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Securities and LLC Fiduciary Duty Law

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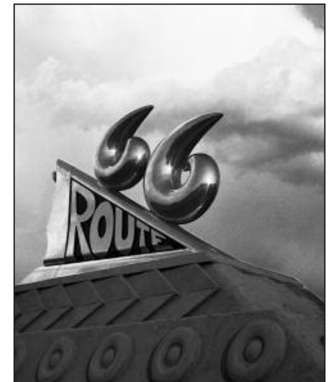

COVER: "Route 66 Monument, Tucumcari, New Mexico," Photograph by Larry Gustafson, Dallas.

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Dear Section Members:

This issue marks the beginning of my term as Section Chair. I am honored to serve and look forward to working with you and our Section Council during the coming year.

I would like to take this opportunity to welcome the three incoming members of the Council. Scott Kidwell, Nicole Williams, and John Shoemaker will serve terms running from 2009 to 2012.

I also would like to report on the Section's program at the 2009 State Bar Annual Meeting in Dallas at the Hilton Anatole Hotel. The program was held on June 25, 2009, from 11:00 a.m. to noon. Two former United States Attorneys – Don J. De Gabrielle and Richard B. Roper – presented *New Trends in Complex White Collar Crime Enforcement and Corporate Responsibility in a New Administration*. This was an interesting and informative program, and was well attended and well received. If you missed the program, stay tuned to the section email blasts because we plan on presenting update versions around the state over the coming year.

The Section has now sponsored two teleconference CLE programs, one in December 2008 and the other in April 2009, which provided updates on a variety of business litigation topics, including those addressed in the *Journal*. We anticipate conducting these teleconferences on a regular basis, with the next one planned to occur in September. If you are interested in participating as a speaker in one of these programs, please contact me to discuss your suggested topics. I'd appreciate hearing from you.

The *Journal* continues to provide Section members with valuable news and scholarship covering a wide variety of topics of interest to business litigators. Thanks to Gerry Pecht and Peter Stokes for their annual survey of securities law developments, and their summary of a recent merger-related state court decision, and Cindy Andrew for her article on Delaware fiduciary duty law applicable to limited liability companies. As always, thanks also to Larry Gustafson for his cover photograph. If you have an article in mind, please contact Mike Ferrill (amferrill@coxsmith.com) – we're always on the lookout for interesting articles touching on any aspect of business litigation.

In closing, I would like to thank Bill Katz for his terrific leadership during the past year. He did an outstanding job, and together with the Section's Council I look forward to building on his fine work.

Best regards,
Leslie Sara Hyman
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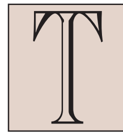
FROM ▪ THE ▪ EDITOR



his issue of the Journal features the annual survey article on securities law, as well as an article on the Delaware fiduciary duty law applicable to limited liability companies.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, arbitration, class actions, D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor

Fifth Circuit Securities Update

By Gerard G. Pecht and Peter A. Stokes[1]

Gerard G. Pecht

Peter A. Stokes

Since the last survey period, the Fifth Circuit has addressed several important securities-related issues, including: (1) the scienter requirement under the Private Securities Litigation Reform Act ("PSLRA") and Rule 9(b) of the Federal Rules of Civil Procedure,[2] (2) the requirement for pleading and proving loss causation; (3) the criminal trial of Enron's former CEO; (4) the authority of a federal court to enjoin securities lawsuits in state courts; (5) the requirements for establishing scienter and obtaining disgorgement in SEC enforcement proceedings; (6) whether evidence obtained by a court-appointed receiver in an SEC enforcement action may be used in a criminal securities fraud trial; (7) whether a dismissal under the Securities Litigation Uniform Standards Act ("SLUSA") has *res judicata* effect as to the merits of a plaintiff's claim; (8) whether an issuer's untimely filing of a Form 10-K is grounds for default under the Trust Indenture Act; (9) the requirements for a conversion claim by a purchaser who acquires a stock certificate for shares that were purportedly cancelled by the company; and (10) the requirements for a contempt finding based on the violation of an asset freeze order.

