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Texas Annual Survey: Securities Regulation

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SECURITIES REGULATION

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SECURITIES regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Two major Texas statutes combat securities fraud: the Texas Securities Act (TSA) and what is referred to here as the Texas Stock Fraud Act (TSFA).[1] Although this Article includes Fifth Circuit cases under federal law, the author has attempted to limit the material to that involving state law and has touched federal securities law only when necessary. The author does not intend this Article to exhaust all aspects of securities regulation but rather to update the Texas-based securities practitioner with developments of interest.

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1. *See* TEX. REV. CIV. STAT. ANN. art. 581-1 (Vernon Supp. 2009); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon Supp. 2009). The TSFA is included in a statute that also covers real estate fraud, so many of the cases dealing with TSFA's statutory fraud also deal with real estate. *See id.* § 27.01.

I. REGULATION OF SECURITIES

The basic rule of most securities laws is that the issuer must register the securities with the regulatory agency unless the securities fall within an exemption to registration. The TSA created a regulatory body, the State Securities Board (Board), to handle the registrations required by TSA and to serve as an enforcement mechanism. Enforcement actions generally focus on issuers' failures to register their securities and their misleading statements made to aid the sale.

With respect to securities registration, the Board adopted a new rule that replaced prior securities registration guidelines in nineteen areas with those of the Statements of Policy (SOP) of the North American Securities Administrators Association (NASAA).[2] The change aimed to achieve uniformity with other states participating in the NASAA Coordinated State Review programs, to facilitate nationwide registration for certain issuers,[3] and to insure that those issuers could determine if the SOPs applied to their registrations in Texas. The new rule specifically referred to the SOPs, and issuers could find and obtain copies of the SOPs. The new rule's references to the SOPs also required the Board to repeal those Texas rules that contained the full text of the SOPs to avoid redundancy and its resulting ambiguity.[4]

The Eastland Court of Appeals examined the impact on an issuer's stock option plan of the failure to register underlying securities under either the TSA or the federal Securities Act.[5] In *Key Energy Services, Inc. v. Eustace*,[6] the court considered whether an employee could exercise incentive stock options issued under an employer plan during a black-out period when the registration statement for the underlying stock was ineffective. In the past, some enterprising Texas employees have asserted that they properly exercised their options by providing notice and pay-

2. *See* 33 Tex. Reg. 8704 (2008), *adopted* 34 Tex. Reg. 43 (2009) (codified at 7 TEX. ADMIN. CODE § 113.14) (adopting the new rule without comment).

3. *See* George Lee Flint, Jr., *Securities Regulation*, 62 SMU L. REV. 1435, 1440 (2009) (discussing a recent adoption of the NASAA guidelines for real estate programs).

4. *See* 33 Tex. Reg. 8704 (2008) (proposing the new rule); *see also* 33 Tex. Reg. 8704 (2008), *adopted* 34 Tex. Reg. 43 (2009) (repealing rules 113.14 through 113.25 for registration of securities); 33 Tex. Reg. 8705 (2008), *adopted* 34 Tex. Reg. 44 (2009) (repealing rules 117.1-117.9 containing the administrative guidelines for registration of real estate programs); 33 Tex. Reg. 8706 (2008), *adopted* 34 Tex. Reg. 44 (repealing rules 121.1-121.10 containing the administrative guidelines for oil and gas programs); 33 Tex. Reg. 8707, *adopted* 34 Tex. Reg. 45 (2009) (repealing rules 129.1-129.9 containing the administrative guidelines for registration of asset-backed securities); 33 Tex. Reg. 8707 (2008), *adopted* 34 Tex. Reg. 45 (2009) (repealing rules 133.31-133.32 containing forms concerning real estate guidelines cross reference sheet and real estate investment trusts guidelines cross reference sheet); 33 Tex. Reg. 8708 (2008), *adopted* 34 Tex. Reg. 45 (2009) (repealing rules 141.1-141.8 containing the administrative guidelines for registration of equipment programs); 33 Tex. Reg. 8708 (2008), *adopted* 34 Tex. Reg. 46 (2009) (repealing rules 143.1-143.8 containing the administrative guidelines for registration of real estate investment trusts).

5. Key Energy Servs., Inc. v. Eustace, 290 S.W.3d 332 (Tex. App.—Eastland 2009, no pet.); *see* 15 U.S.C. § 77a (2006); TEX. REV. CIV. STAT. ANN. art. 581-1.

6. 290 S.W.3d at 332. This Article omits the issues on wrongful termination, impossibility of contractual performance, and the impact of fault.

ment during the black-out period and that the employer needed only delay delivery of the stock until after the black-out period.[7] In *Key Energy Services*, the employee, after termination, used the above procedure to exercise his options, but the employer refused to issue the underlying stock even after the expiration of the black-out period. The employee sued in district court for wrongful termination and recovered an amount representing the value of the options. The issuer appealed the options damage award, claiming that the options had expired by their own terms during the black-out period, which rendered them worthless. Prior to the employee's attempted exercise of the options,[8] the issuer had withdrawn the effectiveness of its registration statement for the underlying shares by its failure to file its annual report with the Securities and Exchange Commission (SEC). The issuer had also announced to the employees that it was temporarily suspending the exercise of the incentive stock options as provided in the plan. The issuer's current report on Form 8-K filed with the SEC explained that the withdrawal of effectiveness was caused by a failure to maintain the financial books, some under the control of the suing employee, in accordance with generally accepted accounting principles, which mandated a restatement of past financial statements and delayed the current one.[9] Before the issuer completed the restatement process, the employee's 140,000 options expired along with 1,755,995 other employee options. The incentive stock option plan provided that the exercise would be effective only if the company counsel determined that the issuance and delivery of the underlying stock complied with all applicable laws. The plan also allowed the issuer to delay the effectiveness of any option exercise to allow issuance of the underlying stock to be made pursuant to a registration statement or an exemption from registration. Under the plan the issuer was under no obligation to make effective any registration under federal or state law.[10]

The *Key Energy Services* court presented the securities as whether the employee could exercise his options during the period without an effective registration statement and whether the issuer could delay delivery of the underlying shares until a registration statement was effective. The court misunderstood the prior opinion of the Houston Fourteenth Court of Appeals in *Walden v. Affiliated Computer Services, Inc.*,[11] which allegedly allowed such a procedure, and went to great lengths to distinguish

7. *See* Walden v. Affiliated Computer Servs., Inc., 97 S.W.3d 303 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) (Office of Thrift Supervision order prohibiting issuer from issuing stock); *see also* George Lee Flint, Jr., *Securities Regulation*, 56 SMU L. Rev. 1995, 2005 (2003) (discussing *Walden*).

8. The court assumed the employee satisfied the conditions precedent to the exercise of the options, namely notice and payment. *Key Energy Servs., Inc.*, 290 S.W.3d at 342 n.7.

9. *Id.* at 343; *see generally* Fed. Accounting Standards Advisory Bd., Statements of Federal Financial Accounting Concepts and Standards (June 30, 2009), *available at*, http://www.fasab.gov/pdffiles/codification_report2009.pdf.

10. *Id.* at 335-36, 340-41.

11. 97 S.W.3d 303 (Tex. App.—Houston [14th Dist.] 2003, pet. denied).

that prior opinion.[12] Because the *Walden* court faced a prohibition against only the issuer and not the option holders, the *Key Energy Services* court emphasized the options as securities separate and apart from the underlying stock.[13] The court noted that the Securities Act's definition of a security specifically included an option[14] and that the short-swing profit liability rules under the Exchange Act[15] providing disgorgement of a profit from the sale and purchase of a security by an insider within a six month period[16] included the grant of an option and the exercise of the option (excluded from the short-swing profit rule by SEC regulation).[17] Consequently, the exercise of the options by the option holder would also be subject to the same registration requirement that prevented the issuer from issuing the underlying stock, thus distinguishing the case from the *Walden* situation, where the restriction applied only to the issuer.[18] Despite this misunderstanding, the *Key Energy Services* court did recognize that the employee's exercise of notice and payment, if accepted by the issuer with an agreement to delay delivery of the underlying stock until a registration statement for the stock became effective, would amount to a contract of sale as of the date of acceptance.[19] The Securities Act made it unlawful to sell a security, or enter into a contract to do so, without an effective registration statement or compliance with a

12. The *Key Energy Services* court believed the *Walden* court approved the delayed issuance procedure. *See Key Energy Servs.*, 290 S.W.3d at 343. However, in *Walden*, the black-out period expired before the exercise period (by a few hours) so in that brief post-black-out period the options could be exercised, and the court found the advance notice and payment acceptable for an issuance in that brief post-black-out period. *See Walden*, 97 S.W.3d at 327 (discussing an issuer conceded that it could issue stock options exercisable on Sept. 26, 1997, because the cease and desist order terminated on Sept. 26, 1997, and determining that, under contract language, options were exercisable until 4:30 p.m. on Sept. 26, 1997, beyond the options expiration time of 11:59 p.m. of Sept. 25, 1997, as asserted by issuer. *Cf. In re* Walkup, 122 S.W.3d 215, 217 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (stating that for "effective on day" court orders, day begins at midnight).

