquired McDermott stock. March 25, 2024 Opinion, at *1. "Class members who both converted CB&I stock into McDermott stock *and* purchased McDermott stock will hold claims in both subclasses." *Id.* at 2. It otherwise adopted the M&R as the opinion of the Court. *Id.* at 1.

2. Shareholder Derivative/Fiduciary Duty Action

(a) *Cruz v. Reid-Anderson*, 2024 WL 150443 (N.D. Tex. Jan. 12, 2024) (Pittman, J.).

In this recently filed shareholder derivative litigation filed on behalf of Six Flags Entertainment Corp.,[6] the district court upheld the board's refusal to pursue derivative claims against the Company's former officers and directors as a proper exercise of its business judgment. For the past several years, Six Flags and its former officers have been litigating securities fraud class action claims arising from the Company's attempted expansion into China.[7] In February 2023, a shareholder demanded that the board obtain tolling agreements and pursue breach of fiduciary duty claims against the company's former officers and directors based on the same facts alleged in a parallel securities fraud class action. The board obtained tolling agreements but refused to conduct an investigation or pursue any claims because, even assuming the derivative claims had merit, pursuing them would force the company to take inconsistent positions in the securities litigation. When the plaintiff filed suit claiming his demand was wrongfully refused, the district court dismissed the action with prejudice because plaintiff failed to allege with particularity any basis to challenge the board's business judgment.

Factual Background

Shortly after Six Flags was sued for securities fraud, shareholder Antonio de la Cruz sent a request to inspect the Company's books and records. In response to his request, the Company sent him certain documents and Cruz took no further action. Two years later, after the district court dismissed the securities case but the Fifth Circuit revived it, Cruz sent a demand letter to the Six Flags Board. His letter dated February 1, 2023, demanded that the Six Flags Board (1) file claims against former officers and directors for breach of fiduciary duty based on the allegations in the securities action; (2) obtain tolling agreements from former officers and directors before February 20, 2023; and (3) respond to the demand letter within six days. The Company's Chief Legal Officer responded promptly stating that the Company was endeavoring to obtain tolling agreements and the Board would consider the demand at its next scheduled meeting in March. Instead of waiting for the Board's response, Cruz filed a derivative action on February 21, 2023 claiming that his demand was constructively refused.

The Six Flags Board met on March 8 to consider Cruz's demand. Skadden – which served as Company counsel and also represented certain officers in the securities action – was present at the Board meeting. Skadden advised the Board about the demand letter and its potential impact on the securities action. Skadden did not weigh in on the facts but assumed, for purposes of its advice, that the allegations in the demand were meritorious and that the Board decided to pursue claims against the Company's former officers and directors. Based on these assumptions, Skadden advised that it would force the Company to take inconsistent positions in the securities action. For this and other reasons not tied to the merits of the demand, the Six Flags Board decided it was not in the Company's best interests to pursue the claims. It sent a letter to Mr. Cruz on March 10 refusing the demand and

[6] An earlier derivative action was dismissed for failure to plead demand futility. *See* FH 2Q21 Newsletter, at 14-16 (dismissing derivative action for failure to plead demand futility).

[7] *See* FH 1Q21 Newsletter, at 7-9 (district court dismissal of securities fraud class action complaint); FH 1Q23 Newsletter, at 2-6 (5th Circuit reversing district court dismissal of securities fraud class action complaint).

setting forth its reasons. Cruz then amended his derivative action to claim actual wrongful refusal of his demand (rather than just constructive refusal).

Defendants moved to dismiss the demand-refused case on several grounds, including a standing argument under Rule 23.1. As the Court explained: "Delaware law requires an aggrieved shareholder to demand that the board take the desired action or show that such a demand would be futile." *Id.* at *3 (quoting *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990)). Pre-suit demand gives the board an opportunity to address shareholder concerns without litigation and decide what is in the best interests of the corporation and all its shareholders. *Id.* (citing *Spiegel*, 571 A.2d at 773). If a shareholder demand is rejected, the board is entitled to the presumption that it acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company. *Id.* (citing *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996), *abrogated on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)). A shareholder may challenge the presumption by alleging facts with particularity that create a reasonable doubt that the board is entitled to the presumption, but the only issues to be examined are the good faith and reasonableness of the board's investigation. *Id.* (citing *Grimes*, 673 A.2d at 1219, and *Spiegel*, 571 A.2d at 777).

Plaintiff argued that the Board acted unreasonably and in bad faith because it was advised by conflicted counsel. Plaintiff claimed Skadden could not impartially advise the Six Flags Board how to respond to the demand since Skadden also represented two defendants in the securities action. In support, plaintiff cited *Stepak v. Anderson*, 20 F.3d 398 (11th Cir. 1994), a case in which Troutman Sanders advised a board on a litigation demand while it represented the company's officers and directors in several criminal investigations arising from the same facts. Troutman Sanders orchestrated an investigation of the demand allegations; gave factual presentations to the board about the demand allegations; advised the board how to respond to the demand; remained in the room during the board's deliberations; and otherwise acted as the company's general counsel since it had no in-house lawyers. *Id.* at *4. On those facts, the 11th Circuit held that Troutman Sanders (1) had a conflict of interest by representing both the company and the individual directors; and (2) dominated the investigation and consideration of the litigation demand presented to the board. *Id.* (citing *Stepak*, 20 F.3d at 408.

The *Cruz* court rejected the plaintiff's argument that Skadden had a conflict of interest and distinguished *Stepak*. Unlike Troutman Sanders, Skadden did not "lead an investigation into the merits of the [demand] allegations." *Id.* at *4. Skadden "did not furnish the Board with voluminous factual and legal analyses responsive to the demand." *Id.*, at *5. Skadden simply assumed the allegations were meritorious and then advised the Six Flags Board on several considerations, including "whether pursuing the claims would force the company to take a position inconsistent with its position in the Securities Action." *Id.* at *4. Because Skadden did not investigate the merits of the demand allegations, it did not face the same issues of divided loyalty and confidentiality that Troutman Sanders faced in *Stepak*. In addition, the interests of Six Flags and its officers were aligned in the civil securities action. Since the allegations in the demand letter were the same as in the securities action, there was no reason for any conflicts to exist. And, unlike Troutman Sanders, Skadden was not separately representing individuals in criminal proceedings at the time it advised the Six Flags board.