In *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*,[3] the Fifth Circuit affirmed a Rule 12(b)(6) dismissal in favor of TXU Corp. (now known as Energy Future Holdings Corp.) and its former CEO, C. John Wilder. The plaintiffs filed a class action securities fraud lawsuit in the Northern District of Texas on behalf of all investors who sold TXU convertible securities to TXU in connection with a 2004 self-tender offer.[4] The plaintiffs alleged that TXU made misrepresentations and omissions regarding the timing and magnitude of a stock repurchase program and dividend increase to induce investors to accept TXU's offer to purchase their securities.[5] According to the lawsuit, TXU's board of directors approved a 400% increase in the company's stock repurchase program and a 350% dividend increase on October 22, 2004, nine days after the closing of the tender offer on October 13, 2004.[6] The announcement of the increases allegedly caused TXU's share price to jump by 20%, which led to a similar increase in the value of the convertible securities that the plaintiffs sold in the tender offer.[7]

The plaintiffs further alleged that TXU planned the increases before the tender offer closed and fraudulently misrepresented and concealed the increases until after the tender offer to induce investors to sell their convertible securities to TXU.[8] The amended complaint included an expert report by a law professor who attempted to discredit TXU's assertion that it was awaiting feedback from the credit rating agencies regarding the impact of a potential dividend increase on TXU's credit rating and did not receive such feedback until six days after the tender offer closed.[9] The report contended that the credit rating agencies could not have conducted such a review during the short time period after the tender offer closed and, accordingly, that TXU knew during the tender offer that the dividend and stock repurchase increases would not affect TXU's credit rating.[10] The plaintiffs also pointed to a letter from TXU indicating that a "detailed report" regarding the dividend was provided to the credit rating agencies before the tender offer closed.[11] The lawsuit asserted claims for securities fraud under sections 10(b) and 14(e) of the Securities Exchange Act as well as a claim for common law fraud.[12]

The Fifth Circuit affirmed the district court's Rule 12(b)(6) dismissal of all claims. While agreeing with the plaintiffs that the timing of the dividend increase was "suspect" and that the case presented a "close question," the Fifth Circuit nonetheless held that the complaint failed to allege sufficient facts to support a "cogent and compelling" inference of scienter.[13] The court observed that TXU disclosed in May 2004 that it anticipated recommending a dividend increase in 2005 and further disclosed in September 2004 that the dividend policy was already "under review."[14] The panel concluded that that the "under review" disclosure "appears to be a statement that, although vague, accurately represents the state of the dividend policy during the tender offer period."[15] Because the totality of the plaintiffs' factual allegations failed to support a strong inference of scienter, the court affirmed the district court's dismissal of the federal section 10(b) and 14(e) claims.

The Fifth Circuit also affirmed dismissal of the common law fraud claim. The court observed

that state law fraud claims are not subject to the PSLRA's "strong inference" test, but emphasized that Rule 9(b) still requires a plaintiff to allege specific facts to support an inference of fraud.[16] A plaintiff can satisfy this requirement by showing a defendant's motive to commit fraud or identifying circumstances that indicate conscious behavior by the defendant.[17] The court concluded that Wilder's alleged desire to complete the tender offer and increase the value of his personal TXU stock holdings did not amount to a legally sufficient motive to commit fraud.[18] The panel further concluded that the complaint failed to satisfy the "more stringent standard" of demonstrating "conscious behavior" by Wilder.[19] The court thus affirmed the district court's dismissal in its entirety.

