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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 Decisions – The Supreme Court issued two important securities decisions this quarter.
    - In *SEC v. Jarkesy*, the Court upheld the Seventh Amendment right to a jury trial when the SEC seeks to impose civil penalties for fraud. Since the SEC has filed nearly all contested enforcement actions in federal court (as opposed to ALJ proceedings) since 2018, the ruling is not likely to have a significant impact on SEC enforcement actions. However, it may have a significant impact on other agencies that rely heavily on in-house administrative proceedings to impose civil money penalties.
    - In *Macquarie Infrastructure Corp. v. Moab Partners, L.P.*, the Court resolved the question whether the failure to disclose information required by Item 303 of Regulation S-K (such as known trends that could materially impact net sales, revenues, or income), standing alone, is actionable under Rule 10b-5. In a unanimous opinion, the Court answered no, holding that "[p]ure omissions are not actionable under Rule 10b–5(b)." The Court confirmed "that the failure to disclose information required by Item 303 can support a Rule 10b–5(b) claim only if the omission renders affirmative statements made misleading."
- Fifth Circuit Rulings – In *National Assoc. of Private Fund Mgrs. v. SEC*, the Fifth Circuit vacated new SEC rules that would have significantly expanded compliance requirements for advisers of private equity funds and real estate funds. The Court ruled that the SEC exceeded its statutory authority under the Investment Advisers Act and rejected the SEC's argument that Dodd-Frank expanded that authority. In *Cory v. Stewart*, the Fifth Circuit addressed for the first time the issue of loss causation in a private market context and ruled that plaintiffs must show that a misstatement was a substantial factor in causing at least some portion of the plaintiff's actual economic loss by producing evidence that (a) certain misstated risks were responsible for the loss and (b) reasonably distinguishes the impact of those risks from other economic factors. The Fifth Circuit reversed district court orders in two securities fraud actions. In *Anadarko*, the Court vacated class certification on procedural grounds, ruling that the district court abused its discretion by (a) denying defendant leave to respond to a rebuttal report that injected new evidence and (b) failing to perform the required *Daubert* analysis with respect to that rebuttal report. In *Six Flags*, the Court reversed the district court's judgment on the pleadings, clarifying that its prior ruling had not ruled that all fraud allegations were fully

disclosed by October 2019 but only that certain fraudulent statements after that date were not actionable. Thus, the lead plaintiff retained standing to proceed, and another putative shareholder who purchased shares before the October 2019 disclosure was entitled to intervene.

- District Court Rulings – In one of the Stanford Ponzi-scheme cases against a clearing broker, Judge Godbey denied summary judgment for the defendant, ruling that genuine issues of material fact existed on limitations, as well as fraud and breach of fiduciary duty claims. In a Texas Securities Act case, Judge Rosenthal granted a Norwegian defendant's motion to dismiss for lack of personal jurisdiction but denied its U.S. affiliate's motion to dismiss claims on limitations grounds because the factual allegations were sufficient to state a claim and the factual record on limitations was not sufficiently developed. Reviewing the settlement of a securities class action against Fluor Corporation, Judge Starr awarded attorneys' fees based on a lodestar approach and questioned why lawyers for class members in a common-fund settlement should ever be awarded a multiplier that would reduce the recovery by their clients. In an SEC enforcement action against a cryptocurrency seller and influencer based overseas, Judge Ezra ruled as a matter of law that the SEC had jurisdiction under Sections 5 and 17 of the Securities Act because U.S. residents were targeted online and "offers" were made in the United States.

CASE SUMMARIES

I. FEDERAL CASES

A. United States Supreme Court

1. *SEC v. Jarkesy, 144 S. Ct. 2117 (2024).*

In an appeal from an SEC administrative enforcement proceeding that imposed civil penalties for fraud, the Supreme Court of the United States held that "the Seventh Amendment entitles a defendant to a jury trial when the SEC seeks civil penalties against him for securities fraud." *Id.* at 2127. The majority ruling by Chief Justice Roberts affirmed a 2022 Fifth Circuit decision vacating the SEC award against Mr. Jarkesy.[1] The Fifth Circuit had invalidated the SEC administrative order on three constitutional grounds, but the Supreme Court only addressed the Seventh Amendment issue. While the *Jarkesy* ruling limits the types of enforcement actions the SEC may pursue administratively, it is not expected to have much practical effect on SEC enforcement actions because the SEC has filed nearly all contested proceedings in federal court since 2018. However, as discussed below, the *Jarkesy* ruling may have a broader impact on other governmental agencies that rely heavily on in-house administrative proceedings to impose civil money penalties.

Background

George Jarkesy created two hedge funds and appointed Patriot28, LLC, as the funds' investment adviser. Between 2007 and 2010, the funds raised about $24 million from 120 accredited investors. According to the SEC, Jarkesy and Patriot28 misled investors in at least three ways: (1) misrepresenting the investment strategies the funds employed; (2) lying about the identity of the

[1] See FH Newsletter 2Q22, at 2-5.

funds' auditor and prime broker; and (3) inflating the funds' claimed value so the defendants could collect larger management fees.

In 2010, Congress passed the Dodd-Frank Act which, among other things, gave the SEC authority to pursue the same penalties in administrative proceedings as it did in federal court. Armed with this new authority, the SEC instituted an administrative action in 2010 against Jarkesy and Patriot28. The SEC alleged, among other things, that they were liable for civil money penalties based on violations of various antifraud provisions including § 17(a) of the Securities Act, §10(b) of the Exchange Act, and Section 206 of the Investment Advisers Act. The SEC administrative law judge (ALJ) held an evidentiary hearing and found the petitioners liable. The Commission reviewed the decision and released its final order in 2020, which (1) levied a civil money penalty of $300,000 against Jarkesy and Patriot28, (2) directed them to cease and desist from committing or causing violations of the antifraud provisions, and (3) prohibited Jarkesy from participating in the securities industry or offerings of penny stocks. The petitioners sought judicial review of the SEC's administrative order.

The Fifth Circuit vacated the Commission's order on three constitutional grounds: (1) the use of an ALJ violated the petitioners' Seventh Amendment right to a jury trial and did not meet the "public right" exception; (2) Congress violated the non-delegation doctrine by authorizing the SEC without adequate guidance to litigate before an ALJ or an Article III judge; and (3) the statutory restrictions on removal of the SEC's ALJs violated the separation of powers doctrine. The Supreme Court decision only addressed the first of these constitutional issues.

Right to Jury Trial

The Seventh Amendment guarantees that in "[s]uits at common law, … the right of trial by jury shall be preserved." This guarantee extends to statutory claims if they are "legal in nature." *Id.* at 2128 (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 53 (1989)). To determine whether a suit is legal in nature, courts consider the cause of action and the remedy it provides, with the remedy being the "more important" consideration. *Id.* at 2129. Civil penalties were a type of remedy at common law that could only be enforced in courts of law. The civil money penalties imposed on Jarkesy and Patriot28 were punitive in nature, not just compensation for injuries. *Id.* at 2130-31.

The SEC argued that the Seventh Amendment did not apply because Congress may assign certain matters for decision by an agency under the "public rights" exception. Acknowledging that its opinions governing the public rights exception "have not always spoken in precise terms," *id.* at 2133, the Court emphasized that if a claim involves the nature of an action under common law, then it presumptively concerns "private rights" not "public rights." *Id.* at 2132. The "public rights" exception has, therefore, been limited to cases involving things such as the collection of revenue, immigration, assessment of tariffs, relations with Indian tribes, veterans' benefits, and patent rights. Because the SEC's claims under the "antifraud provisions" were not claims "unknown to common law," they are presumptively "private rights" that must be tried before a jury in federal court. *Id.* at 2135-36.