13. *Key Energy Servs.*, 290 S.W.3d at 344.

14. *See* 15 U.S.C. § 77b(a)(1) (2006) ("'security' means any . . . option"); *see also id.* § 78c(a)(10) (same for the Exchange Act); *see also* TEX. REV. CIV. STAT. ANN. art. 581-4(E) (Vernon Supp. 2009) (defining "sale" of a security as including options).

15. *See* 15 U.S.C. § 78a (2006).

16. *See id.* § 78p(b) ("[A]ny profit realized by [such beneficial owner, director, or officer] from any purchase and sale . . . within any period of less than six months, . . . shall inure to and be recoverable by the issuer . . . .").

17. *See* 17 C.F.R. § 240.16a-1(b) (West 2009) ("[A] *call equivalent position* shall mean a derivative security position . . . including . . . a long call option . . . ."); *id.* § 240.16a-1(c) ("[*D*]*erivative securities* shall mean any option . . . ."); *id.* § 240.16b-6(a) ("The establishment of . . . a call equivalent position . . . shall be deemed a purchase . . . . "); *id.* § 240.16b-6(b) ("The closing of a derivative security position as a result of its exercise . . . shall be exempt from the operation of section 16(b) . . . .").

18. *See Key Energy Servs.*, 290 S.W.3d at 342. It is doubtful that the sale or disposition of the option as a security to the issuer is of the type of transaction requiring the protection of the securities laws since the information to be disclosed is already in the possession of the issuer. It is also doubtful that the option holder, as an officer of the company, needs the protection of disclosure afforded by the securities laws, but the option holder did not assert that any exemption from registration applied. *See id.* at 342; *see also* 15 U.S.C. § 77b(a)(15) (2006) (defining accredited investor to include officers of the issuer); *id.* § 77d(6) (providing an exemption from registration for accredited investors).

19. *Key Energy Servs.*, 290 S.W.3d at 344.

registration exemption.[20] Because of this, the issuer would violate the securities laws, thereby rejecting the exercise, if it entered into the employee's proposed delayed delivery arrangement.[21] Hence, in *Key Energy Services*, the options expired worthless, and the court reversed the lower court's award of lost options damages.[22]

Key Energy Services and *Walden* should alert employees holding incentive stock options that those options may not be worth as much as they had hoped upon grant. The plan under which the issuer issued the options may provide for periods of non-exercise during which the options could expire unexercised. During such black-out periods, the best that option holders can hope for is to provide proper notice and payment (ideally near the end of the option period to avoid a collapse of the price of the underlying stock) and then hope that the black-out period ceases before the options expire. Employees should also note that the black-out period eradicating their options frequently will be under the control of the issuer such as in *Key Energy Services*, where the issuer controlled preparation of the financial statements.

One of the Board's cease and desist orders became the subject of review by the Austin Court of Appeals. In *Texas State Securities Board v. Miller*,[23] an issuer and its affiliates sold, through seminars, standard investment contracts for ATM machines coupled with lease-backs under which the issuer and its affiliates would manage operations and service the ATM machines with a supposed return of twelve percent. The Board issued an emergency cease and desist order, which was to last until the securities and the selling agents were registered.[24] The issuer and its affiliates challenged the order before the State Office of Administrative Hearings (SOAH). At the hearing, the Board called as a witness its en-

20. *See* 15 U.S.C. § 77b(a)(3) (2006) ("'[S]ell' shall include every contract of sale or disposition of a security . . . for value."); *id.* § 77d ("The provisions of section [15 U.S.C. § 77e] shall not apply to . . . [listing transactions exempt from registration]."); *id.* § 77e(a)(1) ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person . . . to sell such security . . . ."); *see also* TEX. REV. STAT. ANN. art. 581-4(E) (Vernon Supp. 2009) ("The term 'sale' means and includes contracts and agreements whereby securities are sold, traded or exchanged . . . ."); *id.* art. 581-5 ("[T]he provisions of this Act shall not apply to the sale of any security when made in any of the following transactions . . . [listing transactions exempt from registration]."); *id.* art. 581-7A ("No dealer or agent shall sell or offer for sale any securities . . . except those which have been registered . . . .").

21. The *Key Energy Services* court found support for denying the delayed delivery procedure from a Third Circuit case. *Key Energy Servs.*, 290 S.W.3d at 343 (citing *In re* Cendant Corp. Sec. Litig., 181 F. App'x 206 (3d Cir. 2006) (similarly refusing option damages arising during a black-out on the exercise of options due to the necessity to restate financial statements when confronted with the same proposal to delay delivery of the underlying stock)).

22. *Id.* at 342-44.

23. No. 03-06-00365-CV, 2009 WL 1896075 (Tex. App.—Austin July 1, 2009, no pet.) (mem. op.) (J. Jones). The author served with J. Woodfin Jones as a director of the University of Texas Law School's Legal Research Board in 1975.

24. *See In re* Thell G. Pruett dba Fresh Start Funding Group, No. CDO-1538, 2003 WL 22284602 (Tex. St. Sec. Bd. Sept. 22, 2003); *see also* George Lee Flint, Jr., *Securities Regulation*, 57 SMU L. REV. 1207, 1218 n.56 (2004) (suggesting possible unawareness of security status for *Pruett*).

forcement director, a long-time employee who had handled the action against the issuer. The witness testified as to whether the issuer's investment program constituted a security. The appealing affiliates' attorney made no objection to the witness's testifying nor to his actual testimony, although a co-defendant's counsel did. The SOAH confirmed the Board's order, and the Board later finalized it.[25] The appealing affiliates sought judicial review, and the district court reversed the Board's order, concluding that allowing the enforcement director to testify was an abuse of discretion.[26]

The *Miller* court quickly dispatched the abuse of discretion point because the affiliates' attorney had not preserved the error as required by law.[27] The affiliates' attorney then claimed unwaivable fundamental error but could support it only with flimsy ideas. The witness had not violated the Rules of Professional Conduct, which prohibit an advocate before an adjudicative body from testifying before that body but do not prevent the witness's assistance in preparation of the case outside the adjudicative body as occurred in *Miller*.[28] The witness had not testified on a pure question of law because whether an investment is a security is a mixed question of fact and law, and courts allow experts to testify on such mixed questions.[29] The *Miller* court therefore reversed and remanded.[30]

The *Miller* opinion reveals the inadvisability of sending ill-prepared or inexperienced lawyers to handle hearings before the Board. Such lawyers need to be well versed both in securities law and civil litigation procedures.

II. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of state regulation in this area is the requirement to register as a seller of securities before selling securities in the state and as an investment advisor before rendering investment advice.[31]

25. *See In re* Thell G. Pruett dba Fresh Start Funding Group, No. ENF-04-CDO-1572, 2004 WL 2314506 (Tex. St. Sec. Bd. Sept. 22, 2004); *see also* George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. Rev. 1135, 1143 n.39 (2005) (mentioning *Pruett*).

26. *Miller*, 2009 WL 1896075, at *1.

27. *Id.* at *2-3; *see* Tex. Gov't Code Ann. § 2001.081 (Vernon 2007) (stating that in administrative actions, rules of nonjury civil case in district court apply, with a few exceptions); Tex. R. Evid. 103(a) (stating that an error on a ruling excluding evidence cannot be predicated unless timely objection is made stating the specific ground of the objection).

28. Tex. Disciplinary R. Prof'l Conduct 3.08, *reprinted in* Tex. Gov't Code Ann., tit. 2, subtit. G app. A (Vernon Supp. 2009) (Tex. State Bar R. art. X, § 9) (lawyer as witness).

29. *Miller*, 2009 WL 1896075, at *3; *see* Bailey v. State, 155 S.W.3d 346, 351 (Tex. App.—El Paso 2004) (stating that whether a document qualifies as a security depends on facts, so the jury should have heard expert testimony on circumstances of the particular document), *rev'd on other grounds*, 201 S.W.3d 739, 743 (Tex. Crim. App. 2006) (noting that an appellate court cannot reverse on grounds not ruled on by the trial court and not raised on appeal); *see also* U.S. v. Johnson, 700 F.2d 163, 170, 174-75 (5th Cir. 1983) (summarizing that the definition of a security is a question of law and whether a transaction is a security is a question of fact for jury).

30. *Miller*, 2009 WL 1896075, at *2-4.

31. *See* Tex. Rev. Civ. Stat. Ann. art. 581-13 (Vernon Supp. 2009).