In *Brunig v. Clark*,[20] the Fifth Circuit reversed the dismissal of a federal securities fraud claim asserted in the Southern District of Texas. The plaintiff, who was an attorney, alleged that the defendant defrauded him into accepting a 40% interest in certain mineral leases as consideration for legal services that the plaintiff previously performed on the defendant's behalf.[21] The complaint asserted various claims, including RICO claims, securities fraud claims under section 10(b) and Rule 10b-5, and various state law claims.[22] The district court adopted the magistrate judge's recommendation that: (i) the federal claims be dismissed pursuant to Rule 12(b)(6); (ii) the court should decline supplemental jurisdiction over the state law claims; and (iii) the court should sanction the plaintiff for violating Fed. R. Civ. P. 11.[23]

The Fifth Circuit reversed the dismissal of the section 10(b)/Rule 10b-5 claim. It held that the complaint adequately alleged a specific false promise by the defendant that all expenses associated with the plaintiff's interest in the lease would be paid from revenues and that the plaintiff would not be required to make any payments himself.[24] The court further held that the complaint adequately alleged that the defendant misleadingly failed to disclose that he had taken an overriding royalty interest in the leases at issue, which would reduce the production available to the plaintiff.[25] The court likewise found that the complaint stated facts giving rise to a strong inference of severe recklessness because the defendant was in possession of documents showing what interests were owned and who would be responsible for which payments, and because the defendant's "secret" overriding interest would have clearly made the investment less attractive to the plaintiff had the interest been disclosed.[26] The court affirmed dismissal of the RICO claim based on the complaint's failure to allege plausible facts satisfying the "enterprise" requirement.[27] Because the court revived the federal securities claim, however, it reversed the district court's dismissal of the state law claims on supplemental jurisdiction grounds.[28] The court also reversed the Rule 11 sanctions order and remanded it for reconsideration in light of the court's opinion.[29]

In *Dorsey v. Portfolio Equities, Inc.*,[30] the Fifth Circuit affirmed in part and reversed in part the Rule 12(b)(6) dismissal of a securities fraud lawsuit filed in the Northern District of Texas. The plaintiff asserted various fraud claims under federal and state law against Portfolio Equities, Inc. ("PEI"), Charter Home Funding, Inc. ("CHF"), the president of PEI and CHF (who was the same individual), an officer and director of CHF, and two other entities.[31] The plaintiff alleged that PEI made false statements in a 1997 private placement memorandum ("PPM") and in subsequent conversations to induce the plaintiff to acquire promissory notes from PEI and to use the interest payments from the notes to acquire additional promissory notes from PEI with the same terms.[32] PEI allegedly represented that the proceeds from the notes would be used by CHF to purchase residential real estate properties, with PEI receiving a security interest in the properties acquired by CHF.[33] The plaintiff further alleged that PEI ultimately failed to repay the notes when due and had no documentation of any security interests in the real estate CHF had purchased.[34]

The plaintiff filed a class action lawsuit alleging federal securities fraud claims under section 10(b) of the Exchange Act and Rule 10b-5, and state law claims for common law fraud and violation of Texas Business and Commerce Code section 27.01 and section 33(A)(2) of the Texas Securities Act.[35] After allowing an opportunity to amend, the district court granted the defendants' motion to dismiss for failure to state a claim.[36] It dismissed the federal securities fraud claims as either time-barred or deficient under the PSLRA and dismissed the state statutory and common law claims for failure to plead with particularity under Rule 9(b).[37]

The Fifth Circuit affirmed the dismissal of the section 10(b) and Texas Business and Commerce Code claims.[38] It held that all of the section 10(b) claims were time-barred because the plaintiff failed to allege any securities purchases after March 5, 1999, which was the cutoff date for the three year statute of repose in effect at the time.[39] The Fifth Circuit also affirmed dismissal of the Texas Business and Commerce Code claim because the plaintiff purchased only debt instruments and not stock or real estate.[40]