The *Cruz* court also rejected the suggestion that Skadden dominated the Board's consideration of the litigation demand. First, it noted there is no prescribed procedure a board must follow in considering a litigation demand, and Delaware law does not require a board to conduct a formal, substantive investigation of demand allegations. *Id.* at *6 (citations omitted). Second, a board's decision to refuse a litigation demand that would force it to take inconsistent positions in litigation is

routinely upheld as an exercise of business judgment. *Id.* (citations omitted). Finally, the litigation impact of pursuing derivative claims was only one factor the board considered in rejecting the demand. *Id.* (citing other factors). For these reasons, the Court found that (1) Skadden did not dominate the Board's consideration of the litigation demand, and (2) plaintiff did not allege particularized facts that overcame the business judgment rule presumption.

This case is on appeal to the Firth Circuit.

(b) *In re Cabot Oil & Gas* Corp. *Deriv. Litig.*, 2024 WL 23365 (S.D. Tex. Jan. 2, 2024) (Rosenthal, J.).

Shareholders filed a third amended derivative complaint against officers and directors of Cabot Oil & Gas for allegedly failing to exercise proper oversight and causing the Company to issue material misrepresentations about whether its fracking in Pennsylvania complied with applicable laws and regulations. Defendants moved to dismiss arguing that plaintiffs failed to allege futility of demand with particularity and failed to correct the deficiencies the Court identified in the prior complaint. Judge Lee Rosenthal granted the motion to dismiss for failure to allege demand futility because plaintiffs failed to allege particularized facts showing that at least half of the ten-member board could not impartially consider the shareholders' demands. The Court's ruling provides a roadmap for how to address derivative claims after a motion to dismiss parallel securities litigation has been denied, and it highlights the potential evidentiary benefit in litigation for defendants that produce documents in response to a books and records demand.

Factual Background[8]

Cabot is an oil and gas company that uses hydraulic fracturing, or fracking, in its well operations. Most of Cabot's production comes from the Marcellus Shale underneath Susquehanna County, Pennsylvania. Sometime after 2006, the residents of Dimock Township in Susquehanna County began to notice sediment and "effervescence" in their drinking water, and some experienced tunnel vision, nausea, and "body blotches." After a residential water well near a Cabot drilling site exploded, the Pennsylvania Department of Environmental Protection ("Pennsylvania EPA") began to investigate. The investigation concluded that methane gas was migrating from Cabot's drilling sites into the Dimock aquifer. In 2010, the Pennsylvania EPA and Cabot then entered into a consent order ("Consent Order") in 2010 requiring Cabot to cease drilling in a 9-mile square area, remediate Dimmock's drinking water and Cabot's wells, and comply with all applicable environmental laws and regulations going forward.

Between January 2011 and March 2020, the Pennsylvania EPA cited Cabot for 781 violations. It issued three notices of violation relevant to this litigation: (a) September 2011 – contamination of nearby residential water supplies by the Stalter wells; (b) June 2017 – contamination of nearby residential water supplies by the Howell wells; and (c) November 2017 – contamination of nearby residential water supplies by certain Jeffers Farm Wells. To address these notices, Cabot entered into a series of consent orders with the Pennsylvania EPA that required it to cease operations in a certain

[8] For additional details about the Cabot derivative case, see the Court's opinion and FH 1Q22 Newsletter, at 15-17 (derivative litigation – motion to dismiss). The following summary of the allegations was taken from the Court's opinions.

area near Dimock Township and "take all actions necessary to maintain compliance with all applicable environmental laws and regulations."

In February 2020, a Pennsylvania grand jury recommended that criminal charges be brought against Cabot for knowingly contaminating residential water supplies in Susquehanna County. On June 15, 2020, the Pennsylvania AG filed criminal charges against Cabot for (1) knowingly discharging industrial waste at wells near Dimock Township and in other locations through June 11, 2018 and (2) failing to comply with the Consent Order based on Cabot's conduct from December 15, 2010 to January 9, 2020. After the charges were filed, Cabot's stock price dropped by 3%.

Derivative Claims

In their third amended complaint, plaintiffs brought the following claims against Cabot's officers and directors:

1. Disclosure claim against Cabot's officers for breach of fiduciary duty by making untrue statements to shareholders;

2. Contribution claim against Cabot's officers for alleged violations of section 10(b);

3. Disclosure claim against Cabot's directors for breach of fiduciary duty by making or permitting untrue statements to be made to shareholders;

4. Insider trading claim against one officer under Delaware law (*Brophy* claim);

5. Waste of corporate assets claim against all defendants for allowing the Company to repurchase stock at allegedly inflated prices; and

6. Unjust enrichment claim against all defendants for receiving excessive compensation.

Defendants moved to dismiss, but before the Court addressed that motion in the derivative case it partially granted and partially denied the motion to dismiss claims in the securities litigation. The Court asked the parties to brief the impact of its securities litigation ruling on the derivative litigation. Based on the Court's ruling that one category of disclosure claims were non-actionable opinion statements, the derivative plaintiffs decided not to pursue that category of disclosure claims in the derivative action.

When the third amended complaint was filed, the Cabot board of directors consisted of ten directors: five defendants and five non-defendants. To allege demand futility under Delaware law, the plaintiffs had to allege with particularity that at least five directors could not fairly consider a litigation demand because they (1) received a material personal benefit from the alleged misconduct; (2) faced a substantial likelihood of liability on any of the claims; or (3) lacked independence from someone who received a material personal benefit from the misconduct. *United Food & Com. Workers Union v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021). Plaintiffs claimed the five director defendants faced a substantial likelihood of liability for their misconduct; they also claimed that one non-defendant director who was also an officer of the company was not independent because his employment was controlled by the defendants, and he derived substantially all his income -- $11 million in 2021 – from his employment at Cabot.

Analysis

The Court identified the legal standards applicable to shareholder derivative actions and to its demand futility analysis and then proceeded to analyze the specific claims and the likelihood of liability of each defendant director. The Court also noted that, without objection by the plaintiffs, it would take judicial notice of the documents produced in response to the § 220 demand and the notices of violation issued by the Pennsylvania EPA. *Id.* at *13 (citing *US ex. rel. Jackson v. Ventavia Research Group, LLC*, 2023 WL 2744394, at *1 n.4 (E.D. Tex. Mar. 31, 2023) and *Funk v. Stryker*, 631 F.3d 777, 783 (5th Cir. 2011)).