Registration infractions generally surface when applying or reapplying for registration.

The Texas Supreme Court achieved the distinction of being one of the first to interpret the recently amended arbitration rule of the Financial Industry Regulation Authority (FINRA). Both Texas law and federal law require registered selling agents to file Form U-4 with the Texas State Securities Commissioner and FINRA, respectively.[32] That form contains an arbitration provision referencing FINRA's rules. In *In re Next Financial Group, Inc.*,[33] the dealer terminated an at-will selling agent for failure to perform required duties in connection with a FINRA audit. The registered selling agent, a regional supervisor, claimed the firing occurred because he refused to conceal a supervised trader's fraudulent churning transactions as requested by the dealer for the FINRA audit after the supervisor reported the fraud to the dealer. The terminated selling agent sued the dealer for wrongful discharge for refusing to commit an illegal act,[34] an action allowed in Texas by judicial precedent.[35] The dealer, lacking any written employment agreement with the selling agent, moved to compel arbitration based on the arbitration provision contained in the selling agent's registration application on Form U-4 to which the dealer was not a signatory. That provision[36] contained an agreement of the registered selling agent to arbitrate any dispute between him and his dealer firm for which the FINRA rules, as amended from time to time, required arbitration. The district court denied the request to arbitrate, and the court of appeals denied the dealer's petition for a writ of mandamus.[37]

The securities issue addressed by the Texas Supreme Court was whether the amended rules of FINRA required arbitration between the supervisor and the dealer for wrongful termination. The Court dispensed with the objection that the third-party beneficiary–dealer could not enforce the arbitration provision contained in the selling agent's Form U-4, noting its own opinion allowing a third-party beneficiary to enforce an arbitration provision and a federal opinion permitting the same for Form U-4.[38] At the time of the selling agent's hiring, FINRA's arbitration rule provided for arbitration of claims "arising out of or in connection with the business of any member . . . or arising out of the employment or

32. *See* 7 Tex. Admin. Code § 115.2(a)(2) (2010); 17 C.F.R. § 240.15b7-1 (2009).

33. 271 S.W.3d 263 (Tex. 2008). This Article omits the issue on the applicability of the Federal Arbitration Act.

34. The illegal acts would have been mail and wire fraud. *See* Brief in Support of Response, *In re Next Fin. Group*, 271 S.W.3d 263, 2008 WL 2364234, at *2; *see also* 18 U.S.C. § 1341 (2006) (stating that mail fraud occurs when a devisor of scheme to defraud places matter in mail to execute the scheme); *id.* § 1343 (stating that wire fraud occurs when a devisor of scheme to defraud transmits communication by wire to execute the scheme).

35. *See* Sabine Pilot Serv., Inc. v. Hauck, 687 S.W.2d 733, 734-35 (Tex. 1985) (identifying an exception to the usual employment-at-will doctrine).

36. *See* Item 5, Section 15A, Rev. Form U4 (05/2009).

37. *In re Next Fin. Group*, 271 S.W.3d at 265-66.

38. *Id.* at 267; *see In re* Palm Harbor Homes, Inc., 195 S.W.3d 672, 677 (Tex. 2006); *In re* Prudential Ins. Co. of Am. Sales Practice Litig., 133 F.3d 225, 230 (3d Cir. 1998).

termination of employment."[39] Before FINRA absorbed the enforcement arm of the New York Stock Exchange,[40] FINRA amended its arbitration rules to provide for arbitration of a claim that "arises out of the business activities of a member."[41] The selling agent first contended that the deletions of "in connection with" and "termination of employment" from the arbitration rule meant that the amendment narrowed the scope of the arbitration requirement to exclude his lawsuit.[42] With respect to the first deletion, the Texas Supreme Court noted that in Texas, "arises out of" is broadening language, not narrowing language.[43] With respect to the deletion of employment termination, the Court noted that the SEC, with respect to FINRA's amended arbitration procedure, specifically stated that employment termination claims would continue to be covered by FINRA's arbitration rule.[44] Moreover, the FINRA rules contained an exception to arbitration for lawsuits alleging employment discrimination in violation of a statute,[45] meaning that without the exception, the employment discrimination lawsuits would be included under the rule for arbitration.[46] The selling agent then contended that his lawsuit involving wrongful discharge for refusing to commit an illegal act fell within the statutory employment discrimination exception to arbitration. The Court noted that wrongful discharge did not involve discrimination, nor was it statutory.[47] Additionally, the SEC had specifically stated that the exception did not apply to causes of action created by judicial precedent, such as the Texas cause of action, without an associated claim of discrimination protected by a specific statute.[48]

In re Next Financial Group should alert registered brokers and dealers to the arbitration agreements contained in their state and federal registrations. Those arbitration agreements are subject to the rules of FINRA.

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39. *In re Next Fin. Group*, 271 S.W.3d at 267 (quoting 58 Fed. Reg. 39070 (July 21, 1993) (proposed rule) and citing 58 Fed. Reg. 45932 (Aug. 31, 1993) (SEC order approving the rule)).

40. FINRA, About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/index/htm (last visited Mar. 16, 2010).

41. *See* Fin. Indus. Regulatory Auth., FINRA Manual, Rule 13200 (effective Dec. 15, 2008); *see also* 70 Fed. Reg. 36430-01 (June 25, 2005) (noting the text of changes on a URL and describing the substantive changes within, none of which affect Rule 13200).

42. There is some authority for the proposition that the language "arising out of" is narrower than "in connection with." *See* Tracer Research Corp. v. Nat'l Envtl. Servs. Co., 42 F.3d 1292, 1295 (9th Cir. 1994) (stating that "arising out" is narrower than "relating to" in arbitration clauses).

43. *In re Next. Fin. Group*, 271 S.W.3d at 268-69; *see* Utica Nat'l Ins. Co. of Tex. v. Am. Indem. Co., 141 S.W.3d 198, 203 (Tex. 2004) (involving an insurance contract); Red Ball Motor Freight, Inc., v. Employers Mut. Liab. Ins. Co. of Wis., 189 F.2d 374, 378 (5th Cir. 1951) (involving an insurance contract).

44. *In re Next Fin. Group*, 271 S.W.3d at 267-68; *see* 72 Fed. Reg. 45077 (Aug. 10, 2007) (considering the New York Stock Exchange's interim arbitration rule after its absorption in FINRA).

45. *See* Fin. Indus. Regulatory Auth., FINRA Manual, Rule 13201 (effective Dec. 15, 2008).

46. *In re Next Fin. Group*, 271 S.W.3d at 269-70.

47. *Id.*

48. *Id.* at 267-70; *see* 62 Fed. Reg. 66164 (Dec. 17, 1997).

The rules provide that all disputes between the registered selling agents and their employing dealers are subject to arbitration, with only the narrow exception of employment discrimination in violation of a statute.[49]

III. SECURITIES FRAUD

One of the major reasons legislatures passed securities acts was to facilitate investors' actions to recover their money through a simplified fraud action that removed the most difficult elements to prove in a common law fraud action, namely scienter and privity. However, these Securities Act actions generally apply only to the primary market, so when investors purchase in the secondary market, their actions reintroduce these obstacles. Moreover, Congress has added additional burdens to the secondary market securities fraud action through the Private Securities Litigation Reform Act (PLSRA) of 1995.[50]

A. Court Decisions Under the Texas Acts

Federal courts, through their diversity and removal jurisdictions, also deal with securities fraud lawsuits brought under the Texas acts. Their opinions under the TSA and TSFA have raised two issues of interest.

1. *Failure to Satisfy the Buried Facts Doctrine for Materiality Under the TSA*

One federal bankruptcy court considered the adequacy of disclosure under the TSA. In *In re Perry*,[51] limited partners purchased class B limited partnership interests from an existing limited partnership engaged in the sourcing, planning, and development of real estate assets ranging from commercial office buildings to retail and single-family lot development. Included in its assets was equity in another limited partnership whose investments were controlled by an investment committee. The limited partners claimed they had been induced to purchase the limited partnership interests by a prospectus that contained material omissions and, thus, under the TSA, they had the right to rescind their purchases.[52] The purported omissions were the failure to disclose in the prospectus that (1) the class A limited partners could transfer their interests amongst themselves, which led investors to believe a tripartite management would manage the partnership indefinitely and (2) the general partner could replace members of the investment committee with partnership employees. The debtor in the chapter 11 bankruptcy reorganization action, an individual, was the chief executive officer of the limited partnership and a

49. Fin. Indus. Regulatory Auth., FINRA Manual, Rules 13200-01 (effective Dec. 15, 2008).
50. *See* 15 U.S.C. § 78u-4(b) (2006).
51. 404 B.R. 196 (Bankr. S.D. Tex. 2009).
52. The TSA provides that a person who sells a security by omitting a material fact may sue for rescission. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(2) (Vernon Supp. 2009).