In *Granfinanciera*, the Court held that fraudulent conveyance claims in bankruptcy proceedings must be tried to a jury since the remedies for those statutory claims traditionally sounded in common law. *Id.* at 2134-35. The Court ruled that *Granfinanciera* effectively decides this case because the substance of the action against Mr. Jarkesy – fraud claims imposing a punitive remedy – target the same basic conduct as common law fraud. Congress cannot "conjure away the Seventh Amendment

by mandating that traditional legal claims be … taken to an administrative tribunal." *Id.* at 2136 (quoting *Granfinanciera*, 492 U.S. at 52).

The majority also rejected the argument that *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S. 442 (1977) was controlling precedent because OSHA did not "borrow its cause of action from the common law." *Id.* at 2137. That case involved "a new cause of action, and remedies therefor, unknown to the common law." *Id.* (quoting *Atlas Roofing*, 430 U.S. at 461).

Dissenting and Concurring Opinions

The dissent disagreed with the majority's characterization of the SEC's claims and its narrow reading of *Atlas Roofing*, but the dissent argued more broadly that Congress had the authority to create statutory claims and assign them to administrative courts and had done so in reliance on "settled judicial construction" for nearly 50 years in more than 200 statutes. In a paragraph likely to be quoted in the future, Justice Sotomayor, joined by Justices Kagan and Jackson, stated:

> Make no mistake. Today's decision is a power grab. Once again, "the majority arrogates Congress's policymaking role to itself." It prescribes artificial constraints on what modern-day adaptable governance must look like. In telling Congress that it cannot entrust certain public-rights matters to the Executive because it must bring them first into the Judiciary's province, the majority oversteps its role and encroaches on Congress's constitutional authority. Its decision offends the Framers' constitutional design so critical to the preservation of individual liberty: the division of our Government into three coordinate branches to avoid the concentration of power in the same hands. Judicial aggrandizement is as pernicious to the separation of powers as any aggrandizing action from either of the political branches.

Id. at 2175 (citations omitted).

Justice Gorsuch, joined by Justice Thomas, filed a concurrence, in which he described the historical basis for the Seventh Amendment jury-trial right and how it works together with Article III (entitling individuals to independent judges) and the Due Process Clause (promising that trials will be conducted pursuant to the time-honored procedures recognized at common law). *Id.* at 2139-54.

Implications

When the SEC decides to bring fraud claims and pursue civil money penalties from a defendant, *Jarkesy* now requires the SEC to litigate those cases in federal court. This should provide defendants with some discovery and evidentiary rights that are not always available in administrative proceedings, but it could also expose defendants to greater publicity since federal court proceedings are more public than SEC administrative proceedings. As a practical matter, *Jarkesy* may not change much because the SEC has been filing virtually all contested cases in federal court since 2018. The SEC could decide to address the Seventh Amendment issue by allowing litigants in administrative proceedings to remove their cases to federal court, but it is hoped *Jarkesy* will not change the current practice of using administrative proceedings to settle enforcement cases in a less public setting.

For agencies other than the SEC, *Jarkesy* could have a broad and lasting impact, especially for those agencies that rely heavily on in-house administrative proceedings to impose civil money penalties. As the dissent in *Jarkesy* notes, "Congress has enacted countless new statutes in the past 50

years that have empowered federal agencies to impose civil penalties for statutory violations." *Id.* at 2173. More than two dozen agencies are currently authorized to impose civil penalties in administrative proceedings, and at least two agencies other than the SEC (the EPA and the Consumer Financial Protection Bureau) can pursue civil penalties in both administrative proceedings and federal court. *Jarkesy* "means that the constitutionality of hundreds of statutes may now be in peril, and dozens of agencies could be stripped of their power to enforce laws enacted by Congress." *Id.* at 2174.

Finally, when combined with the termination of the "*Chevron* deference" doctrine announced in *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (June 28, 2024), *Jarkesy* signals a sea change in the way the legislative, executive, and judicial branches will operate in the future. As a society, we should want individual defendants accused of fraud to have the right to defend themselves before a jury of their peers (*Jarkesy*), but we may not be ready for the increased legal challenges, inconsistent court decisions, and general uncertainty that will accompany future agency rulemaking (*Loper Bright*). Instead of deferring to agency interpretations in regulatory areas, non-expert judges will now provide the "best interpretation" of what non-expert members of Congress intended. While this may rein in some overzealous agency interpretations, the slow pace of legal decisions and the lack of predictability in technical, evolving, and complex areas of law may be more damaging for business and society as a whole than the current system.

2. *Macquarie Infrastructure Corp. v. Moab Partners, L.P.*, 144 S. Ct. 885 (2024).

The Supreme Court resolved the question whether the failure to disclose information required by Item 303 of Regulation S-K (such as known trends that could materially impact net sales, revenues, or income), standing alone, is actionable under Rule 10b-5. In a unanimous opinion, the Court answered no, holding that "[p]ure omissions are not actionable under Rule 10b–5(b)." *Id.* at 888. The Court confirmed "that the failure to disclose information required by Item 303 can support a Rule 10b–5(b) claim only if the omission renders affirmative statements made misleading." *Id.* at 892.

Moab Partners, L.P. (Moab) filed a securities fraud class action against Macquarie Infrastructure Corporation (Macquarie), which owns businesses that operate liquid storage terminals. Moab alleged that Macquarie made material misrepresentations and omissions under Section 10(b) and Rule 10b-5 because it did not disclose, as required under Item 303, the potential impact of new international regulations that effectively banned high sulfur fuels, including the company's largest storage product. The trial court dismissed the claims, but the Second Circuit reversed.

The Court examined the plain meaning of Rule 10b-5 and held that "[l]ogically and by its plain text, the Rule requires identifying affirmative assertions (i.e., 'statements made') before determining if other facts are needed to make those statements 'not misleading.'" *Id.* at 890. The Court contrasted Section 11(a) of the Securities Act of 1933, which imposes liability for pure omissions by explicitly prohibiting any registration statement that "omit[s] to state a material fact required to be stated therein," from Section 10(b) and Rule 10b-5(b) which contain no similar language.

The Court rejected Moab's argument that without private liability for pure omissions under Rule 10b–5(b), there will be "broad immunity any time an issuer fraudulently omits information Congress and the SEC require it to disclose" because (1) "private parties remain free to bring claims

based on Item 303 violations that create misleading half-truths" and (2) "the SEC retains authority to prosecute violations of its own regulations." *Id.* at 892.

B. Fifth Circuit

1. *National Assoc. of Private Fund Mgrs. v. SEC*, 103 F.4th 1097 (5th Cir. 2024).

In August 2023, the SEC voted 3-2 to adopt a final set of rules ("Rules") under the Investment Advisers Act of 1940 (the "IAA") that would have significantly expanded compliance requirements for advisers of private equity funds and real estate funds. *Private Fund Advisors: Documentation of Registered Investment Adviser Compliance Reviews*, 88 Fed. Reg. 63206 (Aug. 23, 2023).[2] Before the Rules went into effect, several industry groups ("Private Fund Managers") challenged the SEC's statutory authority to promulgate the rules. They filed their challenge in the Fifth Circuit as authorized by the IAA. After extensive briefing, including amicus briefs from numerous industry groups, the Court upheld the challenge to the SEC's authority and vacated the Rules.

The SEC argued that it was authorized to promulgate the Rules under § 211(h) and § 206(4) of the IAA, and that § 913 of the Dodd-Frank Act expanded that authority "by authorizing the Commission to issue rules 'for the protection of investors' concerning certain disclosures, sales practices, conflicts of interest, and compensation schemes." *Id.* at 1109.