1. *Caremark* Claims

The Court characterized certain claims alleging breach of the duty of oversight as *Caremark* claims which can take one of two forms. First, directors may be liable if they "utterly failed to implement any reporting or information system or controls." *Stone ex. rel. AmSouth Bancrorporation v. Ritter*, 911 A.2d 362, 372 (Del. 2006). Second, directors may be held liable if they implemented a system of controls but "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Id.* at 370. To state a claim under the second form, a plaintiff must plead with particularity that the board knew there was evidence of corporate misconduct – the proverbial "red flag" – yet acted in bad faith by consciously disregarding its duty to address that misconduct. For either form of *Caremark* claim, a plaintiff must plead with particularity "a sufficient connection between the corporate trauma and the board." *Louisiana Mun. Police Empls.' Ret. Sys. v. Pyott*, 46 A.3d 313, 340 (Del. Ch. 2020), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013).

The plaintiffs argued the director defendants faced a substantial likelihood of liability under *Caremark's* second form because they consciously ignored red flags, including (a) 254 notices of violations issued by the Pennsylvania EPA between 2016 and 2018; (b) that the Company's remediation efforts were insufficient to release Cabot from liability under the 2010 Consent order; and (c) that the Company continued to violate the 2010 Consent Order and Pennsylvania law. The plaintiffs described the conduct of the director defendants as "serial non-compliance with mission critical regulatory requirements" after receiving negative reports on environmental compliance during Board committee meetings. The defendants disagreed, pointing to the documents produced in response to the plaintiffs' books and records request (§ 220 demand) and arguing they showed the Board was told (a) the Company had plans to remediate the alleged violations, (b) testing confirmed the Company's efforts were successful, (c) Cabot actually undertook the remedial actions, (d) Cabot hired outside consultants, and (e) Cabot engaged in ongoing dialogue with the Pennsylvania EPA to resolve the violations.

The Court agreed with the defendants, stating that "[t]he allegations and Section 220 documents, considered in total, do not allow the inference that the defendants are guilty of a "serious failure of oversight sufficient to support an inference of bad faith." *Cabot*, 2024 WL 23365, at *16 (quoting *In re McDonald's Corp. Stockholder Deriv. Litig.*, 291 A.3d 652, 661-62 (Del. Ch. 2023)). "At most, the Section 220 documents support the conclusion that the defendants 'responded in a weak, inadequate, or even grossly negligent manner' to the [Pennsylvania EPA's] regulatory actions, which is not enough for *Caremark* liability." *Id.* (quoting *McDonald's*, 291 A.3d at 661-62).

Using the § 220 documents, the Court detailed the extensive information provided to the board and numerous reports stating that the impact of Cabot's wells on residential water supplies was waning or had been eliminated due to remediation efforts. While the Court acknowledged the § 220 documents showed some successes and some failures, what was critical was they showed "Cabot was working in good faith to remediate the defective wells and restore contaminated water supplies." *Id.* at *19. The Court compared the allegations about the Cabot Board to derivative cases against the boards of MoneyGram, FedEx, and General Motors where no *Caremark* liability was sufficiently alleged.

The Court also distinguished the actions of the Cabot board from three cases cited by the plaintiffs. In *Massey Energy*, the directors made the conscious choice to put miners at risk. "In this case, unlike *Massey*, there is evidence that the defendants 'ma[de] good faith efforts to ensure that [Cabot] cleaned up its act.'" *Cabot*, 2024 WL 23365, at *20. In *Marchand*, the directors of Blue Bell did not undertake good-faith efforts to put a board-level system of monitoring and reporting in place, but plaintiffs did not allege this form of *Caremark* liability. "Rather, they allege that, despite Cabot's monitoring system – including regular Committee meetings with reports on environmental issues – the defendants did not do enough to insure that Cabot was in compliance. *Id.* at *20. Finally, in *Walton*, Wal-Mart shareholder alleged that the Company had not installed any monitoring system to detect diversion of opioids and suspicious activity. "*Walton* and *Massey* are distinguishable from this case for the same reason: the defendants here, unlike the defendants in those cases, took good-faith, effective steps to bring Cabot into compliance." *Id.*

2. The Disclosure Claims

Under Delaware law, "a shareholder plaintiff can demonstrate a breach of fiduciary duty by showing that the directors 'deliberately misinform[ed] shareholders about the business of the corporation, either directly or by a public statement.'" *In re Citigroup Inc., S'holder Deriv. Litig.*, 964 A.2d 106, 132 (Del. Ch. 2009) (quoting *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998)). "[A] plaintiff can demonstrate a substantial likelihood of liability that would excuse demand only by making 'particularized factual allegations that support the inference that the disclosure violation was made in bad faith, knowingly, or intentionally.'" *Fisher on behalf of LendingClub Corp. v. Sanborn*, C.A., 2021 WL 1197577, at *17 (Del. Ch. Mar. 30, 2021) (citing *Citigroup*, 964 A.2d at 106). The plaintiffs argued they alleged demand futility because the defendant directors (half of the board) issued public statements they knew were false, including

- Category 1 - statements regarding the Company's remediation of problems with the Stalter Wells identified in the September 2011 Notice of Violation;
- Category 2 - statements regarding the Company's belief that it had remediated methane leaks from the Stalter Wells identified in a June 2016 Consent Order; and
- Category 3 - statements about the Company's continuing efforts to address issues raised in the November 2017 Notice of Violation.

The Court addressed the Category 1 and Category 2 statements that related to the Stalter Wells together. First, the Court noted that plaintiffs only referred to four defendant directors in their response brief or less than half of the board. Second, the third amended complaint did not contain specific factual allegations linking two directors, Brock, and Watt, to statements in the Form 10-Ks

and 10-Qs. Third, the Section 220 documents preclude an inference that the director defendants knew the statements were false because they "heard reports at each meeting that the Stalter Wells were being or had been successfully remediated." Fourth, while the Section 220 documents showed the directors disagreed about the efficacy of the remediation efforts, this did not make false Cabot's statements that it had performed appropriate remediation efforts, the source of methane had been remediated, and Cabot was working with the Pennsylvania EPA to reach agreement and dispose of the matter.

As to the Category 3 statements, the Court gave several reasons why the plaintiffs did not adequately allege demand futility. First, Category 3 statements related to two different groups of wells: Howell Wells and Jeffers Farms Wells. Cabot's public statements referred to resolution of issues only with the Howell Wells and stated that it was continuing to investigate the Jeffers Farm Wells and work with the Pennsylvania EPA to finalize a consent agreement. Second, like the Stalter Wells, the directors received regular reports about the remediation efforts on the Howell Wells and Jeffers Farm Wells which supported the Company's public statements. Third, there was no reasonable inference from the Section 220 documents that the directors knowingly caused the Company to misrepresent the status of the Jeffers Farm Wells. The Company did not state the issues with Jeffers Farm Wells were resolved and instead referred to continued work on a remediation plan with the Pennsylvania EPA.