"control person" of the general partner of the limited partnership.[53] The limited partners filed bankruptcy claims against the debtor contending that the debtor, as a control person, was liable for the stated omissions.[54] The bankruptcy court denied their claims, finding the alleged omissions were not material.[55]

The *Perry* court noted that a material omission under the TSA requires "a substantial likelihood that a reasonable investor would consider it important in deciding to invest."[56] In the Fifth Circuit, the objective standard of the reasonable investor imputes knowledge of the contents of the disclosure documents to the investor[57] and weighs that disclosure in its context—whether the method of presentation obscures or distorts the significance of material facts (the buried facts doctrine).[58] Applying this standard, the bankruptcy court found the two alleged omissions adequately disclosed in the prospectus.[59] The prospectus made it clear that the general partner, not the class A partners, managed the limited partnership.[60] The prospectus included a conspicuously bolded risk factor about dependence on key personnel of the general partner, a second conspicuous risk factor about the potential non-involvement of one class A limited partner, numerous provisions instructing investors to review the included limited partnership agreement which contained the buy/sell provision allowing class A limited partners to transfer their interests among themselves, and a conspicuously bolded section of the summary of the limited partnership agreement which included a description of the buy/sell provision.[61] The management and investment committee sections of the prospectus also made it clear that the general partner, not the invest-

53. The TSA provides that control persons, those directly or indirectly in control of a perpetrator of securities fraud, are jointly and severally liable with the perpetrator. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(F)(1) (Vernon Supp. 2009). The debtor stipulated he was a control person of the general partner of the limited partnership. *Perry*, 404 B.R. at 212 n.2.

54. The Bankruptcy Code has a provision that prevents shareholders from using their securities law right to rescind for securities fraud from using that rescission to elevate their interest in the bankrupt's estate to that of a general creditor with priority over the other shareholders. *See* 11 U.S.C. § 510(b) (2006) (subordinating such claims to those of the general creditors). The provision, however, only applies to issuer debtors and their affiliates. The definition of affiliates specifically excludes limited partnerships. *See* 11 U.S.C. § 101(2) (2006) (defining affiliate as twenty percent ownership in a corporation); *id.* § 101(a) (defining corporation to exclude limited partnerships).

55. *Perry*, 404 B.R. at 199-213.

56. *Id.* at 213 (quoting Weatherly v. Deloitte & Touche, 905 S.W.2d 642, 649-50 (Tex. App.—Houston [14th Dist.] 1995, writ dism'd w.o.j.)).

57. *Id.* at 214 (citing Isquith v. Middle S. Util., Inc., 847 F.2d 186, 201 (5th Cir. 1988) and listing numerous opinions from other circuits to a similar effect); *see also* Mercury Air Group, Inc. v. Mansour, 237 F.3d 542, 547 (5th Cir. 2001). The *Isquith* court reversed a district court that found the alleged omissions in the disclosure documents because the district court neglected to consider the context in which the issuer made the proper disclosures. *Isquith*, 847 F.2d at 200 n.9.

58. *Perry*, 404 B.R. at 216 n.6 (citing a FSLIC opinion and decisions from other circuits); *see also Isquith*, 847 F.2d at 201-03 (adopting the doctrine in the Fifth Circuit).

59. *Perry*, 404 B.R. at 210.

60. *Id.*

61. *Id.* at 215-18.

ment committee, controlled the entity that made decisions for the affiliated limited partnership.[62]

Perry shows both investors and their lawyers the importance of reading the disclosure documents: investors, so they will know what they are purchasing, and lawyers, so they will not appear to be fools before the judge. *Perry* was not a case where the issuer buried the material information in a manner to obscure the disclosure—it highlighted the material information with many cautionary warnings.

2. *Attempt to Impose Federal "Loss Causation" Under the TSFA*

A federal district court ruled on a motion for summary judgment in an aiding and abetting claim under the TSFA in *In re Enron Corp. Securities, Derivative & "ERISA" Litigation.*[63] In that case, a financial bank entered into a number of transactions with Enron, and the bank's employees were aware that Enron accounted for the transactions to misrepresent Enron's financials. The financial bank failed to disclose the Enron misrepresentations and benefitted from that undisclosed falsity through increased business fees and future business. Enron had numerous similar transactions with other entities. The investors purchased a number of Enron securities from entities other than Enron and retained these securities through Enron's collapse. The investors brought this action under the TSFA among other claims against the financial bank for aiding and abetting.[64] The financial bank moved for summary judgment on the grounds that the investors could not show causation, that is, that the financial bank's silence had caused their damages.[65] The district court denied the motion.[66]

The securities issue the district court confronted was how to apply causation for an aider and abettor under the TSFA in a complex situation

62. *Id.* at 218-19.

63. 623 F. Supp. 2d 798 (S.D. Tex. 2009). This Article omits the issues on civil conspiracy. The district court had previously dismissed claims under the TSA. *Id.* at 805 n.3; *see also In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 540 F. Supp. 2d 759, 797-99 (S.D. Tex. 2007); George Lee Flint, Jr., *Securities Regulation*, 61 SMU L. REV. 1107, 1128 (2008) (discussing *Enron*).

64. *Enron*, 623 F. Supp. 2d at 805-08. *See also* TEX. BUS. & COM. CODE ANN. § 27.01(b) (Vernon 2009) ("A person who . . . commits the fraud described in Subsection (a) of this section . . . is liable to the person defrauded for actual damages."); § 27.01(d) ("A person who (1) has actual awareness of the falsity of a representation . . . made by another person and (2) fails to disclose the falsity of the representation . . . to the person defrauded, and (3) benefits from the false representation . . . commits the fraud described in Subsection (a) of this section and is liable to the person defrauded for exemplary damages."); Glazener v. Jansing, 2003 WL 22207226, at *5-6 (Tex. App.—Austin 2003, no pet.) (mem. op.) (finding an aider and abettor liable for both actual and exemplary damages under the TSFA).

65. *Enron*, 623 F. Supp. 2d at 814. Texas courts recognize the TSFA action as differing from common law fraud only in that the investors need not prove scienter, so proximate cause is a requirement. *See* Robbins v. Capozzi, 100 S.W.3d 18, 26 (Tex. App.—Tyler 2002, no pet.) (real estate fraud: "caused an injury"); Larsen v. Carlene Langford & Assocs., Inc., 41 S.W.3d 245, 249 (Tex. App.—Waco 2001, pet. denied) (real estate fraud: "which caused an injury"); Scott v. Sebree, 986 S.W.2d 364, 371 (Tex. App.—Austin 1999, pet. denied) (real estate fraud: "resulting in damages").

66. *Enron*, 623 F. Supp. 2d at 805 n.3, 807 n.6, 814, 819, 827.

with possibly multiple aiders and abettors. The financial bank insisted that the investors had to show what portion of their loss was attributable to the financial bank's wrongdoing, which, due to the myriad of other possible factors causing the Enron collapse, required competent expert testimony, and the investors had provided none. Such a "loss causation" requirement is appropriate under federal securities law for primary violators.[67] The investors countered that under the TSFA, causation is with respect to the primary violator, not the secondary aider and abettor. They claimed that the aider and abettor has the same liability as the primary violator, and the lay testimony on causation the investors had provided for the primary violator was sufficient.[68] The district court agreed with the financial bank that it was liable for losses caused only by the fraudulent transactions of Enron of which it was aware.[69] But as to causation, Texas law recognizes that there may be more than one cause of an event[70] and so finds causation satisfied if the perpetrator's acts were a substantial factor in bringing about the injury.[71] The district court found, in light of the evidence concerning the magnitude of the financial bank's loans to Enron presented by the investors, that a reasonable person could infer that the bank's transactions with Enron were a substantial factor in causing the investors' injuries.[72]

Although the investors in *Enron* avoided showing "loss causation" (showing which portion of the investors' loss derived from the perpetrator's acts), the issue may reappear in the calculation of damages. The issue is whether the aider and abettor is liable under the TSFA for all damages caused by the primary violator or only that portion of the damages derived from the aider and abettor's acts. The TSFA, not designed with multiple aiders and abettors in mind, seems to support the investors. The aider and abettor is jointly and severally liable, presumably with the right of contribution from the other aiders and abettors, although the district court in *Enron* seemed to lean toward limiting a particular aider and abettor's damages.

B. Court Decisions Under the Federal Acts

Since the fraud provisions of the TSA are modeled on the federal statutes,[73] there is an interest in Fifth Circuit securities law opinions. Originally, this meant Texas courts interpreting the TSA's similar language

67. *See* 15 U.S.C. § 78u-4(b)(4) (2006) (imposing a "loss causation" element to class action securities fraud cases); Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007) (imposing in the Fifth Circuit a "loss causation" requirement before application of the fraud-on-the-market presumption for the reliance element).