The court, however, reversed the dismissal of the common law fraud claim as to PEI, CHF, and the two individuals, holding that the case involved "special circumstances that, when considered together, lend themselves to a sufficient inference of scienter" to survive dismissal under Rule 9(b).[41] In particular, the court described PEI, which was run by the same individual as CHF, as a "one-trick pony" that had no employees and no business other than to make loans to CHF.[42] Under these circumstances, the allegations supported a reasonable inference that the individual defendants "knew or were severely reckless in not knowing whether PEI had failed to make secured loans to CHF" at the time of the alleged misrepresentations.[43] The court affirmed dismissal of the common law fraud claim as to the other two entities because the complaint failed to identify any alleged misrepresentations by those entities.[44]

The Fifth Circuit also reversed the district court's dismissal of the Texas Securities Act claim as to PEI, CHF, and the entities' president, holding that section 33(A)(2) did not require the plaintiff to plead scienter to establish a claim for seller liability.[45] The court observed

that section 33(F)(2) requires scienter for aiding and abetting liability but concluded that the plaintiff disavowed such a claim in his briefing and was relying solely on a primary "seller" claim under section 33(A)(2).[46]

In *Lormand v. US Unwired, Inc.*,[47] the Fifth Circuit reversed in part the dismissal of a section 10(b) and Rule 10b-5 putative investor class action filed in the Eastern District of Louisiana. The complaint alleged that US Unwired made false statements regarding its implementation of subprime subscriber programs and the alteration of its relationship with the Sprint wireless communications network.[48] In 1998, US Unwired contracted with Sprint to become a "Type III" wireless affiliate.[49] This affiliation gave US Unwired the exclusive right to sell Sprint products and services in portions of 14 states while allowing US Unwired to retain maximum control over its customer billings and service.[50]

In 1999, Sprint allegedly began to pressure US Unwired to convert to a "Type II" affiliation, which would significantly reduce US Unwired's autonomy and thereby adversely affect US Unwired's business model.[51] During 1999 and 2000, Sprint allegedly attempted to coerce US Unwired to change its affiliation status by allegedly delaying US Unwired's ability to market new services, demanding approximately $30 million in additional fees from US Unwired, and threatening to declare that US Unwired had breached its affiliation contract with Sprint.[52] The complaint alleged that US Unwired acceded to Sprint's demands in September 2000 and agreed to become a Type II affiliate, which gave Sprint access to US Unwired's subscriber payments.[53] This, in turn, allegedly allowed Sprint to withhold payments or underpay US Unwired for collections from US Unwired's customers.[54]

In May 2001, Sprint allegedly forced US Unwired to participate in a nationwide calling program for subprime customers called "ClearPay," which allowed subprime customers to subscribe without a deposit or credit check.[55] US Unwired allegedly attempted, unsuccessfully, to dissuade Sprint from forcing it to offer ClearPay and other subprime customer promotions based on its prior unsatisfactory experience with subprime customers.[56] According to the lawsuit, US Unwired experienced substantial increases in deactivations and a significant rise in churn and debt levels as a result of these no-deposit programs.[57] The complaint asserts that US Unwired continued to complain about ClearPay to Sprint management throughout 2001 and early 2002.[58] In February 20002, Sprint allowed US Unwired to resume requiring a deposit from subprime customers, although US Unwired allegedly continued the no-deposit programs in certain regions and continued to experience adverse effects from its dealings with subprime customers.[59]

The complaint alleged that US Unwired made at least 24 false representations during 2001 and 2002 regarding the company's relationship with Sprint and the subprime customer programs.[60] These statements included a November 8, 2000 press release stating that US Unwired's integration into the Sprint network would position US Unwired "to fully capitalize on Sprint's successes," an August 8, 2001 press release stating that it was adhering "to the sound fundamentals of our business plan over the last two years" that did not disclose the alleged problems with the conversion to a Type II affiliation, and various statements in a March 2002 public conference call that US Unwired believed the no-deposit subprime customers "are necessary to reach our full market penetration" and that the churn (*i.e.*, cancellation) rate "would start to decrease."[61] The complaint included statements from alleged former US Unwired employees claiming that senior management was aware of the adverse effects on US Unwired's business from the Type II conversion and ClearPay program before making these public statements.[62] Several members of the company's senior management also sold substantial percentages of their personal US Unwired stock holdings during the alleged class period.[63] The lawsuit alleged that the "true facts" were revealed to the market in several public disclosures between June 6, 2002, and August 13, 2002, which allegedly caused the stock price to fall from $4.94 to $0.90 per share.[64]