3. Other Claims

The Court quickly dispensed with the other claims. The Contribution claim seeking damages failed for the same reason as the disclosure claims, and the plaintiffs did not plead that at least five directors could not fairly consider it. The insider trading claim (*Brophy* claim) was only asserted against the CEO, and the complaint did not allege that a majority of the other board members could not fairly consider a demand on this claim. The Corporate Waste claim failed because the Company's stock repurchase was not "so one sided that no businessperson of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Id.* at 29 (citing *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006)). The Unjust Enrichment claim was based on the stock repurchase and compensation payments to the directors and officers. But the plaintiffs did not allege how much the stock was worth at the time of repurchase and, even if was allegedly inflated, it was not an extreme case sufficient to state an unjust enrichment claim. Nor did the plaintiffs cite any authority for the proposition that payment of compensation to directors and officers later accused of wrongdoing qualifies as unjust enrichment.

Because the plaintiffs failed to allege particularized facts supporting demand futility after two attempts and the Court concluded that further attempts would be futile, the Court dismissed the case with prejudice.

3. Government Enforcement Actions

(a) *United States v. Constantinescu*, 2024 WL 1221579 (S.D. Tex. Mar. 20, 2024) (Hanen, J.).

Judge Hanen dismissed without prejudice a superseding indictment for securities fraud under 18 U.S.C. §§ 1348 and 1349 against seven defendants because it failed to allege a "scheme to defraud" consistent with the U.S. Supreme Court's decision in *Criminelli v. United States*, 598 U.S. 306 (2023). The Government indicted seven individual defendants for engaging in a "pump and dump" scheme that involved various securities. According to the superseding indictment, Defendants

> purchased shares of a [listed] security in their trading accounts, posted messages on social media platforms with false, positive information about the security—including, among other things, the defendants' position in the security, how long the defendants intended to hold the security, the defendants' view that the security would increase in price, and the price the security could reach—to induce other investors to buy the security and artificially drive up its price.

Id. at *2. According to the indictment, after posting false information on websites like Twitter and Discord that drove up the price of the securities, the Defendants then "secretly sold their own shares" at the inflated price. *Id.* Over a two-year period from 2020 to 2022, the Defendants allegedly made $114 million in profits from this scheme.

The Defendants moved to dismiss the superseding indictment as legally insufficient for two reasons. First, the indictment was premised on the "right to control theory" adopted by the Second Circuit but rejected by the U.S. Supreme Court in *Criminelli*. The theory allowed the Government to prove a scheme to deprive victims of money or property by showing the victim's right to control its assets was denied by depriving the victim of information necessary to make discretionary economic decisions. *Id.* at *2. Second, the indictment failed to allege that any investors suffered actual harm because of the alleged deception. The Government countered that the indictment was more than adequate and it was not necessary to allege actual harm to investors. The Court agreed with the defendants but gave the Government an opportunity to replead.

The Court's opinion reviews several recent appellate cases limiting the scope of federal fraud statutes. In *United States v. Kelly*, 140 S.Ct. 1565, 1571 (2020), the Supreme Court held that the Government must show not only that the defendant "engaged in deception" but also that "an object of the[] fraud was property." In *United States v. Greenlaw*, 84 F.4th 325 (5th Cir. 2023), the Fifth Circuit held that that "intent to defraud" requires both an intent to deceive and an intent to cause some harm resulting from the deceit. *Id.* at 350. In *Criminelli*, the Supreme Court rejected the "right to control theory" and ruled that federal fraud statutes are "limited in scope to the protection of property rights." *Opinion.* at *5.

Examining the indictment, the Court found a "dearth of factual allegations" connecting the alleged scheme to the deprivation of others' property. *Opinion,* at *5. It did not allege that Defendants "actually harmed anyone's traditional property interests (or that the object of the scheme was to harm anyone's traditional property interests)." *Id.* at *5. There were allegations that defendants sought to maximize their trading profits through their tweets and posts "often at the expense of their Twitter followers …." However, the indictment suggested that losses by followers were incidental rather than an object of the scheme. In short, the Court concluded that the superseding indictment was based on the "right to control theory" rather than actual deprivation of property rights as required and dismissed the case without prejudice.

An appeal to the Firth Circuit is pending.

(b) *SEC v. Verges*, 2024 WL 531260 (N.D. Tex. Feb. 9, 2024) (Fitzwater, J.).

Judge Fitzwater denied a motion to dismiss the SEC's complaint for failure to plead fraud with particularity and for failure to state a claim on which relief can be granted. The SEC complaint alleged

that defendants Blue Citi LLC ("Blue Citi"), Robert Malin ("Robert") and Linda Malin ("Linda") violated Exchange Act §10(b) and Rule 10b-5(a) and 10b-5(c) and Securities Act; it also alleged §17(a)(1) and (3) the same defendants committed a secondary violation of these laws and rules by aiding and abetting co-defendant Phillip Verges' securities fraud. The SEC also alleged "control person" liability under §20(a) of the Exchange Act

a. The Alleged Scheme

Robert and Linda, acting through Blue Citi, played "a key role" in Verges' complex pump-and-dump scheme carried out from January 2017 through June 2022. The complaint alleges the scheme took place in four phases. First, Verges took control of five penny stock companies by installing trusted friends as the CEOs to conceal his involvement. Verges entered into "sham" consulting agreements with the companies under which he would receive a service fee that exceeded the companies' revenue. But Verges knew, based on his control of the companies' bank accounts, that the companies had no real business and generated little, if any, revenue. Verges used the sham consulting agreements to obtain debt instruments from the companies as purported compensation, typically through a debt settlement or convertible promissory note to Verges' companies. *Id.* *1.

In the second phase of the scheme, Verges enlisted Robert and Linda, acting through Blue Citi, to purchase the penny stock companies' debt instruments that he held, and in turn, convert the debt into stock at below-market prices. For example, Verges assigned to Blue Citi his rights in a debt settlement, and Blue Citi then executed a note of conversion for 20 million shares of the penny stock, which it sold at a substantial profit two days later. Blue Citi paid Verges $12 million as a kickback. *Id.*

The third phase entailed Verges' material misrepresentations and omissions to successfully pump up the value of the penny stocks. Verges allegedly directed another co-defendant to prepare disclosures that omitted information regarding the promissory notes issued to Robert and Linda. Verges also purportedly prepared other voluminous promotional materials under aliases. The alleged misrepresentations included online postings that misquoted the conversion price pursuant to the promissory note by a substantial margin. *Id.* at *2. The disclosure statements and other press releases prepared by Verges successfully increased trading volume.