68. *Id.*

69. *Enron*, 623 F. Supp. 2d at 828.

70. *See, e.g.*, Lear Siegler, Inc. v. Perez, 819 S.W.2d 470, 471 (Tex. 1991).

71. *See, e.g.*, Union Pump Co. v. Albritton, 898 S.W.2d 773, 775 (Tex. 1995), *abrogated on other grounds*, Ford Motor Co. v. Ledesma, 242 S.W.3d 32 (Tex. 2007).

72. *Enron*, 623 F. Supp. 2d at 814-22, 828.

73. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2009).

would look to federal decisions under the federal statutes.[74] But more recently, litigants and judges have tended to graft federal concepts onto the TSA, even when the language is not similar.[75]

1. *Pleading "Loss Causation" Under the PSLRA*

The most frequent issue for the Fifth Circuit under the federal acts deals with developing rules for "loss causation" pursuant to the U.S. Supreme Court's *Dura Pharmaceuticals*[76] decision. For the Fifth Circuit the issue of "loss causation" enters the lawsuit at two points. First, the court's implied private cause of action for damages from securities fraud, under the PLSRA,[77] has "loss causation" as one of its elements.[78] Second, the Fifth Circuit requires a finding of "loss causation" before allowing substitution of the fraud-on-the-market theory's rebuttable presumption for the reliance element of the cause of action.[79]

a. As an Element of the Cause of Action

In *Catogas v. Cyberonics, Inc.*,[80] the Fifth Circuit determined that the "loss causation" element requires tying the specific corrective disclosure to an immediate decline in stock price. The issuer's management backdated and repriced executive stock options, thereby rendering prior financial statements misleading by not reporting the stock-based compensation as an expense. The corrective statements included an analyst's report raising questions about certain stock options granted, an SEC informal inquiry into the matter, a U.S. attorney's subpoena of documents, an announcement of the appointment of an internal audit committee to investigate the matter, a press release announcing a delay in filing the issuer's annual report on Form 10-K to the SEC in light of the internal investigation, and a press release stating that the issuer had received a letter from NASDAQ that the issuer was subject to delisting if it did not file its Form 10-K. On the days of disclosure, only the last disclosure involved a significant decline in stock price. The earlier disclosures in-

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74. *See, e.g.*, Anglo-Dutch Petroleum Int'l, Inc. v. Haskel, 193 S.W.3d 87, 103 n.13 (Tex. App.—Houston [1st Dist.] 2006, pet. denied); *see also* George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. Rev. 1293, 1300-01 (2007) (discussing *Anglo-Dutch Petroleum*).

75. *See In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 623 F. Supp. 2d 798, 815-16 (S.D. Tex. 2009) (representing a failed attempt to graft federal "loss causation" onto the TSFA); *see also* Dorsey v. Portfolio Equities, Inc., 540 F.3d 333, 343-44 (5th Cir. 2008) (applying the federal rules for pleading fraud with particularity to the TSA and TSFA); Flint, *supra* note 7, at 2005 (discussing *Dorsey*).

76. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 339 (2005).

77. *See* 15 U.S.C. § 78u-4 (2006).

78. *See Dura Pharms.*, 544 U.S. at 341 (stating that the cause of action requires (1) a material misrepresentation or omission, (2) scienter, (3) a connection with a purchase or sale of a security, (4) reliance, (5) economic loss, and (6) "loss causation", that is, a causal connection between the material misrepresentation and the loss). The latter two elements come from the PSLRA. *See* 15 U.S.C. § 78u-4(b)(4) (2006).

79. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007) (per curiam); *see also* Flint, *supra* note 63, at 1128-29 (discussing *Oscar*).

80. 292 F. App'x 311, 314 (5th Cir. 2008).

volved price declines of one to two percent, while the last disclosure involved a price decline of twenty-five percent. The district court had dismissed the investor's complaint for not sufficiently pleading facts to raise a strong inference of scienter, a different element of the cause of action.[81]

Rather than investigate the scienter pleading matter, the *Catogas* court focused on an alternative ground of "loss causation" to affirm the district court. Seizing on language in a recent U.S. Supreme Court pronouncement on "loss causation" for securities fraud,[82] the Fifth Circuit determined that the "loss causation" requirement is not satisfied unless there is a price decline immediately following the corrective disclosure.[83] Examining only the price declines on the day of the disclosures,[84] the Fifth Circuit found only one significant price decline—the last one.[85] And that allegedly corrective disclosure revealed no new information about the option grants. The only mention of the stock options in that disclosure referred to disclosures in prior announcements. The Fifth Circuit had previously determined that statements confirmatory of prior statements cannot constitute a corrective disclosure.[86] Moreover, the only new disclosure contained in the last release involved the delisting, which, although caused by the delay in filing the Form 10-K brought about by the erroneous stock option accounting, touched only the earlier fraudulent statements.[87] It did nothing to correct the inaccuracy of the prior misstatements or bring to light any new fraud of the issuer.[88]

Under *Catogas*, an issuer might escape liability for a private securities fraud action if the disclosures can be made vague enough so as not to cause a significant price decline until the new issue of delisting causes the

81. *Catogas*, 292 F. App'x at 311-13. The PSLRA added the scienter pleading requirement to the scienter element of the cause of action. *See* 15 U.S.C. § 78u-4(b)(2).

82. *See Catogas*, 292 F. App'x at 314 (focusing on *Dura Pharmaceuticals*' aside: "The complaint's failure to claim that Dura's share price fell significantly after the truth became known suggests that the plaintiffs considered the allegation of purchase price inflation alone sufficient."). The Supreme Court in *Dura Pharmaceuticals* made it clear it ruled only on the inconsistency of the Ninth Circuit's approach to "loss causation" allowing price inflation to satisfy the requirement. *See Dura Pharms.*, 544 U.S. at 346 ("[W]e find the Ninth Circuit's approach inconsistent . . . . We need not, and do not, consider other proximate cause or loss-related questions."). The Supreme Court, however, did cite approvingly the Restatement of Torts, which does have the thought seized by the Fifth Circuit. *See Dura Pharms.*, 544 U.S. at 344 ("Indeed, the Restatement of Torts, in setting forth the judicial consensus, says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].' § 548A, comment b, at 107.").

83. *Catogas*, 292 F. App'x at 316-17.

84. The price declines were determined by judicial notice. *Id.* at 316 (citing *In re* Merck & Co., Sec. Litig., 432 F.3d 261, 265 n.3 (3d Cir. 2005)).

85. *See id.* at 317 (Speculating that the investors did not use the earlier corrective statements for the "loss causation" requirement because the respective price drops were insignificant.).

86. *Id.* at 314 (citing Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 663 (5th Cir. 2004)); *see also* Flint, *supra* note 25, at 1156-57 (discussing *Greenberg*).

87. *Catogas*, 292 F. App'x at 315-16.

88. *Id.*

significant price decline. The matter of delisting is in the control of the issuer.[89]

In *Lormand v. US Unwired, Inc.*,[90] the Fifth Circuit dealt with the pleading standard for "loss causation" and the connection between the corrective disclosure and the fraud. The issuer became an affiliate of a telecommunications company with the exclusive right to provide the telecommunications company's products and services in a multi-state region. The first set of problematic transactions dealt with the affiliation. The telecommunications company had several types of affiliates. The issuer's affiliation allowed the issuer to have control over its operations and customer base that the issuer's management believed was essential to its success. The telecommunications company desired to change the affiliation to one in which the telecommunications company had control of the issuer's customer care, servicing, and billing. The telecommunications company applied economic pressure to achieve the change in affiliation, such as threatening exorbitant fees, contractual breach, and withholding of product.[91] Ultimately the issuer's management agreed to the new affiliation, even though it had vigorously fought the change in affiliation and knew the change would end the issuer's business plan that had been successful in the past. Throughout this time period, the issuer conducted several stock offerings to fund its acquisitions, and some of the issuer's managers sold most of their shares. The securities disclosures touted the affiliation and did not disclose any risks with respect to ceding control over the issuer's customer care and billing.

The second set of problematic transactions involved subprime–credit customers.[92] The telecommunications company originally required this class of customers to pay deposits as a condition of subscription. The telecommunications company decided to go to a no-deposit, spending-limit account for the subprime–credit customers. The issuer's past experience with this customer class indicated that the policy change would lead to customers' dropping service and an increase in bad debt. The issuer's management so informed the telecommunications company. The securities disclosures, however, spoke positively with respect to the no-deposit program. When the truth about customers' dropping service and about an increase in bad debt leaked out in connection with the subprime–credit customer situation over a two-month period, the issuer's stock price plunged by eighty percent. The investors brought a class action for securities fraud under Rule 10b-5.[93] The district court dismissed the action, ruling that some of the alleged misrepresentations were protected by the PSLRA's safe harbor for forward-looking statements and

89. *See* NASDAQ Manual, Marketplace Rules, Rule 4310(c)(14) (requiring listed issuers to file copies of SEC filings with NASDAQ and deeming electronic filings with the SEC as satisfying the requirement).