The district court dismissed the complaint pursuant to Rule 12(b)(6) on loss causation grounds, holding that the complaint did not sufficiently identify how the "truth" regarding the changed affiliation and subprime customer issues was disclosed to the market and caused the stock price to fall.[65] The district court also concluded that several of the alleged false statements were protected by the PSLRA's "safe harbor" for forward-looking statements.[66]

The Fifth Circuit reversed the district court's dismissal with respect to the "subprime customer" claims and addressed all of the dismissal arguments defendants raised in the district court.[67] First, the panel concluded that the PSLRA safe harbor did not apply because the cautionary language accompanying US Unwired's disclosures was too general and did not provide "sufficiently meaningful caution about clearly present danger that was materializing."[68] In particular, the Fifth Circuit held that the cautionary language regarding the no-deposit subprime customer promotions inaccurately characterized the problem "as a future risk of *limited* magnitude that would be averted rather than certain dangers that had already begun to materialize."[69] Second, the court held that US Unwired's public statements about the Type II affiliation and no-deposit programs were rendered materially misleading by the omission of information regarding the "severe risks" associated with these developments, which the opinion stated had "already materialized" and "would almost certainly lead towards disaster."[70] Third, the Fifth Circuit concluded that the allegations supported a "strong inference" that the individual management defendants acted knowingly or with severe recklessness.[71] The complaint included specific internal emails and communications and statements from former US Unwired employees stating that US Unwired's senior management "privately knew, at the time of the representations, that the no-deposit programs and Type II affiliation conversion would be disastrous for the company but continued to tout their benefits publicly."[72] These allegations were held sufficient to support a strong inference of scienter.[73]

Lastly, the Fifth Circuit held that the complaint adequately alleged loss causation—*i.e.*, a causal connection between the alleged fraud and a subsequent decline in the stock price following a "corrective" disclosure relating to the prior alleged misstatement—as to the subprime customer claims but not as to the Type II affiliation claims.[74] The court agreed with the defendants that the complaint failed to identify a corrective disclosure where the "truth" regarding the Type II affiliation change was revealed to the market and resulted in a stock price decline.[75] The complaint did, however, identify sufficient corrective disclosures relating to the subprime customer claims, including public disclosures relating to problems that other Sprint affiliates experienced with the same subprime customer programs, as well as analyst reports discussing the negative impact of Sprint's subprime customer programs on the wireless industry, US Unwired's reduction of its second quarter 2002 guidance, and more specific subsequent disclosures regarding the continuation of high churn rates among US Unwired's customers during a two-month period when the stock price fell from $4.94 to $0.90 per share.[76] The court concluded that these allegations supported a plausible inference that the disclosure of "corrective information" regarding the alleged "subprime customer" misrepresentations caused a decline in the stock price.[77] The opinion also clarified that loss causation may be established by "showing partial or indirect disclosures of [the] truth by persons other than the defendants."[78] Lastly, the panel held that the defendants' argument that the stock price decline resulted from other factors was fact-based and inappropriate for resolution on a Rule 12(b)(6) motion.[79] The court thus affirmed dismissal of the claims relating to the change in affiliation but reversed dismissal of the claims relating to no-deposit customers.[80]