The Private Fund Managers argued the SEC exceeded its statutory authority under the IAA and Dodd-Frank did not expand it. Congress drew a "sharp line" between private funds and funds that serve retail customers in the Investment Company Act ("ICA") and its sister statute, the IAA, both of which were simultaneously enacted in 1940 as Title I and Title II of the same legislation. The Dodd-Frank Act did not expand the SEC's rulemaking power and only provided for limited regulation of advisers to private funds in the context of their duties as an investment adviser. *Id.* at 1109-10.

Section 211(h)

The Court acknowledged that § 211(h) "seemingly grants" the Commission the power to 'facilitate the provision of simple and clear disclosures to [all] investors … including any material conflicts of interest" and "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes" for any investment advisers that the Commission deems contrary to "the protection of investors." *Id.* at 1110 (quoting statute). But it noted the IAA was a "sister statute" to the ICA and had to be read in context of the overall statutory scheme. *Id.* at 1111. Under the ICA, Congress chose not to impose the same prescriptive framework on private funds owned by "qualified purchasers" and left them free to negotiate their own fund agreements, access to periodic financial reports, and internal governance structures. *Id.*

[2] Among other things, the Rules would have required private fund advisers to provide investors with quarterly statements detailing information regarding private fund performance, fees, and expenses; obtain an annual audit for each private fund; and obtain a fairness opinion or valuation opinion in connection with an adviser-led secondary transaction. The Rules also would have prohibited advisers from engaging in certain activities and practices unless they provided certain disclosures to investors, and in some cases, received investor consent; and would have prohibited providing certain types of preferential treatment that have a material negative effect on other investors and prohibit other types of preferential treatment unless disclosed to current and prospective investors.

Further, the section of the Dodd-Frank Act relied upon by the SEC only applies to retail customers, not private fund investors. And the section that applies to private fund advisers only imposes limited reporting and recordkeeping requirements on some advisers – not the broadscale provisions recently adopted by the SEC. *Id.* at 1112. The Court agreed with the Private Fund Managers' interpretation and concluded that "section 211(h) applies to 'retail customers,' and thus, the Commission exceeded its statutory authority in relying on that section to adopt the Final Rule." *Id.*

Section 206(4)

Section 206(4) authorizes the SEC to "define, and prescribe means reasonably designed to prevent … fraudulent, deceptive, or manipulative" acts regarding any investment adviser. 15 U.S.C. §80b-6(4). The SEC claimed this provision gave it the authority to adopt new rules governing private fund managers.

The Court disagreed, calling the "anti-fraud" measure in the Rules pretextual. *Id.* at 1113. The SEC failed to explain how the Rules would prevent fraud, and Section 206(4) failed to authorize the SEC to impose disclosure and reporting requirements. Moreover, the Court claimed the Rule lacks a "close nexus" because it "conflates a 'lack of disclosure' with 'fraud' or 'deception,' but a failure to disclose 'cannot be deceptive' without a 'duty to disclose.'" *Id.* at 1114.

While the merits of this decision will likely be hashed out in further appeals or future attempts to regulate private funds, it is notable that the Court repeatedly quotes the Rules to emphasize the number and size of private funds that would have been subject to the new Rules and the potential costs of compliance:

- "Private funds are pooled investment vehicles that are (as implied) private, not part of the public securities market. … There are many types of private funds, including private-equity funds, hedge funds, private credit funds, real estate funds, venture-capital funds, and collateralized loan obligations." *Id.* at 1101.

- "Over the past decade, the number of private funds has increased from 32,717 to 100,947, and the value has grown from $9.8 trillion in 2012 to $26.6 trillion in 2022. Amongst pension funds, the median allocation to private equity has risen from less than 1 percent in 2001 to approximately 9 percent in 2020. And over the past 20 years, pension funds have earned returns of 9.25% per year in private equity, as opposed to only 5.4% per year in the public markets." *Id.* at 1102."

- [C]ompliance costs associated with preparation and distribution of quarterly statements … will include an aggregate internal cost of $339,493,120 and an aggregate annual external cost of $148,229,760, or a total cost of $487,722,880…. The Commission also estimated that 'the total costs of making the required disclosures pursuant to the rule prohibiting preferential treatment without disclosure will impose an aggregate annual internal cost of $364,386,264.48 and an aggregate annual external cost of $41,475,520 for a total cost of $405,861,784.48 annually. "[T]he estimated total auditing fee for all advisers to private funds" including internal time is about $3,948,214,720." *Id.* at 1108 n.8.

2. *Cory v. Stewart*, 103 F.4th 1067, (5th Cir. 2024).

In a case of first impression involving loss causation in the private-market context, the Fifth Circuit required a plaintiff to show that a misstatement was a substantial factor in causing at least some portion of the plaintiff's actual economic loss by producing evidence that (a) certain misstated risks were responsible for the loss and (b) reasonably distinguishes the impact of those risks from other economic factors.

The Court partially affirmed and partially reversed summary judgment rulings in this litigation arising from a failed business venture. Defendant Atherio, Inc. was a company led by three individual defendants (James Cory, Greg Furst, and Thomas Farb). Atheros's business plan was to roll-up similar companies into a single conglomerate. The first company it acquired was Red River Solutions, LLC, for a price of $6.75 million. Under the terms of the purchase agreement, the Sellers were paid $3.25 million up front with the promise of $3.5 million in cash and stock to follow. Shortly after this initial purchase, Atherio failed to raise additional capital, defaulted on early loans, and failed to pay Sellers the promised additional $3.5 million.

The Sellers sued Atherio and the three individual defendants for fraud under the federal securities laws; the Texas Securities Act (the "TSA"); and Delaware common law. Among other things, the Sellers alleged that defendants misrepresented in the purchase agreement that Thomas Farb was Atherio's CFO because he resigned that position before the deal closed. Over several years of litigation, the district court granted summary judgment to defendants on all the Sellers' claims, and they challenged three of those rulings on appeal.

<u>Extracontractual Fraud Claims Barred by Disclaimer of Reliance Clause</u>

The district court ruled that the Sellers' extracontractual fraud claims were barred by the Disclaimer of Reliance clause in the purchase agreement. That clause stated on behalf of each Seller that (a) he or she was not relying on any representations or warranties by any person or entity, and (b) the representations and warranties in the agreement were the only ones made by Atherio to them. *Id.* at 1073. The Sellers countered that the Disclaimer or Reliance clause was subject to a carve-out provision that revived their right to sue for actual fraud. *Id.* ("nothing contained … in this Agreement shall limit the [Sellers'] right to bring claims for actual fraud ….").

The Court reviewed and evaluated the contractual provisions under Delaware law and noted that Delaware enforces clear disclaimer-of-reliance clauses even if the agreement also has a specific fraud carve-out provision preserving the right to assert fraud claims. "When an agreement has both clauses, the disclaimer of reliance defines 'the contractual universe of information on which a fraud-claim can be based' while the fraud carve-out 'clarifies' the exact fraud remedies the parties intended 'to preserve.'" *Id.* at 1073-74 (citing *ChyronHego Corp. v. Wight*, 2018 WL 3642132 (Del. Ch. July 31, 2018) and *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35, 55 (Del. Ch. 2015)). Applying this rule to the specific language in the purchase agreement, the Court concluded the disclaimer of reliance on extracontractual statements was explicit and clear. Because it was clear, the fraud carve-out provision only clarifies the intent to preserve the Sellers' right to sue for actual intracontractual fraud (i.e., fraudulent statements contained within the four corners of the contract). *Id.* at 1074-75.