In the final phase of the scheme, Verges allegedly facilitated transactions among certain co-defendants, Robert, Linda, and third parties to "dump" their shares into the market. Verges and Linda corresponded directly with transfer agents, or at other time Verges directed the figurehead CEOs, to issue third-party transfers. Over the alleged time period, Blue Citi converted over 2.5 billion shares of artificially inflated stock in Verges' companies at an aggregate conversion price of roughly $6 million. At the time of issuance, the stock's market value was roughly $47 million, giving Blue Citi a discount of nearly $41 million on Verges' stock over five years. *Id.* From these proceeds, Robert received roughly $12 million, and Linda directly received at least $533,750. Robert and Linda's sophisticated coordination of the third-party transfers with Verges' and others' misrepresentations concealed Verges involvement and misled investors. *Id.* at *11.

Defendants moved to dismiss the SEC complaint, arguing that it lacked the particularity required by Rule 9(b). *Id.* at *10. Defendants also moved to dismiss under Rule 12(b)(6) because the complaint neither alleged that defendants committed a deceptive or manipulative act or acted with scienter to incur primary liability, nor alleged that defendants were aware of Verges' securities fraud or knowingly rendered substantial assistance to incur secondary liability. *Id.* at *3. The court quickly

concluded that the SEC's complaint satisfied Rule 9(b)'s particularity requirements because it contained the "who, what, when, where, and how" generally required in securities cases. *Id.* at *10. The court then addressed the SEC's primary liability claims before turning to the secondary liability and control persons claim. *Id.* at *4.

b. Primary Scheme Liability

In analyzing the SEC's claims, the district court noted that the Fifth Circuit has not yet considered the pleading requirements for scheme liability.[9] However, district courts within the Fifth Circuit have followed the Second, Eighth, and Ninth Circuits, which hold that a plaintiff pleads a scheme liability claim when the scheme encompasses conduct distinct from the misrepresentations and omissions that give rise to Rule 10b-5 liability. *Id.* at *4 (citing *Yoshikawa v. Exxon Mobil Corp.*, 2023 WL 5489054, at *3 (N.D. Tex. Aug. 24, 2023); *Stephens v. Uranium Energy Corp.*, 2016 WL 3855860, at *22 (S.D. Tex. July 15, 2016)). Scheme liability requires proof of participation in an illegitimate, sham, or inherently deceptive transaction where the defendant's *own conduct* has the purpose and effect of creating a false appearance. *Id.* (emphasis original). Thus, the SEC was required to allege sufficient facts for the court to draw the reasonable inference that the defendants (1) committed a deceptive or manipulative act; (2) in furtherance of the alleged scheme to defraud; and (3) with scienter. *Id.* at *5.

The SEC's allegations were sufficient to support a reasonable inference that defendants committed a deceptive or manipulative act. "Defendants played a 'key active role' in Verges pump-and-dump scheme by 'dumping' the artificially inflated penny stock at strategic times over a five-year period." *Id.* at *7. The detailed allegations of Blue Citi's conversions of artificially inflated stock, Robert and Linda's proceeds, and Defendants' strategic timing of the sales of the penny stock in coordination with Verges' promotions were actions to propel a pump-and-dump scheme that was deceptive and manipulative. *Id.* at *6-7. Robert and Linda's acts to facilitate the debt-for-equity exchanges and third-party sales, which could be imputed to Blue Citi, were distinct from any misrepresentation or omission made by Verges or other co-defendants and were sufficient to support a reasonable inference that the defendants had committed deceptive or manipulative acts. *Id.* at *6.

Turning to the issue of scienter, the SEC's allegations were sufficient to enable a reasonable inference that defendants acted with scienter because they had motive and opportunity. *Id.* at *8. The court highlighted two cases, *SEC v. Farmer*, 2015 WL 5838897, at *11 (S.D. Tex. Oct. 7, 2015) and *SEC v. Garber*, 959 F.Supp.2d 374, 379 (S.D.N.Y. 2013), in support of its determination that the SEC's allegations supported a reasonable inference of motive. In *Farmer*, the SEC established motive based on the defendants' pocketing of $4.1 million of pump-and-dump proceeds over one year's participation in the scheme. *Id.* at *9. In *Garber*, a strong inference of fraudulent intent was established based on allegations that the defendants had pocketed $1 million in proceeds from a complex scheme that it had supported with ample resources. Here, the allegations of motive were based on "concrete and personal benefits that defendants received directly from their participation in the fraudulent pump-and-dump scheme." *Id.* The allegations of opportunity were based on the five-year relationship between Robert, Linda, and Verges working in concert to locate and market investment opportunities. *Id.* at *9. The court further noted that the complaint's allegations regarding Robert and Linda's sophistication and experience – such as Robert's prior judgment for his role in a fraudulent front-

[9] The district court noted that claims under § 10(b) and § 17(a) "are often analyzed as one," because other than the requirement of proof of scienter for § 10(b) claims, the two sections are similar. *Id.* at 5.

running scheme and Linda's longstanding license to practice law in New York – enabled the court to draw the reasonable inference that they acted with scienter. *Id.* at *9-10.

c. Secondary Liability

The court next addressed the SEC's aiding and abetting securities fraud claim. *Id.* at 10. For purposes of a motion to dismiss, the Fifth Circuit permits district courts to assume the existence of a securities violation by the primary violator, focusing the determination on the second element of an aiding and abetting securities fraud claim: whether the alleged aider and abettor had "general awareness that one's role was part of an overall strategy that is improper." *Id.* (quoting *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 95 (5th Cir. 1975) (cleaned up)). In the context of securities fraud, recklessness is the proper scienter for civil aiding and abetting liability. *Id.* at*11. Reckless behavior is demonstrated through "allegations that the aider or abettor encountered red flags of suspicious events creating reasons for doubt that should have alerted him to the improper conduct of the primary violator." *Id.* However, how substantial the abettor's assistance is may determine how knowing the abettor is. Substantial assistance may be adequately alleged based on facts showing the defendant's conduct to be a "substantial causal factor" in the primary violator's fraud.