In *Catogas v. Cyberonics, Inc.*,[81] the Fifth Circuit affirmed, on loss causation grounds, the Rule 12(b)(6) dismissal of a section 10(b)/Rule 10b-5 class action complaint filed in the Southern District of Texas against Cyberonics, Inc. and various Cyberonics officers and directors.[82] The plaintiffs alleged that Cyberonics made false and misleading statements regarding the marketability, safety, and efficacy of its Vagus Nerve Stimulation Therapy System (the "VNS Device") and the likelihood that the FDA would approve the VNS Device for the treatment of depression.[83] The plaintiffs later amended their complaint to assert claims that Cyberonics improperly accounted for stock options granted to its CEO, as well as additional claims regarding alleged misrepresentations of the prospects for insurance company approval of the VNS Device.[84] The district court dismissed all of the plaintiffs' claims under Rule 12(b)(6) for failure to plead sufficient facts supporting a strong inference of scienter.[85]

On appeal, the plaintiffs challenged only the dismissal of the claims relating to the stock options issue.[86] Instead of affirming on scienter grounds, however, the Fifth Circuit affirmed dismissal based on the defendants' alternative argument that the complaint failed to plead loss causation.[87] The complaint alleged only one "corrective disclosure" where the stock price allegedly fell due to the disclosure of corrective information relating specifically to the stock options issue.[88] The court held that the options-related information contained in this disclosure had previously been disclosed to the market and was thus entirely "confirmatory" of the earlier disclosures.[89] The only new information in the press release regarding the stock options issue was that the company's stock could be delisted if the company failed to file its Form 10-K on time.[90] Cyberonics, however, had previously disclosed that the Form 10-K had been delayed due to its internal investigation into the stock options issue.[91] The court concluded that the additional disclosure regarding the possible consequences of a late Form 10-K at best merely "touches upon" the plaintiffs' alleged losses and was thus insufficient to demonstrate loss causation.[92] The Fifth Circuit further observed that Cyberonics' subsequent disclosures regarding the results of its stock options investigation did not cause any negative effect on Cyberonics' stock price.[93]

In *Alaska Electrical Pension Fund v. Flowserve Corporation*,[94] the Fifth Circuit again took up the issue of loss causation for Exchange Act claims and addressed the "negative causation" affirmative defense for Securities Act claims. The plaintiffs filed a putative shareholder class action lawsuit in the Northern District of Texas asserting claims under sections 10(b) and 20 of the Exchange Act and sections 11 and 15 of the Securities Act.[95] The lawsuit claimed that Flowserve made false statements regarding the company's financial condition in various press releases and registration statements during 2001 and 2002, including an October 22, 2001 press release allegedly containing fraudulent earnings guidance for 2002 and the filing of a quarterly SEC report that same day allegedly containing false financial statements.[96] The complaint asserted claims against Flowserve and certain of its executive officers for all of the alleged misrepresentations, as well as claims against the underwriters of Flowserve's 2001 and 2002 stock offerings based on the alleged defective registration statements.[97]

According to the complaint, Flowserve's stock declined significantly in July and September 2002 after Flowserve announced downward revisions in its guidance for 2002.[98] Both announcements attributed the guidance revisions to industry and market factors and did not state what plaintiffs claimed were the "real reasons for the decline," which the plaintiffs blamed on the alleged falsity of Flowserve's prior financial statements, Flowserve's alleged failure to comply with its debt covenants, and alleged problems extracting synergies from recent acquisitions.[99] Flowserve ultimately announced on February 3, 2004, that it was restating earnings for financial years 2000-03 by $11 million.[100] The restatement announcement had no statistically significant effect on the stock price.[101] The plaintiffs nonetheless filed suit shortly thereafter, claiming damages based on the alleged July and September 2002 stock price declines.[102]

After denying the defendants' Rule 12(b)(6) motion to dismiss, the district court conducted a class certification hearing and entertained summary judgment motions.[103] The court ultimately denied class certification and granted summary judgment in favor of the defendants.[104] It concluded that the plaintiffs failed to establish loss causation by a preponderance of the evidence at the class certification hearing and failed to raise a triable issue of fact on the defendants'

section 10(b) loss causation defense and their section 11 negative causation affirmative defense.[105]