Texas Securities Act Claims Barred by Choice-of-Law Clause

The district court ruled the Sellers' TSA claims were barred by the purchase agreement's Delaware choice-of-law clause. In Texas, to access Texas law despite a Delaware choice-of-law clause, the Sellers would have to prove the clause is either (1) unenforceable or (2) inapplicable to the asserted claim. *Id.* at 1076. The Sellers did not make either argument, but instead argued the choice-of-law provision did not require a court to apply Delaware law, just to act like a Delaware court without limiting the claims that could be considered. The Court quickly rejected this novel argument, noting that under the choice-of-law clause, the internal laws of Delaware governed the contract and prohibited use of other states' statutes. *Id.* (citing *Maynard v. PayPal, Inc.*, 2019 WL 3552432 (N.D. Tex. Aug. 5, 2019) ("As a result of the application of Delaware law, plaintiffs cannot maintain claims under the Texas statutes.").

Intracontractual Federal Securities and Delaware Common Law Claims

The district court granted summary judgment to defendants on Sellers' intracontractual federal securities law and Delaware common law claims because plaintiffs failed to satisfy the loss causation element. The Sellers argued there was a genuine dispute about the contractual misstatement that Farb was CFO and whether that misstatement caused at least some of the Seller's damages. Specifically, the Sellers pointed to three emails from Farb in which he (a) identified a ton of work that needed to be done to integrate the companies they were acquiring; (b) talked about potential investors who decided not to invest because Farb was leaving the company; and (c) talked about his ability to put together financial information for the banks that would reduce Atherio's risk of failure.

After discussing the standard of review, the Court turned to the elements for securities fraud, and specifically, what is required to show loss causation. While showing loss causation in the public-market context is fairly clear, few courts have addressed how to show loss causation in a private-market context. As the Court stated:

> In our private-market context, we have a misstatement in the Agreement and a drop in the value of Atherio ownership units. There was no "truth" revealed that affected Atherio's stock price. And, without the subsequent public market drop, we cannot graft our public market loss causation analysis directly onto private market loss causation. Because we have not dealt with loss causation in the private market before, we look to the persuasive Third Circuit case *McCabe v. Ernst & Young, LLP*, for guidance.

Id. at 1080. Ultimately, the Court adopted the Third Circuit test, which requires a plaintiff to show that a misstatement was a substantial factor in causing actual economic loss for the plaintiff. To make this showing, a plaintiff must produce evidence that (a) certain misstated risks are responsible for his loss and (b) reasonably distinguishes the impact of those risks from other economic factors. Importantly, a plaintiff does not have to show loss causation for their entire loss, only some rough proportion of the whole loss. *Id.* at 1080-81.

Applying this private-market test for loss causation to the evidence about Farb's impact as CFO, the majority concluded that the three emails show that if Farb had been CFO as promised (1) Atherio would have been better positioned to fundraise – including having two more investors – and (2) its management would have been better prepared to execute Atherio's strategic plan. And, if

Atherio had more capital and better preparation, it is "not implausible" that it would have been less of a failure, reducing the Sellers' loss. *Id.* at 1082. Accordingly, the Court affirmed two of the district court's summary judgment rulings but reversed the third and remanded the federal securities and Delaware law claims for further proceedings.

Chief Judge Richman agreed with the majority's ruling on the first two issues but issued a dissenting opinion about the appropriate inference to be drawn from the email about potential investors. The majority opinion inferred that the two investors chose not to invest in the Company because Farb was leaving and noted that defendants had offered no evidence to suggest the two individuals did invest. The dissent argued (1) the majority's inference that they would have invested went too far and (2) it was improper to expect defendants to come forward with evidence on this point.

3. *Georgia Firefighters' Pension Fund v. Anadarko Petro. Corp.*, 99 F.4th 770 (5th Cir. 2024).

The Fifth Circuit vacated the district court's class certification order on procedural grounds in this putative class action arising out of Anadarko's alleged misrepresentations about the value of its Shenandoah oil field project.[3] The Court held that the district court (1) abused its discretion by denying defendant leave to file a sur-reply to respond to new key evidence in a rebuttal report, and (2) failed to perform the required *Daubert* analysis with respect to plaintiffs' expert rebuttal report.

Trial Court Proceedings

Plaintiffs alleged that Anadarko's stock price declined on May 3, 2017 as a result of its May 2nd disclosure that (1) a certain sidetrack well in its Shenandoah oil field project was dry, (2) it was taking a $902 million write-off on the project, and (3) it was suspending further appraisals related to the project. During class certification proceedings, plaintiffs presented new evidence in a reply brief. The district court denied defendant leave to file a sur-reply.

In their motion to certify the class, plaintiffs invoked the *Basic* presumption to show reliance on defendant's misrepresentations. *See Basic Inc. v. Levinson*, 485 U.S. 224, 247, 108 S. Ct. 978, 99 L.Ed.2d 194 (1988). Under *Basic,* plaintiffs were required to prove "(1) that the alleged misrepresentation was publicly known; (2) that it was material; (3) that the stock traded in an efficient market; and (4) that the plaintiff traded the stock between the time the misrepresentation was made and when the truth was revealed." *Id.* at 773 (citing *Goldman Sachs Grp., Inc. v. Ark. Tchr. Ret. Sys.*, 594 U.S. 113, 118, (2021)).

To demonstrate market efficiency, plaintiffs submitted an expert report on that issue. In response, defendants tried to rebut the *Basic* presumption by showing that the May 2nd disclosure regarding the Shenandoah project did not cause the May 3rd stock price decline. Defendants contended that the May 3rd stock price decline was actually caused by news linking Anadarko to a fatal Colorado home explosion and resulting regulatory requirements expected to cost the company approximately $140 million.

[3] For details about prior rulings in this securities litigation, see FH 1Q21 Newsletter, at 4 (denial of motion to dismiss) and FH 4Q22 Newsletter, at 5 (class certification).

Plaintiffs filed a reply brief and attached a rebuttal report from their expert. The rebuttal report included: (1) evidence that Anadarko's stock price fell 4.1% in after-market trading on May 2nd following the Shenandoah disclosure at 4:16 p.m. – more than 30 minutes before publication of a news article about the Colorado announcement at 4:51 p.m.; and (2) a new event study that controlled for the Colorado news but still found a statistically significant price decline associated with Anadarko's Shenandoah disclosure.

Defendants requested leave to file a sur-reply so they could challenge the new evidence in plaintiffs' reply brief, arguing specifically that (1) the Colorado news became public at 4:03 p.m. (not 4:51 p.m. as plaintiff's expert claimed), (2) there was no evidence that the after-hours market was efficient, and (3) there was no evidence that the stock movement identified by plaintiff's expert was statistically significant. But the district court denied leave on the basis that defendants "chose not to provide an event study," and plaintiffs' reply did not introduce new arguments or evidence. Further, the district court denied defendants' motion to exclude the rebuttal report of plaintiffs' expert under *Daubert* and certified the class, citing the rebuttal report in its class certification order. The district court denied defendants' motion for reconsideration.

Fifth Circuit Opinion

On appeal, the defendants argued the district court abused its discretion by relying on new evidence in plaintiffs' reply without allowing them an opportunity to respond; the district court failed to conduct a proper *Daubert* analysis; and the defendants sufficiently rebutted the *Basic* presumption.

The Fifth Circuit agreed with the defendants that the district court should have allowed them to file a sur-reply. The Court noted that when a party raises new arguments or evidence for the first time in a reply, the district court must either give the other party an opportunity to respond or decline to rely on the new arguments and evidence.[4] Here, plaintiffs' reply brief presented new evidence – evidence of the May 2nd after-hours trading and the new event study – which the district court considered and cited in its certification order. The Court determined that this evidence was "key new evidence directly related to the central class certification dispute" over the cause of defendant's stock price decline. Therefore, the Court held that the district court abused its discretion by not allowing defendants to file a sur-reply.