90. 565 F.3d 228 (5th Cir. 2009) (arising in Louisiana).

91. *Id.* at 233-34.

92. *Id.* at 234.

93. *See* 17 C.F.R. § 240.10b-5 (2009).

that the investors failed to sufficiently plead "loss causation."[94] The Fifth Circuit affirmed the dismissal with respect to the affiliation claims, but reversed with respect to the subprime–credit claims.[95]

The Fifth Circuit found that the PSLRA's safe harbor provision did not protect the alleged forward-looking misrepresentations for two reasons.[96] The safe harbor provides that the fraud action is not actionable to the extent the statement is identified as forward looking, is accompanied by meaningful cautionary statements, is immaterial, or the investors have failed to plead that the forward-looking statement was made with actual knowledge that the statement was false.[97] The district court had ignored the *Lormand* investors' pleading that the issuer's management knew their statements were false.[98] The cautionary statements consisted of a general disclaimer that the documents were not guarantees of future performance and that they involved known and unknown risks. These boilerplate provisions did not amount to meaningful cautionary language since they lacked substantive company-specific warnings based on a realistic description of the risks applicable to particular circumstances.[99] The issuer put forth disclaimers contained in other documents containing the same misrepresentations, but again the Fifth Circuit found these statements warned only of a "limited, general, and vague risk."[100] Having found material misstatements, the Fifth Circuit considered the "strong inference" of scienter that the district court had not reached and found this requirement satisfied also.[101] The pleadings quoted the issuer's management's disapproval and protestations to the telecommunications company concerning both the affiliation coercion and the subprime no-deposit policy.

The issues with respect to the "loss causation" element for the *Lormand* court were the appropriate pleading standard and the relationship between the fraud and the disclosure. For the pleading standard, the Fifth Circuit applied the principles of Rule 8, rather than the stricter requirements of Rule 9, since the Supreme Court used the "short and plain" pleading of Rule 8 for the "loss causation" element in *Dura*

94. *Lormand*, 565 F.3d at 238.

95. *Id.* at 268.

96. *Id.* at 244.

97. *See* 15 U.S.C. §§ 78u-5(c)(1)(A), 5(c)(1)(B) (2006).

98. *Lormand*, 565 F.3d at 243-44 (citing its prior ruling in Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 371-72 (5th Cir. 2004) as applying the clause similarly); *see also* Flint, *supra* note 25, at 1155-56 (discussing *Southland*).

99. *Lormand*, 565 F.3d at 244-45 (citing its prior ruling in Plotkin v. IP Axess, Inc., 407 F.3d 690, 694 (5th Cir. 2005) as finding similar boilerplate language as not meaningfully cautionary); *see also* George Lee Flint, Jr., *Securities Regulation*, 59 SMU L. REV. 1543, 1560-61 (2006) (discussing *Plotkin*).

100. *Lormand*, 565 F.3d at 246. The issuer's management had another argument for the Fifth Circuit to affirm the district court's decision. It argued it was under no duty to disclose. The Fifth Circuit quickly dismissed this argument, noting that in the Fifth Circuit under Rule 10b-5 a duty to speak the full truth arises when a speaker undertakes a duty to say anything. *See id.* at 249 (citing Rubenstein v. Collins, 20 F.3d 160, 170 (5th Cir. 1994)).

101. *Id.* at 239-55.

Pharmaceuticals.[102] For Rule 8, the Fifth Circuit obtained the sub-elements of "loss causation" from *Dura Pharmaceuticals* and the plausibility standard from *Twombly*.[103] Investors must allege both a misrepresentation or omission, followed by a disclosure or leaking out of the relevant truth that caused a significant depreciation of the investor's stock, and sufficient facts giving rise to a reasonable expectation that discovery will reveal evidence of the sub-elements. Applying these pleading standards, the court in *Lormand* found the pleadings for the affiliation claims deficient since the investors had not alleged any disclosures with respect to the affiliation misrepresentations.[104] For the subprime–credit claims, the misrepresentations consisted of press releases noting gains in subscriptions, a conference call stating the issuer could reach the subprime–credit customers profitably, reports of favorable increases in subscriber growth, and an SEC filing stating that cancelled subscriptions and debt collection were consistent with historical norms. The disclosures included a warning issued by another affiliate of the telecommunications company, subsequent analysts' downgrades, a press release of second-quarter results indicating significant subscriber cancellations, a credit rating service placing the issuer's rating on review for possible downgrade, a press release about weak demand due to requiring deposits from, and high disconnects among, subprime–credit customers, and an SEC filing reporting a high disconnect due to adding credit–challenged customers during the year that elected not to continue or were dropped for nonpayment. The disclosure allegations were accompanied by the stock price drops occurring during the two-month period in which the disclosures took place. The Fifth Circuit found that these alleged facts provided the required plausibility.[105]

The Fifth Circuit then addressed three shortcomings in the district court's analysis.[106] First, *Dura Pharmaceuticals* required that the disclosures must reveal the relevant truth about the fraud.[107] The *Lormand*

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102. *Id.* at 255-58. Rule 8 requires "a short and plain statement of the claim showing that the pleader is entitled to relief." *See* FED. R. CIV. P. 8(a)(2). Rule 9 provides, "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." FED. R. CIV. P. 9(b). The Supreme Court in *Dura Pharmaceuticals* did not specify which rule applied. It, however, applied Rule 8 since the claim could not even satisfy the lower standard of that rule.

> And we assume, at least for argument's sake, that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss. But, even so, the 'short and plain statement' must provide the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.' . . . The complaint before us fails this simple test.

Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (quoting Conley v. Gibson, 355 U.S. 41, 47 (1957).

103. *Lormand*, 565 F.3d at 256-58; *see* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 557-60 (2007) (imposing the plausibility standard on anti-trust pleadings under Rule 8).

104. *Lormand*, 565 F.3d at 258.

105. *Id.* at 260.

106. *Id.* at 264-66.

107. *See Dura Pharms.*, 544 U.S. at 342, 346.

court related this requirement to the relevance test under the Federal Rules of Evidence—that the truth disclosed must make the existence of the actionable fraud more probable than it would be without the alleged fact.[108] Using this relevance test, the Fifth Circuit found, with respect to the first shortcoming, that the district court ignored disclosures not made by the issuer and its management.[109] The Fifth Circuit noted that nothing bars proving "loss causation" by circumstantial evidence, so third-party disclosure is sufficient. Second, the district court ignored partial disclosures.[110] The Fifth Circuit found the partial disclosures, when combined with other disclosures, as satisfying the plausibility standard.[111] Third, the district court ignored disclosures that did not contradict prior misrepresentations. The Fifth Circuit noted this method does not work for omissions.[112]

The *Lormand* opinion has made clear that the pleading standard for the "loss causation" element is the short and plain, plausible standard of Rule 8.[113] The opinion also indicates that third parties may be the source of the disclosure, and disclosure may be a series of partial disclosures over a short period of time.[114]

b. As a Prerequisite to the Fraud-on-the-Market Presumption

The Fifth Circuit also considered the type of corrective disclosure required by "loss causation" for both the element of the cause of action and for class certification for the fraud-on-the-market presumption. In *Alaska Electrical Pension Fund v. Flowserve Corp.*,[115] the issuer made a number of misrepresentations over time concerning earnings forecasts, historical financial performance, costs and savings related to acquisitions, and debt covenant compliance. The issuer's press release overstated annual earnings by 140%, and the issuer subsequently released inaccurate quarterly earnings statements.[116] Certain releases also contained overly optimistic earnings guidance for the following year. When the issuer revised the earnings guidance downward, the stock price declined, first in the following July by thirty-seven percent and then in the following September by thirty-eight percent. When the issuer announced the restated earnings for those years, a year and a half later, there was no significant stock price decline. The investors brought an action for securities fraud and moved to certify a class. The issuer moved for summary judgment. The district court denied the class certification because the two statements followed by significant stock price declines were not corrective

108. *Lormand*, 565 F.3d at 256 n.20 (citing FED. R. EVID. 401).
109. *Id.* at 264.
110. *Id.* (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 390-91 & n.30 (1983) (inferring scienter in a securities fraud action by circumstantial evidence)).
111. *Id.* at 264-65.
112. *Id.* at 266.
113. *Id.* at 255-58.
114. *Id.* at 264.
115. 572 F.3d 221 (5th Cir. 2009) (per curiam).
116. *Id.* at 225-26.