In a *per curiam* panel opinion that included former United States Supreme Court Justice Sandra Day O'Connor sitting by designation, the Fifth Circuit vacated the district court's class certification ruling, reversed the summary judgment on the loss causation issue, and vacated the summary judgment on the "negative causation" affirmative defense.[106] On the class certification issue, the court agreed with the district court's conclusion that the plaintiffs were required to prove loss causation by a preponderance of the evidence to certify a class on the Exchange Act claims.[107] The appellate panel, however, concluded that the district court applied an erroneous legal standard in determining whether the plaintiffs had carried this burden.[108] While the court disagreed with the plaintiffs' position that loss causation may result simply by disclosing information regarding a company's "true financial condition" that is not actually "corrective" of prior misstatements, the court likewise rejected what it termed the "fact-for-fact" approach used by the district court.[109] Noting that the plaintiffs had offered expert testimony that the July and September 2002 stock price declines were not caused by other factors, the court concluded that "it was enough [to establish loss causation as to the "false guidance" claim] that the market learned that the October 2001 guidance was wrong and that other negative information unrelated to the reduced FY2002 guidance did not cause the decline in Flowserve's share price."[110] The court cautioned, however, that the mere reduction of Flowserve's earnings guidance was not sufficient, without more, to establish loss causation as to the alleged misrepresentations regarding past financial performance and other past events, and that the plaintiffs therefore could not certify a class on the Exchange Act claims related to those issues unless they could point to a corrective disclosure involving more than missed guidance alone.[111]

The panel thus vacated the district court's denial of class certification and remanded for a new class certification hearing.[112] For similar reasons, the panel also reversed the district court's summary judgment on the loss causation issue.[113] The Fifth Circuit also instructed the district court to revisit its conclusion that 21 of the alleged misstatements were merely "confirmatory" of prior statements and thus inactionable, holding that statements resulting in an increase in Flowserve's stock price are not merely "confirmatory" and thus can potentially support a securities fraud claim.[114]

The court also vacated the district court's summary judgment regarding the "negative causation" affirmative defense, which applied to the plaintiffs' section 11 claims.[115] The panel emphasized that unlike the loss causation defense in Exchange Act cases, negative causation is an affirmative defense, and the defendants must therefore prove that "no reasonable juror" could find that the plaintiffs' July and September 2002 losses were caused by the registration statements.[116] While the registration statements at issue with respect to the section 11 claims did not contain any alleged false financial guidance, the Fifth Circuit concluded that the defendants failed to demonstrate that "no reasonable juror" could find that the registration statements were not responsible for any of the July and September 2002 losses, noting that there was "analyst commentary" suggesting "concerns about debt-covenant compliance and perhaps some concern about Flowserve's financials."[117] The opinion noted, however, that "further proceedings might lead to a finer partitioning of culpability among the different defendants" regarding the July and September 2002, losses and thus vacated the "negative causation" judgment to allow further development in the district court.[118] The court concluded by noting that the "ever higher hurdles" facing securities fraud plaintiffs "are not, however, intended to prevent viable securities actions from being brought."[119]

In *United States v. Skilling*,[120] the Fifth Circuit affirmed the fraud, conspiracy, and insider trading convictions against former Enron Corporation CEO Jeffrey K. Skilling, but vacated the 292-month sentence issued by the Southern District of Texas and remanded for resentencing. The opinion recounted the various alleged fraudulent practices at Enron that formed the basis for Skilling's conviction, including allegations that Enron and its officers: (i) misrepresented Enron's "Wholesale" business to investors as a "logistics company" instead of a "trading company"; (ii) concealed losses from Enron Energy Services ("EES"); (iii) set fraudulent earnings targets for Enron Broadband Services ("EBS") and provided false information regarding Enron's quarterly earnings estimates; (iv) made fraudulent statements during investor conference calls regarding the financial performance of EES and EBS; (v) improperly hedged various Enron assets and investments in transactions with "pseudo" third-party entities run by Enron insiders who were assured through "'secret' oral side deals" that Enron would prevent them from losing money on the transactions; (vi) made misrepresentations to Enron's outside auditors regarding Enron's financial statements and the legitimacy of the hedge transactions described above; and (vii) sold large quantities of Enron stock based on inside information of the company's true financial condition.[121] Skilling was convicted of 19 counts, including one count of conspiracy, 12 counts of securities fraud, five counts of making false statements, and one count of insider trading.[122] He was sentenced to 292 months in prison and ordered to pay $45 million in restitution.[123]