The Court also agreed with the defendants that the district court failed to perform a full *Daubert* analysis with respect to plaintiffs' expert's rebuttal report. Defendant argued that the rebuttal report was unreliable and that the district court failed to conduct a rigorous *Daubert* analysis because it considered the *Daubert* challenge an attempt to re-urge defendant's denied motion for leave to file a sur-reply. The Court noted that *Daubert* applies with the same rigor at the class certification stage as at trial. *Id.* at 774 (citing *Prantil v. Arkema Inc.*, 986 F.3d 570, 575 (5th Cir. 2021)). Further, the Court determined that it was not clear from the record that the district court applied *Daubert's* reliability standard with full force and, thus, defendant's *Daubert* challenge should be fully considered on remand.

[4] *See Residents of Gordon Plaza, Inc. v. Cantrell*, 25 F.4th 288, 296 (5th Cir. 2022); *see also RedHawk Holdings Corp. v. Schreiber*, 836 F. App'x 232, 235 (5th Cir. 2020).

4. *Oklahoma Firefighters Pension and Retirement Sys. v. Six Flags Entertainment Corp.*, 2024 WL 1674125 (5th Cir. 2024) (not designated for publication).

In the latest appeal of this putative securities fraud class action,[5] the Fifth Circuit reversed the district court's order granting judgment on the pleadings to defendants. The Court ruled that the district court misread its prior appellate opinion, improperly concluded that the lead plaintiff lacked standing, and abused its discretion by denying a putative class member's motion to intervene and denying the lead plaintiff leave to file an amended complaint.

Factual and Procedural Background

Six Flags entered into a partnership with Riverside Investment Group, a Chinese real estate developer, to develop 11 Six-Flags branded theme parks in China that were scheduled to open between 2019 and 2021. Six Flags projected that the parks would contribute at least $60 million to its annual EBITDA. Throughout 2018, Six Flags maintained publicly that the parks were "progressing nicely towards their anticipated opening dates." On April and July 2018 earnings calls, the CEO cautioned that international deals sometimes take a long time, and that international contribution has been "lumpy historically, and what makes it lumpy is opening dates," but the parks' openings remained on-time.

In 2019, Six Flags began speaking more cautiously about the parks but continued to assure investors there was "ongoing building" and "no delays" of the opening timelines. In February 2019, Six Flags admitted that due to "macroeconomic events" affecting Riverside's ability to finance the parks, the openings would be delayed 6-12 months. In connection with the 2018 year-end audit, Six Flags disclosed a negative revenue adjustment of $15 million for the fourth quarter of 2018. As a result, Six Flags failed to reach its target EBITDA of $600 million for fiscal year 2018 and the officer Defendants failed to earn equity bonuses tied to the EBITDA target. Despite this setback, Six Flags continued to state throughout 2019 that (1) construction was "progressing," and (2) Riverside continued to pay and was "fully committed to developing and opening these parks," and denied any material change in the opening timelines. However, by October 2019, Six Flags had changed its tune on the timing of park openings and cautioned that it was unrealistic to think the timelines would hold.

In January 2020, Six Flags disclosed that Riverside had defaulted on its payment obligations. One month later, Six Flags terminated its agreements with Riverside. It also disclosed an expected negative $1 million revenue adjustment and aggregate one-time charges of approximately $10 million.

The district court initially dismissed the action for failure to adequately plead that Six Flags made material misstatements, which were grouped into four categories: (1) continuously representing that the parks' opening dates remained on track; (2) representing that construction on the parks continued to progress; (3) assuring investors that Riverside had the necessary finding and financial ability to complete construction and meet its contractual obligations; and (4) improperly recognizing revenue for the parks under GAAP. On appeal, the Fifth Circuit reversed and reinstated the majority of the plaintiff's claims. The Court separated the claims into statements made prior to October 2019

[5] The Fifth Circuit previously reversed the dismissal of this action because the district court overly discounted the allegations of a confidential witness with a "unique and significant title" and "convincing detail" about the alleged fraud. *See* FH Newsletter 1Q23, at 2-6.

and statements made after that date, holding that "the statements before October 2019 satisfy the pleading standard, but, because Defendants had adequately tempered their optimistic language by October, the later allegations do not." *Id.* at *2 (quoting *Oklahoma I*, 58 F.4th at 218). In this prior opinion, the Fifth Circuit held that the October 22 and 23, 2019 alleged misstatements and/or omissions were not actionable as a matter of law. *Id.*

On remand, the plaintiff filed a motion for leave to file an amended complaint, substituting the lead plaintiff with another shareholder, Key West. Plaintiff sought to make this substitution because the lead plaintiff purchased Six Flags' stock *after* the October 23, 2019 corrective disclosure, making it potentially difficult for the lead plaintiff to argue that it was injured by pre-October 2019 statements. By contrast, the proposed new plaintiff, Key West, purchased Six Flags' stock prior to any alleged disclosure of the fraud.

In response to the lead plaintiff's motion for leave to amend, the defendants moved for judgment on the pleadings, arguing that the lead plaintiff was not injured and lacked standing so the case should be dismissed. The district court granted the defendants' motion and denied a subsequent motion by Key West to intervene, as well as the lead plaintiff's motion for leave to amend. The plaintiffs appealed.

Fifth Circuit Analysis

With respect to the judgment on the pleadings, the Fifth Circuit noted that the issue turned on whether it held in *Oklahoma I* that the alleged fraud was fully disclosed by October 2019. If so, then the lead plaintiff would have no standing because its injury was not "fairly traceable" to the alleged misstatements. *Id.* at *3 (citing *Amgen Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455, 472 (2013) (explaining that "a plaintiff whose relevant transactions were not executed between the time the misrepresentation was made and the time the truth was revealed cannot be said to have indirectly relied on the misrepresentation through its reliance on the integrity of the market price.")). However, the Court emphasized that its prior opinion did not address whether the fraud was fully disclosed by the October 2019 statements:

> We never held in *Oklahoma I* that the fraud was fully disclosed by October 2019. Instead, we clearly held that Six Flags' October 2019 statements about the parks' opening dates were not actionable because, by October, Six Flags had adequately tempered its optimistic language about the parks' opening dates. The upshot of this holding is that [the lead plaintiff's] injury can relate to other false statements but not to the opening dates misstatements …. But, of course, there [were] a number of other claimed frauds still in play.

Id. at *4. The Court then reviewed various statements in its prior opinion that should have made that distinction clear and criticized the district court for parsing the opinion like a statute when "context and common sense suggested otherwise." *Id.*

With respect to the motion for leave to amend and Key West's motion to intervene, the Court noted that the only ground on which the motion for leave to amend was denied was the lead plaintiff's lack of standing. Accordingly, both motions should have been granted because (1) the lead plaintiff had standing in the case; and (2) Key West was a member of the putative class and a proper party. The

Court remanded the case for the district court to address whether the lead plaintiff had satisfied the requirements to amend. *Id.* at *5.

C. District Courts

1. *Sanford v. Pershing, LLC*, 2024 WL 1748604 (N.D. Tex. Apr. 23, 2024) (Godbey, J.).

The case arises out of R. Allen Stanford's infamous Ponzi scheme. The scheme entailed the sale of fraudulent certificates of deposit through an offshore bank located in Antigua. Although Stanford represented to investors that the CD proceeds were invested only in low-risk, high-return funds, they were in fact funneled into speculative real estate investments and used to fund Allen Stanford's extravagant lifestyle. On February 17, 2009, the SEC issued a report charging Stanford and his entities with fraud.

The plaintiff purchased two CDs through a Stanford entity in 2005 and 2007, totaling $15 million. He lost his investment when the scheme was exposed. Defendant Pershing served as clearing broker for Stanford's Houston-based broker-dealer. The plaintiff alleged that Pershing provided material assistance to Stanford's scheme and asserted claims against Pershing for breach of fiduciary duty and common-law fraud. The complaint was filed on October 30, 2015. The Court had previously denied Pershing's motion to dismiss on statute of limitations grounds. Pershing re-asserted the same arguments in a motion for summary judgment, in addition to other arguments.