statements.[117] The two earnings guidance revisions did not reveal any prior earnings guidance as fraudulent and did not relate to any other misstatements. Then concluding that the "loss causation" issue determined for the class certification was dispositive of the "loss causation" element for the securities fraud action, the district court granted the issuer's summary judgment motion.[118]

The securities issue for the Fifth Circuit in *Alaska Electrical Pension Fund* was the definition of corrective information for purposes of determining "loss causation." The issuer asserted a fact-for-fact standard where the corrective statement fully corrected prior misstatements. The Fifth Circuit rejected the issuer's definition because an issuer can immunize itself from liability merely by refusing to admit any falsity in prior misstatements or by a protracted series of partial disclosures.[119] The investors urged a true financial condition standard to apply where any disclosure of a weakening financial condition, regardless of whether the disclosure corrects past misstatements, relates to earlier misstatements. The Fifth Circuit rejected the investors' definition since undisclosed information cannot drive the stock price down.[120] The standard adopted by the Fifth Circuit is that the disclosed information must reflect part of the relevant truth obscured by the fraudulent statements.[121] As examples of the standard, the Fifth Circuit used two of its prior cases. In *Greenberg v. Crossroads Systems, Inc.*, the Fifth Circuit found a subsequent press release predicting a significant revenue shortfall in the third quarter as corrective of misstatements pertaining to third quarter earnings, but not corrective of misstatements pertaining to the first and second quarters, even though first and second quarter shortfalls surely caused some third quarter shortfalls.[122] In *Lormand*, the Fifth Circuit found disclosures making clear there were substantial problems in that market as corrective of misstatements about success in the subprime market, but not corrective of misstatements pertaining to becoming an affiliate of a respected company, even though the affiliation was the reason for being in the subprime market.[123] Therefore, the Fifth Circuit vacated the denial of class certification and remanded.[124] Although determination of "loss causation" for class certification purposes does not resolve the issue for the securities fraud action, since the district court applied the wrong standard for "loss causation," the Fifth Circuit also reversed the grant of summary judgment.[125]

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117. *Id.* at 224-25.
118. *Id.* at 225-27, 231, 233.
119. *Id.* at 230.
120. *Id.*
121. *Id.*
122. 364 F.3d 657, 667-69 (5th Cir. 2004); *see also* Flint, *supra* note 25, at 1156-57 (discussing *Greenberg*).
123. *See* Lormand v. US Unwired, Inc., 565 F.3d 228, 260-61 (5th Cir. 2009).
124. *Alaska Elec. Pension Fund*, 572 F.3d at 228, 235.
125. *Id.* at 228-32, 235. The case involved an initial issuance of stock, so the investors also sued for statutory securities fraud under the Securities Act for misrepresentations in a

Although the Fifth Circuit in *Alaska Electrical Pension Fund* did not further immunize issuers and issuer management from private securities fraud damage actions by adopting a fact-for-fact disclosure, the investors have yet to succeed. The investors' action has only been returned to the district court for application of the Fifth Circuit's new definition of a corrective statement with respect to class certification. The investors have plenty of time to run afoul of other Fifth Circuit rules for private securities fraud damage actions, and the Fifth Circuit may concoct additional rules to thwart the investors.

The Fifth Circuit lastly dealt with the application of the circuit's rule for "loss causation" when the corrective statement is intermingled with other negative news. In *Fener v. Operating Engineers Construction Industry & Miscellaneous Pension Fund*,[126] the investors claimed a newspaper engaged in a fraudulent scheme to artificially inflate circulation to gain additional advertising revenue via circulation target bonuses, rigged circulation audits, and a no-return policy for distributors' unsold newspapers. The issuer announced future circulation would be down about three percent. Five months later, after stock market hours, the issuer issued a press release announcing those circulation declines projecting future circulation declines of five to ten percent, and disclosing that the issuer had begun curtailing circulation manipulation.[127] The next trading day saw a seven percent decline in the issuer's stock price. Analysts lowered their earnings estimates for the issuer and downgraded the stock. The issuer later announced it would pay advertisers $23 million plus $3 million for the issuer's internal investigation. The investors brought a private securities fraud damage action and the investors moved to certify a class. Both sides presented expert testimony. The issuer's expert's event study divided the corrective press release into three parts, covering fraudulent overstatements, changes in the issuer's methodology, and industry-wide declines.[128] Upon examining 132 analyst reports, the expert concluded that the stock price decline primarily resulted from non-fraudulent disclosures, so he testified that the investors could not show the press release disclosures were the primary cause of the stock price decline. The investor's expert claimed the press release had to be treated as one disclosure, that the issuer's stock moved with the industry's other stocks, except when the issuer issued the corrective press release. Hence, he testified that the stock price decline was almost entirely attributable to the revelation. The district court denied the certification and the Fifth Circuit affirmed.[129]

registration statement. *See* 15 U.S.C. § 77k(a) (2006). This action has no causation element but reduces damages to the extent the defendant can show loss for reasons other than the misrepresentation. Since the district court placed the burden of proving loss on the investors, the Fifth Circuit also vacated the summary judgment with respect to the Securities Act violations. *Alaska Elec. Pension Fund*, 572 F.3d at 234-35.

126. 579 F.3d 401 (5th Cir. 2009).
127. *Id.* at 405.
128. *Id.* at 408.
129. *Id.* at 404, 406.

The Fifth Circuit viewed the situation as a straight application of its principle developed in *Greenberg*.[130] The investors must show that it is more probable than not that the corrective statement, and not other unrelated negative statements, caused the significant decline in stock price.[131] The *Fener* corrective press release divided itself into three parts, concerning the overstatement, a coupling with earlier reduction announcements, and anticipated lower circulation. The only evidence supplied by the investors related to SEC reports, stock-price charts, analyst reports previously rejected by the Fifth Circuit as well-informed speculation not satisfying the requirements for "loss causation,"[132] and their expert's defective report not delineating that portion of the stock price decline resulting from the corrective statement. Consequently, the investors did not satisfy the *Greenberg* rule.[133]

The *Fener* opinion emphasizes to defalcating issuer management the importance of delaying corrective statements until they can mix the corrective statements with other negative news. The procedure will mask the decline from any stock price decline arising from the corrective disclosure. Further, the procedure will provide them with the change that the investors' expert will be unable to separate out that portion of any stock price decline from any decline resulting from the other negative news.

2. *Pleading Strong Inference of Scienter Under the PSLRA*

Another litigated element of the private securities fraud damage action deals with the requisite degree of scienter needed to satisfy the strong inference requirement of the PSLRA.[134] In response to the U.S. Supreme Court's recent decision in *Tellabs*,[135] the Fifth Circuit has developed a three-step approach to reviewing scienter allegations: take the pleadings as true, include referenced documents and materials capable of judicial notice, and take into account both opposing and supporting plausible inferences.[136]

The Fifth Circuit applied this test to an issuer whose alleged misrepresentations contained cautionary statements. In *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*,[137] the issuer, an electric utility, made a self-tender for convertible securities at a time when the dividend rate was low. An earlier May press release indicated that the issuer did not anticipate a dividend increase until certain benchmarks had been at-

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130. *Id.* at 406-07; *see* Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 663 (5th Cir. 2004); *see also* Flint, *supra* note 25, at 1156-57 (discussing *Greenberg*).
131. *See Greenberg*, 364 F.3d at 666.
132. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 271 (5th Cir. 2007) (per curiam); *see also* Flint, *supra* note 63, at 1128 (discussing *Oscar*).
133. *Fener*, 579 F.3d at 409-11.
134. *See* 15 U.S.C. § 78u-4(b)(2) (2006).
135. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322-24 (2007).
136. *See* Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 533 (5th Cir. 2008).
137. 565 F.3d 200 (5th Cir. 2009).

tained, but the issuer's board might consider other factors in determining when or if to authorize a dividend increase. In the mid-September self-tender materials, the issuer disclosed that management was evaluating whether to recommend that the board reevaluate its dividend policy, but it indicated that the issuer could not predict the outcome of management's evaluation, repeating that the board might consider other factors.[138] At a financial firm's conference at the end of September, the issuer's chief executive officer stated that the dividend policy was under review. The day before the expiration of the self-tender offer, the issuer's management requested from the issuer's credit rating agencies an indication of whether an increase in the dividend would adversely affect its credit rating. The investors tendered their convertible shares and received a price above the then-market value. Six days after the self-tender offer expired, the issuer's management proposed to the board an increase in the dividend, and two days later, after having received a favorable response from the credit rating agencies, recommended a 350% increase in the dividend.[139] The next day the board approved the dividend increase. The issuer publicly announced the increase in dividend three days later and the stock price immediately rose nearly twenty percent. The investors who had tendered their convertible securities brought a private securities fraud damage action under Rule 10b-5 and the Texas common law, claiming the disclosures did not sufficiently disclose the impending dividend increase. The district court dismissed and the Fifth Circuit affirmed.[140]