Following *Woodward* and assuming a primary securities fraud violation, the district court determined that the SEC sufficiently pleaded facts that demonstrated the defendants had a general awareness that their role was part of an overall improper activity. *Id.* at 12. The Complaint alleged that Robert and Linda were sophisticated and experienced investors, which permitted a reasonable inference that they acted with extreme recklessness by assuming that the transactions executed in coordination with Verges were legitimate despite numerous "red flags." The "red flags" included (1) the investment opportunities were with the same five penny stocks over a five-year period, (2) Verges provided Robert and Linda with steep discounts to purchase his debt instruments, (3) the disclosures and press releases were published regarding the same five penny stocks, (4) Robert and Linda then sold the shares a significant profit margin, (5) a press release inaccurately reported on the conversion rate on one specific transaction, and (6) by purchasing and converting Verges' debt instruments, Robert and Linda concealed his involvement. *Id.* Likewise, the court easily concluded that Robert and Linda knowingly and recklessly provided substantial assistance based on the allegations that they agreed with Verges to purchase his debt instruments, converted those instruments, and sold roughly 2.5 billion shares of stock, profited more than any other nominee in Verges' scheme, and worked with Verges for a five-year period. *Id.*

d. Control Person Liability

Finally, the district court addressed the SEC's control liability claim. To make a prima facie case of "control," the plaintiff must plead facts indicating that the defendant had power to directly or indirectly control or influence corporate policy. *Id.* at *12. The district court determined that the SEC's complaint plausibly pleaded that Robert and Linda had the ability to control Blue Citi's transactions with Verges' companies and other third parties. *Id.* at *13. Robert, as Blue Citi's managing member, agreed with Verges that Blue Citi would obtain interests in Verges' companies debt instruments, and that Robert and Linda used Blue Citi to engage in the alleged scheme. Robert and Linda, in their capacities as Blue Citi's managers, also executed notes, agreements, and conversion notices to obtain the penny stock companies' shares. Notably, Defendants offered no argument controverting Robert and Linda's ability to control Blue Citi.

(c) *SEC v. Jaitley*, 2024 WL 36011 (W.D. Tex. Jan. 3, 2024) (Ezra, J.).

The Court adopted the Report and Recommendation (R&R) of Magistrate Judge Lane that partial summary judgment on liability in favor of the SEC should be granted in a civil enforcement action against Defendant Leena Jaitley and Relief Defendants Taraben Patel and OTA LLC. Defendants did not object to the R&R.

The SEC alleged that Jaitley ran a stock options trading scheme and defrauded clients. The SEC asserted four causes of action against Jaitley for violations of the antifraud provisions of (1) the Securities Act, (2) the Exchange Act, and (3) the Advisors Act (Sections 206(1) and 206(2)). The SEC sought permanent injunctive relief, disgorgement, prejudgment interest and civil monetary penalties.

The Antifraud Provisions are violated if the SEC establishes by a preponderance of the evidence that the defendant (1) made a material misrepresentation (2) with scienter (3) in connection with the purchase, offer, or sale of any security (4) in interstate commerce. Section 17(a)(2) of the Securities Act additionally requires finding that the Defendant "obtained money or property" by means of a false or misleading statement.

The Court found that the Defendant had made *a material misrepresentation* because "a reasonable investor would have wanted to know the true identity of who was leading a company" (citing *SEC v. Blackburn*, 15 F.4th 676, 680 (5th Cir. 2021)). The SEC had established scienter because "attempts to avoid detection are characteristic of a scheme to defraud" and "repeated invocation of the Fifth Amendment right against self-incrimination during a deposition strongly supports a finding of scienter" in a civil case. In addition, Jaitley represented that she and Patel had decades of financial services experience at Goldman Sachs, which she knew to be untrue. She also knew that her company did not use any proprietary trading techniques, did not employ numerous traders, and was not located in New York. Lastly, "Jaitley's use of faked names and blocked phone numbers underscores that Jaitley intended to deceive investors." *Id.* at *3. The Report noted that violations of the Securities Act Section 17(a)(2) and (a)(3) require a lesser standard of negligence than the scienter required under Section 17 (a)(1). Thus, the showing of scienter satisfied the lesser burden of negligence. The Report relied on a client's declaration and brokerage statements to establish the third element of "in connection with the purchase of securities." Emails requesting bank wires furnished the evidence for the fourth element regarding interstate commerce. Finally, fee agreements and client declarations were the evidence that the Defendant "obtained money or property" because of their misrepresentation. The Report also found evidence that the Defendant's conduct occurred while acting as an investment advisor for a client, citing *SEC v. Haarman*, 2022 WL 2782648 at *3 (W.D. Tex. Jan. 25, 2022).

(d) *SEC v. Mueller*, 2024 WL 400897 (W.D. Tex. Jan. 11, 2024) (Rodriguez, J.).

Judge Xavier Rodriguez granted in part and denied in part the SEC's motion for summary judgment in an enforcement action against Robert J. Mueller, the founder and investment advisor of two funds known as the "deeproot funds." The deeproot funds were purportedly formed to invest in life insurance policies, the proceeds of which would be paid back to the investors. The SEC alleged that Mueller defrauded more than 300 people who invested over $66 million in the funds.

The SEC filed suit in 2021 alleging claims under Exchange Act § 10(b) and Rule 10b-5(a)-(c); Securities Act § 17(a)(1)-(3); and Sections 206(1), (2) and (4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder.

Mueller moved to strike much of the SEC;s summary judgment evidence as inadmissible. *Id.* at *2. The Court rejected Defendant's evidentiary objections, *Id.* at *2 - *6, but relied on a substantial amount of Defendant's own evidence to find genuine issues of material fact precluding summary judgment.

The SEC contended that Defendant perpetrated the scheme by distributing Private Placement Memorandums ("PPMs") and other marketing materials that contained six categories of affirmative misstatements and material omissions. The Court stated that "[b]ecause the SEC's theory of scheme liability appears to be premised in part on Defendant's dissemination of misleading marketing materials, the Court will analyze each category of misstatements and omissions [under] Rule 10b-5 and under Section 17(a)(2) before reaching the SEC's claims for scheme liability." *Id.* at *8.

Material Misrepresentations. To establish liability under the Antifraud Provisions based on misleading communications, the SEC must demonstrate that Defendant made (1) a material misrepresentation or materially misleading omission (2) with the requisite state of mind (3) in connection with the offering, purchase or sale of securities (4) that were offered or sold through the use of interstate communications, commerce or the mails. *Id.* at *9. Liability under Section 17(a) requires a fifth element that the Defendant obtained "money or property" through his false or misleading statements. *Id.* There was no dispute that elements (3) and (4) were satisfied. *Id.* at *9. Defendants disputed the other elements with respect to each of the six categories of misstatements alleged by the SEC, namely whether the Defendant made materially misleading statements or omissions in the PPMs and whether he made them with the requisite state of mind. Defendant also disputed whether the marketing materials were misleading. The Court analyzed each of the alleged misrepresentations.

Whether the PPMs misrepresented that the funds would purchase life policies. The Court found there were no misrepresentations but found that a genuine dispute of fact existed with respect to whether this misrepresentation was material. In other words, was it material to investors that the funds themselves would own the policies, as they had promised in the PPMs, rather than a related entity owning the policies. *Id.* at *10. The Court concluded this was a jury question.