Statute of Limitations. The Court applied New Jersey law which imposes a six-year statute of limitations for both fraud and participation in breach of fiduciary duty claims. New Jersey also applies an equitable "discovery rule," which tolls the accrual date of a claim where the injured party either does not know of his injury or does not know that a third party is responsible for his injury. When it applies, the discovery rule delays accrual of the action until the plaintiff discovers, or by exercise of reasonable due diligence and intelligence should have discovered, facts which form the basis of a cause of action.

Pershing argued that Sanford became aware of his injury when the SEC filed its claims against Allen Stanford in February 2009, and that the plaintiff's suit filed in October 2015 was 8 months late. Pershing argued that its relationship with Stanford's entities was widely publicized shortly thereafter, and that other plaintiffs filed suit only two months after the SEC claims were filed in 2009. *Id.* at *3. The plaintiff maintained that he was not on notice that he was injured by Pershing until the filing of the Turk class action complaint in November 2009.

The Court concluded that "reasonable minds could differ as to when [the plaintiff] discovered, or should have discovered, his injury, the Court cannot say as a matter of law that limitations began to run in February 2009," and denied summary judgment.

Indirect Fraud Claim. Pershing's MSJ on Sanford's common law "indirect fraud" claim also failed. Pershing made two arguments. The first was that the claim was an impermissible "holder" action – one in which the plaintiffs allege that a material misrepresentation or omission caused them to retain ownership of securities that the acquired prior to the alleged wrongdoing (i.e., there was no purchase or sale). "Holder" claims are barred in the context of federal securities law by *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755, 738, n. 9 (1975). However, the U.S. Supreme Court did

not extend that holding to state common law claims. Noting that no New Jersey court had ruled on the viability of holder claims in the context of common law fraud, the Court declined to extend *Blue Chip Stamps* to New Jersey common law fraud claims. Id. at *4. Pershing also argued there was no evidence that it had made any actionable misrepresentations and that evidence of several other elements of fraud was lacking. Relying on testimony, the Court found that a genuine issue of material fact existed as to all elements of the fraud claim and denied the motion. *Id.* at *6-9.

Breach of Fiduciary Duty. Finally, the Court denied summary judgment on Sanford's participation in breach of fiduciary duty claim. The Court again found genuine issues of material fact as to the elements of the claim. In particular, the Court found that "a reasonable juror could find that Pershing derived benefit from Stanford's wrongdoing and, at a minimum, possessed a general awareness that it was participating in overall activity that was improper, based on Pershing's support for Stanford despite Stanford's suspicious business model." *Id.* at *10, internal marks omitted. The Court also found evidence that Pershing's services to Stanford were "more than ministerial or routine." *Id.*

The overall tenor of the opinion shows a rejection of law-based defenses to the fraud claims. In effect, the Court held that Pershing will have to settle or prove to a jury that it was not at fault for Sanford's losses based on the facts of the case.

2. *American Gen. Life Ins. Co. v. Pareto Secs., Inc.*, 2024 WL 2963796 (S.D. Tex. Jun. 12, 2024) (Rosenthal, J.).

Judge Rosenthal addressed motions to dismiss Texas Securities Act ("TSA") claims filed against the sellers of $75 million in notes that went into default. In January 2019, Plaintiffs American General Life and Variable Annuity Life invested $75 million in notes issued by GTW, a company that was expected to have a substantial increase in revenues once it took over stevedoring operations at a particular port. Plaintiffs bought the notes from (1) Pareto AS, a global investment bank based in Norway, and (2) Pareto Inc., the bank's U.S. subsidiary with offices in Houston. While Pareto told the insurance companies about GTW's new stevedoring contract, it allegedly failed to disclose before they invested that GTW had repudiated the contract. When GTW defaulted on the notes in November 2019, the insurance companies sued the Pareto entities for fraud as "sellers" under the TSA.

Lack of Personal Jurisdiction. Pareto AS moved to dismiss for lack of personal jurisdiction because it was based in Norway and did not do any business in Texas. Plaintiffs argued there was specific personal jurisdiction based on a "control person liability" theory. The Court ruled, however, that Plaintiffs made only conclusory allegations about Pareto AS, namely that: (1) it directly controlled and owned 100% of Pareto Inc.; and (2) it controlled the manner, means, and details of the placement of the notes. The Court ruled these allegations were insufficient to allege that Pareto AS had actual power or control over Pareto Inc. relating to the alleged misrepresentations at issue.

Failure to State a Claim. Pareto Inc. moved to dismiss because the fraud claims were barred by the three-year statute of limitations applicable to TSA. Under the Act, plaintiffs must commence an action within three years of the date they "knew, or should have learned through reasonable diligence, of the alleged fraud." *Id.* at *4 (citing TEX. GOV'T CODE § 4008.062(b)).

Defendants cited several facts to support their argument that plaintiffs' claims were time barred, including the following:

1. Defendants argued the dispute between GTW and another stevedoring company that led to repudiation of the contract was contained in publicly available court documents as early as 2019. Plaintiffs responded they had no affirmative obligation to search court records when the parties entered into a purchase agreement. The Court agreed with plaintiffs on this issue. *Id.* at *5 (citing *Khoury v. Tomlinson*, 518 S.W.3d 568, 582 (Tex. App. – Houston [1st Dist.] 2017, no pet.) ("A purchaser of a security has no duty of due diligence to verify the veracity of a seller's claims.").

2. Defendants argued that GTW sent the plaintiffs a letter in November 2019 stating it was defaulting on its debt service ratio covenants. Defendants argued this letter put plaintiffs on constructive notice of the fraud, imposed a duty of diligent inquiry on the plaintiffs, or constituted a "storm warning" that would have incited a reasonable person to investigate. Plaintiffs argued the letter was not a storm warning and that what constitutes "reasonable diligence to discover fraud is a question of fact for the jury."

Ultimately, the Court denied Pareto's motion to dismiss, ruling that "the present record is inadequate to rule on the statute of limitations issue. This ruling does not foreclose Pareto from reurging limitations on the basis of a fuller record." *Id.* at *5.

3. *Forte Biosciences, Inc. v. Camac Fund, LP*, 2024 WL 2946584 (N.D. Tex. Jun. 11, 2024) (Godbey, J.).

In a short memorandum opinion, Judge Godbey dismissed federal securities claims that were filed as part of a battle for corporate control of Forte Biosciences, Inc. The drug company was testing its flagship product and received unfavorable clinical results. When Forte pivoted to a new, untested product, its stock price dropped and an activist hedge fund (Camac Fund, LP) initiated a proxy contest for board seats. Forte issued new stock to friendly parties to ensure that its slate of directors won. Camac sued Forte and its directors in Delaware Chancery Court for breach of fiduciary duty (entrenchment). While that action remains pending, Forte filed this separate action in Texas against Camac and many others.

Forte alleged that defendants violated the federal securities laws by (1) making misleading proxy statements in violation of Exchange Act § 14(a) and Rule 14a-9; (2) failing to disclose they were acting as a "group" as required by Exchange Act § 13(d); and (3) improperly earning "short swing" profits in violation of Exchange Act §16(b). Forte also alleged defendants were tortiously interfering with prospective business relations in violation of Texas state law. Defendants moved to dismiss all claims for lack of standing and mootness, and the Court agreed.

No standing for issuer to bring proxy claim. While shareholders have a private right of action under § 14(a), the Fifth Circuit has ruled that only shareholders with voting rights have standing to pursue § 14(a) claims. *7547 Corp. v. Parker & Parsley Dev. Partners, L.P.*, 38 F.3d 211, 229-30 (5th Cir. 1994). Applying this same logic, the Court ruled that issuers like Forte have no standing to bring § 14(a) claims. *Forte*, 2024 WL 2946584, at *2 (citing *Ashford Hosp. Prime Inc. v. Sessa Cap. (Master) LP*, 2017 WL 2955366, at *9 (N.D. Tex. 2017)).