The securities issue for the Fifth Circuit in *Flaherty & Crumrine Preferred Income Fund* was whether the pleadings and submitted documents gave rise to a strong inference of scienter. Scienter requires intent to deceive the investors or severe recklessness in which the danger of misleading investors is known or should have been known.[141] Although the Fifth Circuit doubted that the alleged misstatements (not adequately disclosing the steps taken to increase the dividend) amounted to a material misrepresentation,[142] the court focused on the two statements for scienter. With respect to the mid-September tender offer materials, the Fifth Circuit noted that, although the timing of the dividend increase provides some inference of scienter, timing alone does not establish a strong infer-

138. *Id.* at 204.
139. *Id.* at 205.
140. *Id.* at 203.
141. *See* R2 Invs. LDC v. Phillips, 401 F.3d 638, 643 (5th Cir. 2005); *see also* Flint, *supra* note 99, at 1559 (discussing *R2 Invs.*).
142. *Flaherty & Crumrine Preferred Income Fund*, 565 F.3d at 209 (setting forth investor's view); *id.* at 210 (setting forth the court's view); *cf.* Basic Inc. v. Levinson, 485 U.S. 224, 239 (1988) (rejecting, in the context of materiality, non-disclosure of merger negotiations for disclosure governed by indicia of interest in the transaction by highest corporate levels). Perhaps "under review" does not provide the shareholder with sufficient information to determine whether to tender of not. *Cf.* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (noting that materiality for proxy statements is satisfied if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote").

ence.[143] With respect to scienter for the late-September conference and in addition to their petition, the investors had produced a letter of the issuer's counsel and a report by a finance professor. The counsel's letter set forth dates of certain events used by the report to show that credit agencies could not complete their review in the time that management claimed. The investors contended this report provided evidence that management knew of the impending dividend increase before the end of the tender offer.[144] As to motive, the investors relied on the chief executive officer's possibility of gain as a stockholder and his position to gain knowledge of the board's intention. The Fifth Circuit did not find the report and motives as providing a strong inference.[145] The disclosure of "under review," although vague, accurately disclosed the dividend policy status.[146] To say more could be deceptive if the board failed to approve the dividend increase.[147] Also, the Fifth Circuit has previously determined that the potential for knowledge acquisition by position with the issuer and the potential for economic gain from stock granted as compensation based on company performance are insufficient to establish a strong inference of scienter.[148] Furthermore, considering inferences opposing the allegations of fraud, as required by the U.S. Supreme Court in *Tellabs*, disclosure of dividends "under review" is susceptible of an inference that the decision to raise the dividend has yet to be made.[149]

As to the Texas common law fraud claim on the same facts, the *Flaherty & Crumrine Preferred Income Fund* court noted that, with respect to scienter, securities fraud claim in Texas requires pleading an inference of either motive or conscious behavior.[150] Motives that are universal to corporations and their officers, as in the instant situation, are insufficient to allow the inference.[151] Position within the issuer, in the absence of special circumstances such as a one product issuer with few employees, are insufficient to satisfy the inference of conscious behavior.[152]

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143. *Flaherty & Crumrine Preferred Income Fund*, 565 F.3d at 210 (citing another circuit's district court case, *In re* Digital Island Sec. Litig., 223 F. Supp. 2d 546, 555-56 (D. Del. 2002), *aff'd*, 357 F.3d 322 (3d Cir. 2004)). The Fifth Circuit provided no rationale as to why timing is not sufficient, but under the *Tellabs* test of consideration of opposing inferences, timing does not rule out the possible inference of learning of the situation after the statement.

144. *Id.* at 209.

145. *Id.* at 210.

146. *Id.* at 209.

147. *See* Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1085-86 (5th Cir. 1970) (stating the tender offeror is not required to make predictions that may make investors rely on them unjustifiably).

148. *Flaherty & Crumrine Preferred Income Fund*, 565 F.3d at 208-12; *see* Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 535, 543-44 (5th Cir. 2008).

149. *Id.* at 211-12.

150. *Id.* at 213 (citing Herrmann Holdings Ltd. v. Lucent Techs., Inc., 302 F.3d 552, 565 (5th Cir. 2002)).

151. *See Herrmann Holdings*, 302 F.3d at 565-66.

152. *See* Dorsey v. Portfolio Equities, Inc., 540 F.3d 333, 342-43 (5th Cir. 2008); *see also* Flint, *supra* note 3, at 1449 (discussing *Dorsey*).

The *Flaherty & Crumrine Preferred Income Fund* opinion reveals the value to issuer management of including vague cautionary material or warnings in their disclosures. These statements may provide a non-fraudulent inference defeating the strong inference of scienter required by the PSLRA.

IV. CONCLUSION

The securities law opinions during this Survey period encompass two major groups. The first grouping deals with incompetent lawyers or lawyers who convinced their clients to pay for half-baked arguments.[153] In *Miller*, a state court reinstated a cease and desist order against an issuer whose lawyer failed to object to a witness's testimony when a co-defendant's counsel did.[154] In *In re Next Financial Group*, the Texas Supreme Court granted a mandamus to order arbitration for the termination of a broker when the arbitration agreement permitted only an exception for statutory discrimination, not a common law exception to the employment-at-will doctrine.[155] And in *In re Perry*, a bankruptcy court rejected claims based on the failure to read the disclosure documents.[156]

The Fifth Circuit opinions narrowing the eye of the needle that investors must thread to be successful in a securities fraud action under the PSLRA[157] constitute the second grouping. Recognizing that this high hurdle was not intended to prevent viable securities fraud actions, the Fifth Circuit at least cut some slack for investors. The primary focus was on "loss causation." Continuing the drive to thwart securities fraud actions, the Fifth Circuit in *Catogas*, affirming a dismissal, determined that for "loss causation," investors must show an immediate decline in the issuer's stock price following corrective disclosure.[158] In *Fener*, the Fifth Circuit denied class certification, requiring that loss causation requires separating that portion of the loss stemming from the corrective disclosure from that portion of the loss caused by disclosure of other negative

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153. The Fifth Circuit was not immune to the plague of incompetency. In *Brunig v. Clark*, 560 F.3d 292 (5th Cir. 2009), Justice Higginbotham dealt with a district court's dismissal for failure to plead fraud with particularity for an assignment of an interest in an oil and gas lease received as an attorney's fee. The perpetrator–client moved to dismiss a statutory fraud action under the Securities Act and a Rule 10b-5 action under the Exchange Act on the grounds that the transaction was exempt from registration under the Securities Act. *See* 15 U.S.C. § 77l(a)(2) (2006) (whether or not exempt from registration); *Brunig*, 560 F.3d at 295 n.6 (noting the misstatement of the law). The lawyer fared no better. His unartful and prolix complaint confused the district court, but Justice Higginbotham managed to conclude that he had pled an omission, a misrepresentation, and a strong inference of scienter, so he reversed the dismissal. *See Brunig*, 560 F.3d at 296-97. Justice Higginbotham served as a visiting professor in 2008, and is so serving in 2009, at the same institution as the author.

154. No. 03-06-00365-CV, 2009 WL 1896075, at *2-4 (Tex. App.—Austin July 1, 2009, no pet.).

155. 271 S.W.3d 263, 267 (Tex. 2008).

156. 404 B.R. 196, 214 (Bankr. S.D. Tex. 2009).

157. *See* Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) ("eye of the needle").

158. 292 F. App'x 311, 314 (5th Cir. 2008).

information.[159] With respect to a strong inference of scienter, the Fifth Circuit in *Flaherty & Crumrine Preferred Income Fund* affirmed a dismissal, determining that vague cautionary statements and warnings defeat the strong inference.[160] In contrast, the Fifth Circuit determined in *Lormand* that the pleading standard for loss causation is the short and simple pleading of Rule 8, not the particularity of Rule 9, and that serial disclosure does not defeat a finding of loss causation.[161] In *Alaska Electrical Pension Fund*, the Fifth Circuit, in reversing a perpetrator's summary judgment, held that the disclosure need not be a fact-for-fact disclosure and that reflecting part of the truth obscured by the fraud is sufficient.[162]

Other opinions related to a state court finding in *Key Energy Services* that an issuer need not issue shares in violation of the securities laws (absence of a registration statement) under an employee option plan before the options expire. In *Enron*, a federal district court temporarily thwarted an attempt to impose the federal loss causation element on an action under the TSFA.

159. 579 F.3d 401, 404, 406 (5th Cir. 2009).
160. 565 F.3d 200, 203 (5th Cir. 2009).
161. 565 F.3d, 228, 255-58 (5th Cir. 2009).
162. 572 F.3d 221, 230 (5th Cir. 2009).