Whether the marketing documents failed to disclose that the Defendant previously sold off fractional shares of the insurance policies. The Court again found a jury question as to whether the disclosures were sufficient to alert investors of the possibility of outside investors in the policies. Defendant had pointed out that none of the investors who submitted declarations for the SEC complained that they were not informed about the outside investors in the policies, which the Court appeared to find compelling. *Id.* at *11.

Whether the marketing documents falsely stated that the fund would invest at least 50% of assets in life insurance policies. Specifically, the SEC calculated that the funds should have invested approximately $28.6 million of the $66 million raised in life policies (after subtracting other expenses).

Defendant proposed an alternative calculation method which resulted in a requirement that the funds invest $12 million in life policies, which was the precise amount actually invested. *Id.* at *12. The Court found that this alternative calculation raised a material fact issue regarding how the PPMs' allocation requirements would be analyzed by a reasonable investor, precluding summary judgment. The Court also found conflicting interpretations of "generic disclosures" in the PPMs which gave rise to a fact issue.

Whether PPMs falsely stated the funds would purchase shares or other interests in affiliated "deeproot" companies. The SEC contended that the funds transferred money to these affiliates without documenting the funds' [equity] interests in the affiliates. As it had with respect to the first category, the Court found that there was a misrepresentation but that the materiality thereof was a jury question. And the Court again noted that the investor declarations did not question the manner of the funds' investment in the affiliates. *Id.* at *14.

Whether PPMs falsely understated the amount the funds would invest in affiliated companies and spend on operating expenses. The Court agreed with the Defendant that there were credible questions about whether the funds exceeded the amount that the PPMs disclosed, which will need to be adjudicated by a jury. *Id.* at *14. Unlike the previous categories finding that there was a misstatement but questioning its materiality, here the Court found that the SEC had failed to carry its burden as to whether there was a misstatement at all.

Whether the marketing documents failed to disclose that Defendant used the "Company Advance" to make Ponzi-like payments whereby new investments paid commitments to existing investors. *Id.* at *15. The Court found that Defendant had raised a material fact issue regarding whether the PPMs "when construed together, sufficiently disclosed that funds allocated to Company Advance would be used to pay earlier investors." *Id.* at *16, citing *SEC v. Blackburn*, 431 F. Supp. 774, 812 (E.D. La. 2019). However, the Court also found that the PPMs failed to disclose that investor funds could be used to repay *investors in other funds*, including four debenture funds established before the deeproot funds. Defendant failed to rebut the SEC's argument on this point. The Court found that the PPMs' failure to disclose that Defendant diverted $3.8 million to investors in these earlier debenture funds was an omission. Moreover, the Court concluded that this omission was material as a matter of law because the PPMs never disclosed that potential use of funds. *Id.* The Court found that "it simply strains credulity to suggest that a reasonable investor would not consider these undisclosed payments representing over 5% of total investments as significantly altering the total mix of information made available." *Id.*

Thus, of the six categories of materially misleading statements or omissions alleged by the SEC, the Court found sufficient evidence that only half of one category was both a misstatement and material at the summary judgment stage.

Scienter and Negligence. Turning to scienter, the Court found that the SEC had failed to prove both scienter, which applies to the 10b-5 claim, and the lesser standard of negligence, which applies to Section 17(a)(2) claim. Defendant proffered testimony of other deeproot employees who said that Defendant believed he was acting lawfully, and also pointed to the fact that he had received the advice of counsel in preparing the PPMs. The Court essentially determined that a disputed mental state

cannot be resolved on summary judgment: "… the competing deposition testimony advanced by both parties creates a material fact dispute that the Court cannot resolve at the summary judgment stage." *Id.* at *18. "Given the disputed nature and extent of counsel's advice to Defendant, the Court cannot find as a matter of law that Defendant acted with scienter." *Id.* The Court reached the same conclusion with respect to negligence. *Id.* at *19.

Obtain money or property. Defendant did not dispute the existence of the Section 17(a)(2) requirement that the Defendant "obtain money or property" by means of a false or misleading statement. *Id.*

Scheme Liability. Scheme liability refers to employing a fraudulent scheme and engaging in deceptive acts that operate as a fraud. To succeed on that theory, the plaintiff must prove that the defendant engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. *Id.* at *19. With respect to the SEC's allegations of scheme liability, the SEC alleged that Defendant was responsible for disseminating the PPMs, which can be a basis for scheme liability. *Id.* at *20. Because Defendant offered no rebuttal evidence in response to the SEC's argument, the Court concluded that Defendant's dissemination of the Category Six documents and omissions regarding payments to investors in the earlier debenture funds was a "device, scheme or artifice to defraud" and an "act, practice, or course of business that operates or would operate as a fraud or deceit on any person" under the two applicable statutes. The Court also found that Defendant's undisclosed diversion of $3.8 million from deeproot fund investors to investors in the earlier debenture funds and Defendant's diversion of $1.3 million to pay his own personal expenses constituted deceptive schemes or acts. However, the Court rejected the SEC's contention that Defendant's "entire course of conduct" was deceptive. Turning to *scienter*, the Court found for the same reasons as set forth above that there are genuine issues of material fact as to whether Defendant had the requisite scienter, particularly with respect to Defendant's asserted reliance on counsel. With respect to negligence, the Court found that diverting investor funds in a manner contrary to the PPMs for his personal enrichment was indisputably negligent, relying in part on the investor affidavits. *Id.* at *22. The Court found that Defendant had failed to present competent evidence disputing the SEC's proof of negligence.

Investment Advisers Act. The Court found that Defendant was an investment adviser within the meaning of Section 202(a)(11) and concluded that Defendant violated Sections 206(2) and (4) because of his negligent misappropriation of investor funds for personal use. On the first point, Defendant presented no rebuttal evidence and on the second, the rebuttal evidence was deemed to be not competent.

II. STATE CASES

A. *O'Donnell v. ROO Investment Fund II*, 2024 WL 469558 (Tex.App.—Dallas Feb. 7, 2024).

The Fifth Court of Appeals in Dallas affirmed summary judgment against Michael O'Donnell for violations of the Texas Securities Act (TSA) and breach of fiduciary duty. As managing member and president of Pepperwood Fund II GP, LLC (Pepperwood GP), O'Donnell created Pepperwood Fund II, LP ("Pepperwood LP"), a limited partnership which he used to solicit investments from

appellees to purchase a controlling interest in Behavioral Recognitions Systems, Inc. (BRS). Pepperwood GP was the general partner of Pepperwood LP.