Forte has standing to bring § 13(d) claims, but they are moot. Defendants argued that Forte lacked standing to sue under § 13(d). The Court agreed with respect to damages claims, but it held that Forte had standing to pursue claims for declaratory and injunctive relief. Even though Forte had standing to assert claims for declaratory or injunctive relief, the Court concluded that defendants mooted any claim based on the allegation they were acting as a "group" by "disclosing Forte's contentions while continuing to dispute them." *Id.* at *3 (citing *Taro Pharm. Indus., Ltd. v. Sun Pharm. Indus., Ltd.*, 2010 WL 2835548, at *16 (S.D.N.Y. July 13, 2010) (tender offeror should not be placed in position to admit liability it disputes or violate the securities laws by failing to disclose the alleged, disputed violation)).

No standing to pursue § 16(b) claim. The Court ruled that Forte lacked standing to pursue a claim to recoup short-swing profits under § 16(b) because the company did not plead any concrete injury caused by the statutory violation. *Id.* Relying on the *Packer* decision from EDNY, the Court held Forte lacked constitutional standing to pursue a §16(b) claim because the company failed to allege a concrete injury as required by *TransUnion LLC v. Ramirez*, 594 U.S. 413, 434-35 (2021). *Id.* at *3 (citing *Packer on behalf of 1-800-Flowers.com, Inc. v. Raging Capital Mgmt., LLC*, 661 F.Supp.3d 3, 9-18 (E.D.N.Y. 2023)).

The Court's ruling in Texas is not likely to be appealed since the parties are focused on the corporate control litigation in Delaware. However, its ruling about constitutional standing in § 16(b) cases is subject to challenge. Three weeks after *Forte* was decided, the Second Circuit reversed the EDNY decision on which the court relied. *See Packer on behalf of 1-800-Flowers.com, Inc. v. Raging Capital Mgmt., LLC*, 2024 WL 3092561 (2d Cir. June 24, 2024). In rejecting the district court's analysis that claims under § 16(b) require proof of concrete injury, the Second Circuit noted that an intangible injury can be sufficiently concrete to confer constitutional standing under *TransUnion* if there is a close historical or common-law analogue for the asserted injury. *Id.* at *3-4. For claims under §16(b), the Second Circuit stated the historical analogue is a claim for breach of fiduciary duty. Section 16(b) imposes a fiduciary duty on 10% beneficial owners, gives issuers the legal right to expect the fiduciary not to engage in short-swing trading, and compensates issuers for the violation of that right by allowing them to claim any profits realized from short-swing trades. *Id.* at *4.

4. *Chun v. Fluor Corp.*, 2024 WL 2402083 (N.D. Tex. May 23, 2024) (Starr, J.).

In this case addressing attorneys' fees in a settled securities class action, Judge Brantley Starr awarded only the lodestar amount (reasonable hours x reasonable rates) without applying any multiplier. The Court followed the familiar two-step process for analyzing such awards, but the bulk of the opinion is an attack on the subjective and "hopelessly amorphous" *Johnson* factors; the use of multipliers in common-fund settlement cases; and the Fifth Circuit's failure to conform its attorney fee jurisprudence after *Perdue v. Kenny A. ex. rel. Winn*, 559 U.S. 542 (2010).

The underlying securities class action was settled for $33 million, part of which was to pay attorneys' fees (i.e., a common-fund settlement). Plaintiffs' counsel asked the Court to award them $9.9 million based on $5.2 million (lodestar amount) and a 1.9 multiplier on those fees, or approximately 30% of the total settlement amount. The Court was apparently offended by the request for an additional 90% in fees "for work [the lawyers] didn't perform" and compared it to a lawyer

shaking his client by the ankles to see what money falls out. The Court asked the Lead Plaintiffs for additional briefing on Supreme Court and Fifth Circuit precedent for the proposed attorney fee award and requested contemporaneous billing records from the four plaintiffs' firms seeking attorney fees. After reviewing the lodestar amount and considering the twelve *Johnson* factors, the Court determined that an award of $5.2 million (the lodestar amount) was appropriate.

The opinion traces the legal background for court approval of attorney fee awards, noting that fees are typically awarded in two very different contexts: (1) pursuant to fee-shifting statutes, or (2) as part of a common-fund settlement. In fee-shifting cases, a fee award comes out of the pocket of the defendant in addition to any settlement or judgment amount. By contrast, in common-fund settlements, a fee award comes out of the total settlement fund, thereby reducing monies available to the class members. The opinion questions why lawyers for class members would ever seek a multiplier in a common-fund settlement when it would reduce the recovery by their clients.

The opinion discusses the *Johnson* factors, noting they were developed by the Fifth Circuit in a fee-shifting case but later applied to both fee-shifting and common-fund settlement cases. They are "subjective factors" that have been criticized for giving "very little guidance to district courts," placing "unlimited discretion in trial judges," and "produc[ing] disparate results." *Id.* at *3 (quoting *Pennsylvania v. Del. Valley Citizens' Council for Clean Air* , 478 U.S. 546, 561-62 (1986)). By contrast, the lodestar approach developed by the Third Circuit is "objective, and thus cabins the discretion of trial judges, permits meaningful judicial review, and produces reasonably predictable results." *Id.* at *4 (quoting *Perdue*, 559 U.S. at 552).

The Court stated that despite the Supreme Court's criticism of the *Johnson* factors and its support for the lodestar approach, the Fifth Circuit continues to require district courts to apply the *Johnson* factors in common-fund cases. While district courts may do a baseline calculation of fees using the percentage method or the lodestar method, they must still consider an adjustment using the *Johnson* factors. *Id.* at *4. The opinion suggests this is not necessary: "A faulty yardstick is faulty, regardless of what it's aiming to measure. Layering *Johnson* over the lodestar adds nothing to the analysis that can justify the instability it inevitably introduces." *Id.* at *6 (citing *Perdue*, 559 U.S. at 557).

5. *SEC v. Balina*, 2024 WL 2332965 (W.D. Tex. May 22, 2024) (Ezra, J.).

The SEC asserted claims against a foreign cryptocurrency seller and "influencer," Ian Balina The SEC and defendants both filed motions for summary judgment seeking to establish or negate jurisdiction. Judge Ezra partially granted the SEC's motion for summary judgment and fully denied defendant Ian Balina's motion for summary judgment. The Court ruled as a matter of law that the SEC had jurisdiction in this action against a cryptocurrency seller and "influencer." The Court held that the *Morrison* test applies to determine whether "sales" under Section 10 of the Exchange Act occurred domestically, but it does not apply to claims under Section 5 and Section 17 of the Securities Act. For these claims, the Court applied a broader jurisdictional test focused on which investors were targeted and where they were located to determine whether "offers" were made in the United States.

Factual Background[6]

The SEC alleged that Sparkster, Ltd. ("Sparkster"), a software development company located in the Cayman Islands, conducted an unregistered securities offering of cryptocurrency asset securities called SPRK Tokens. The offering raised approximately $30 million from 4,000 investors located abroad and in the U.S. In a separate case, the SEC required Sparkster to set up a fund to compensate victims of the registration violations, in addition to other remedies. *Id.* at *1. In this action, the SEC alleged that the defendant Balina, a cryptocurrency investor and "influencer," signed a contract to invest $5 million in the Sparkster offering and sold, offered, and promoted SPRK Tokens without disclosing his compensation by Sparkster, thereby violating Sections 5(a), 5(c) and 17(b) of the Securities Act. *Id.*

As an influencer, Balina operated a Patreon account, which is a paid subscription platform. On that platform, Balina stated that he had invented a methodology for evaluating and grading Initial Coin Offerings ("ICO's") using data and prior successes. Subscribers who paid a fee were then allowed to see his deal flow and his preferred ICOs before he shared them publicly. Balina also gave free advice to followers of his YouTube and Telegram channels. *Id.*

At a 2018 "World Tour" event in Amsterdam, Balina conducted a "Shark Tank" style contest where Sparkster pitched its Tokens and "won" the competition. Afterwards, Balina and Sparkster entered into a contract that would give Balina a 30% bonus for the purchase of a large amount of Tokens in Sparkster's ICO. Balina disputed how many tokens he actually purchased and therefore whether he received that bonus. *Id.* at *2.