O'Donnell represented to appellees that their investments would be used to purchase BRS stock and then issue Series A stock to Pepperwood LP's investors. *Id.* at *1. Appellees gave O'Donnell capital contributions and a loan in exchange for limited partnership shares in Pepperwood LP. Appellees claimed that O'Donnell failed to disclose that he had already purchased the BRS stock and that he had entered into a referral agreement under which O'Donnell received payment for soliciting their investments. *Id.* After appellees became limited partners in Pepperwood LP, O'Donnell first executed a document on behalf of BRS to transfer all its intellectual property assets to Pepperwood LP and then executed a second document to transfer the same assets from Pepperwood LP to Omni AI, Inc. ("Omni"), a separate entity controlled by O'Donnell. O'Donnell failed to inform appellees of these agreements until after they had become limited partners in Pepperwood LP. O'Donnell then offered appellees an option to either exchange their limited partnership interests in Pepperwood LP for interests in Omni or to withdraw from Pepperwood LP and receive their capital contribution plus ten percent interest back. Two appellees did not elect either option; one appellee elected both options but received no payment despite demands for same. *Id.*

After discovery, appellees moved for summary judgment against O'Donnell on their claims for violations of the TSA and breach of fiduciary duty. The trial court held a hearing and entered an order granting partial summary judgment on these claims and subsequently entered final judgment against O'Donnell and awarded damages to each appellee. *Id.* at *2. O'Donnell filed a motion for new trial challenging the evidence supporting the findings that he personally violated the TSA as a "seller" or "control person" and that he owed a fiduciary duty to appellees at the time he made the actionable misrepresentations. The trial court denied the motion for new trial, and O'Donnell appealed. *Id.*

The Fifth Court of Appeals affirmed the trial court's judgment on five points raised by O'Donnell, four of which urged that the appellees failed to conclusively establish elements of their claims. He challenged the evidence establishing that: (1) he was a "seller" under the TSA; (2) that the appellees knew that the sale had already taken place or that Pepperwood LP already had a controlling interest in BRS before investing; (3) he was a "control person" under the TSA; and (4) O'Donnell owed appellees a fiduciary duty.

"Seller" Status. In arguing that he was not a "seller" under the TSA, O'Donnell pointed to his own declaration that he was not acting in his individual capacity when soliciting investments, that he did not pass title to appellees, and that he was not motivated by financial interest to sell the securities. *Id.* at 5. Acknowledging the parties' agreement that Texas courts may look to federal cases to interpret the TSA, the Court of Appeals determined that O'Donnell was a "seller" under the statutory definition in the TSA. *Id.* at *6. The court further pointed to *Pinter vs. Dahl*, 486 U.S. 622, 643 (1988) to conclude that appellees need not establish that O'Donnell passed title to establish liability under the TSA. *Id.* at *5-6. O'Donnell's argument that appellees failed to establish that he was financially interested in the transaction was also unavailing because *Pinter* concluded that liability should extend to brokers and others who solicited because "the solicitation of a buyer is perhaps the most critical stage of the selling transaction" and that "brokers and other solicitors are well positioned to control the flow of information to a potential purchaser … and, in fact, such persons are the participants in the selling transaction who most often disseminate material information to investors." *Id.* at *6 (quoting *Pinter*, 486 U.S. at 646).

Appellees' Knowledge. O'Donnell argued that because he had discussed a sale agreement between the BRS stockholders and Pepperwood LP, a material fact existed as to whether the appellees knew of the untruth or omission. *Id.* at *6. The appellees pointed out that O'Donnell's declaration failed to address their allegation that he failed to disclose he had already purchased the BRS stock and already had a controlling interest in BRS when he solicited them. The Court agreed with the appellees, finding that O'Donnell's statement that he discussed the sale agreement with the appellees did not sustain his burden of proof that appellees knew the sale had already taken place or that Pepperwood LP already had a controlling interest in BRS before appellees' investment. *Id.*

Control Person Liability. As to whether O'Donnell was a "control person" under the TSA, the court again noted that federal cases may guide interpretation of the TSA. *Id.* At *7. However, it did not address this point in light of its conclusions that O'Donnell was a seller and the appellees did not know of the sale agreement between Pepperwood LP and BRS prior to investment. *Id.*

Existence of Fiduciary Duty. Finally, the court affirmed that O'Donnell owed a fiduciary duty to appellees as limited partners in Pepperwood LP. O'Donnell argued that (1) he owed a fiduciary duty only to Pepperwood GP, not to the limited partners of Pepperwood LP, (2) and his purchase of BRS stock occurred before appellees became limited partners so he could not owe them a fiduciary duty at the relevant time. *Id.* at *9 n.7.

O'Donnell admitted that he was the president and manager of Pepperwood GP, and he conceded that a general partner in a limited partnership owes fiduciary duties to the limited partners they serve because of its control over the entity. The court further noted that a third party may be liable as a joint tortfeasor when it knowingly participates in a breach of fiduciary duty. *Id.* at *8. The record established that: (1) O'Donnell was aware of the fiduciary relationship between Pepperwood GP and the appellees; (2) O'Donnell signed agreements that transferred the intellectual property assets out of Pepperwood LP to Omni, and entity over which he had some control; and (3) only after the transfer did he disclose to appellees that the transfer had happened and offered an exchange of their Pepperwood LP interests for Omni shares. Id. at 9. Relying on *Graham Mortg. Corp. v. Hall*, 307 S.W.3d 472, 479 (Tex. App.—Dallas 2010, no pet.), the Court of Appeals concluded that "as a general partner in a limited partnership, [Pepperwood GP] owed fiduciary duties to the limited partners it served because of its control over [Pepperwood LP]," including the duty to disclose material facts. *Id.* O'Donnell engaged in self-dealing and failed to disclose material information and therefore breached his fiduciary duty to appellees. In particular, the Court focused on *Bombardier Aerospace Corp. v. SPEP Aircraft Holdings, LLC,* 572, S.W.3d 213, 220 (Tex. 2019) and the evidence of O'Donnell's transfer of the intellectual property assets as establishing a breach of fiduciary duty, even if there was no formal fiduciary relationship. *Id.* at *9, n. 7. Because a duty to disclose the whole truth may arise when the defendant: (1) discovered new information that made its earlier representation untrue or misleading; (2) made a partial disclosure that created a false impression; or (3) voluntarily disclosed some information, O'Donnell's delay in disclosing the asset transfers from Pepperwood LP to Omni were sufficient to establish a breach of fiduciary duty. *Id.*

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