On the day the contract was signed, Balina created a pool of followers who invested as a group in SPRK tokens. These followers filled out Google docs indicating their desire to invest, including some who were identifiable as U.S. residents. Based on these facts, the SEC alleged that Balina (1) sold and offered to sell unregistered securities to U.S. residents through his pool offering of SPRK Tokens in violation of Section 5; and (2) violated Section 17 when he agreed to receive a 30% bonus from Sparkster on the Tokens he purchased without disclosing the consideration he received when promoting the Tokens. *Id.* at *3.

Cross Motions for Summary Judgment

Balina moved for summary judgment arguing that (1) the SPRK Tokens are not a security; (2) the promotions and transactions all took place outside the United States; (3) even if they did take place in the U.S., he did not sell the Tokens and did not accept compensation for the promotion of Tokens; and (4) the purported sales and offers to sell are exempt under Section 4(a)(1) of the Securities Act because he was not an issuer, underwriter, or dealer. The SEC sought summary judgment on the grounds that the Tokens are securities and U.S. securities laws apply because Balina targeted U.S. investors on U.S. social media platforms. *Id.* at *5.

[6] For additional background and discussion of Balina's efforts to exclude the testimony of the SEC's expert witnesses, see FH Newsletter 4Q23, at 18-21.

Court's Analysis and Conclusions

Balina first argued that the domestic transactions test set forth in *Morrison vs. National Australia Bank Ltd.* (561 U.S. 247)(2010) forecloses the SEC's ability to exercise jurisdiction because no domestic transaction occurred. The SEC argued the *Morrison* test does not apply because it is limited to fraud claims under Section 10 of the Exchange Act, as opposed to the registration (Section 5) and promotions (Section 17) provisions of the Securities Act. The SEC contended the Court had jurisdiction because Balina used U.S. social media channels to target U.S. investors. Alternatively, the SEC argued that even if the *Morrison* test did apply, there was a genuine issue of material fact about whether Balina's sales were domestic transactions. *Id.* at *5. The Court agreed with the SEC and found that the SEC had jurisdiction to assert the claims under Sections 5 and 17 of the Securities Act.

The Court looked to what "parties and interests" the securities laws sought to protect, noting that the "domestic conduct" must relate to such parties and interests. The Court determined that four of the 24 pool investors were U.S. residents and nine had U.S. IP addresses, emphasizing that Balina used U.S. platforms such as YouTube, Instagram, X, Discord, Telegram and Google to sell Tokens to those investors. The Court found it significant that "the United States is the location of the largest share of investors from a known country," *id.* at *6, and determined that Section 5(e) may apply to Balina's offers and Balina's use of U.S. social media platforms to reach U.S. investors was sufficient to show domestic conduct for purposes of Balina's promotion of securities to U.S. investors. The Court noted that its finding that a domestic transaction occurred under these facts was consistent with public policy: "If Balina could evade the SEC's lawsuit simply because he was located outside the U.S. while promoting crypto investments to U.S. investors on U.S. social media platforms, then others could follow in his footsteps in the future, by temporarily leaving the U.S., to evade U.S. securities regulations while targeting U.S. investors and U.S. financial markets." *Id.* at *8.

With jurisdiction established, the Court engaged in a lengthy factual analysis of the *Howey* test and concluded that the Tokens were an investment contract because they were (1) an investment of money (2) in a common enterprise with (3) an expectation of profits to be derived solely from the efforts of individual other than the investors. *Id.* at *8-10 (analyzing factors under *SEC v. Howey*, 328 U.S. 293 (1946)).

Finally, the Court analyzed whether Balina violated Section 5 and 17 of the Securities Act and quickly concluded that – contrary to Balina's assertion that he was part of the pool of purchasers of the SPRK Tokens – Balina purchased the Tokens for himself and then re-sold them to the investor pool, which satisfied the only contested prong of the Section 5 violation. The Court also found that the same facts showed Balina was an underwriter of SPRK Tokens, purchasing them from Sparkster to immediately sell them to members of his pool. *Id.* at *13. Based on these facts, the Section 4(a)(1) exemption did not apply to his conduct. *Id.*

The Court's conclusion as a matter of law that U.S. securities laws apply to cryptocurrency "influencers" who target U.S. investors is likely to be cited in other cases as courts wrestle with the precise scope of the SEC's jurisdiction over cryptocurrency promotions, offerings, and sales. According to the SEC website, it has filed more than 100 enforcement actions involving cryptocurrency assets in the past ten years. *https://www.sec.gov/securities-topics/crypto-assets*.

6. *Edwards v. McDermott Int'l, Inc.*, 2024 WL 1769325 (S.D. Tex. Apr. 24, 2024) (Edison, M.J.) and 2024 WL 3085177 (S.D. Tex. June 21, 2024) (Hanks, J.).

In our last newsletter, we reported that the Court denied plaintiff's motion to certify a *single class* of purchasers in this long-running securities class action.[7] The Court concluded there was a fundamental conflict between shareholders who owned McDermott stock before the merger with Chicago Bridge & Iron (CB&I), and those who acquired McDermott stock as part of the merger. Accordingly, lead plaintiff Nova Scotia could not represent both of these groups so the Court denied Nova Scotia's motion for certification with prejudice. After conferring with the parties, the magistrate judge issued an Amended M&R that recommended partially granting the motion, letting Nova Scotia serve as lead plaintiff for a class of stockholders who acquired McDermott stock as part of the merger, and considering new applications for lead plaintiff to represent shareholders who owned McDermott stock before the merger. The district court adopted the Amended M&R with minor changes.

II. STATE CASES

A. *Phillip Michael Carter v. State of Texas*, 2024 WL 1403346 (Tex. App. - Dallas Apr. 2, 2024).

In this appeal from a jury trial convicting defendant Carter of securities fraud and sentencing him to 45 years in prison, the Dallas Court of Appeals affirmed the conviction. The defendant created Cash Cow, LLC (later renamed North Forty, LLC) to purchase and develop real estate. Carter and Bob Guess, owner of Texas First Financial, LLC, funded property development with more than $28 million in promissory notes, but none of them were registered as securities and neither Carter nor Guess was licensed to sell securities. Guess was investigated by the Texas State Securities Board for money laundering, mail fraud, loan fraud, and securities fraud, which led to a cease and desist order that limited Carter's access to funding. Carter sought alternative funding but failed to disclose investors that he was the subject of government action and bounced a check for more than $6 million dollars. He was then indicted for securities fraud.

On appeal, Carter raised several issues arguing that the trial court abused its discretion by (1) excluding the testimony of his expert, a forensic accountant and certified fraud examiner; (2) allowing a state witness to offer expert testimony without proper designation; (3) denying jury instructions, including that failure to fulfill a promise is not fraud unless the promiser never intended to fulfill it; and (4) the cumulative effect of these errors requires reversal. The Court addressed each of them in turn but concluded for each that any error was harmless and affirmed the conviction.

N. Scott Fletcher
Kenneth P. Held

[7] FH Newsletter 1Q24, at 11.

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