Skilling appealed his convictions and sentence on several grounds. First, he contended that the government improperly instructed the jury that it could convict Skilling of conspiracy based on the alleged deprivation "of the honest services owed by [Enron's] employees."[124] Skilling argued that he could not be convicted under an "honest services" theory because his alleged crimes were committed in furtherance of Enron's business.[125] The court rejected this argument, holding that Skilling failed to establish that Enron's directors or any other Enron decisionmaker "sanctioned Skilling's improper conduct" or "specifically directed the improper means that he undertook to achieve his goals."[126] The opinion noted that "a senior executive cannot wear his 'executive' hat to sanction a fraudulent scheme and then wear his 'employee' hat to perpetuate that fraud."[127]

Skilling also unsuccessfully challenged the district court's "deliberate ignorance" jury instruction, arguing that the instruction

was unsupported by the evidence and could have influenced the jury to convict based on nonculpable negligent conduct rather than intentional fraudulent conduct.[128] The Fifth Circuit held that any error from this instruction was harmless because Skilling admittedly "knew of the allegedly illegal acts" that formed the basis of his convictions and thus could not have been convicted on a negligence-based theory that he "should have known" about the alleged illegal conduct.[129]

The Fifth Circuit also rejected Skilling's argument that many of his statements were immaterial "puffery," concluding that "a reasonable jury could find that Skilling's statements were strongly contrary to verifiable historical facts about the conditions of the businesses, that he misstated his true opinion, and that his statements were misleading to a reasonable investor who would have considered them important."[130]

The court likewise rejected numerous additional challenges to Skilling's conviction, including challenges to the jury instructions on materiality and good faith, the district court's refusal to transfer the case from Houston, various instances of alleged prosecutorial misconduct and witness intimidation, and the alleged suppression of exculpatory evidence.[131] The Fifth Circuit did find "troubling" the government's omission from the FBI Form 302s produced to Skilling of a statement by former Enron CFO Andrew Fastow that Fastow "doesn't think [he] discussed" the alleged list of secret side deals ("Global Galactic") with Skilling.[132] The statement was included in the government's interview notes (which the Fifth Circuit ordered the government to produce in their entirety) but was not included in the documents produced to Skilling.[133] Nonetheless, because the district court never had an opportunity to review the page of the interview notes containing this statement, the Fifth Circuit declined to address Skilling's argument on this issue and held that Skilling must raise this argument in the district court.[134]

Despite affirming the convictions, the Fifth Circuit vacated Skilling's sentence and ordered the district court to conduct a new sentencing. It held that the district court improperly subjected Skilling to a four-level sentencing enhancement for allegedly jeopardizing the safety and soundness of a "financial institution."[135] The panel held that Enron's retirement plans were not "financial institutions" within the meaning of the sentencing statute, and that to hold otherwise would effectively transform every corporate retirement vehicle into a "financial institution" for purposes of the statute.[136] The court noted that any doubts over the meaning of a criminal provision must be resolved in the defendant's favor.[137]

In *Newby v. Enron Corporation*,[138] the Fifth Circuit addressed the denial by the Southern District of Texas of a motion to leave filed by Fleming & Associates, a Houston law firm, seeking permission to file 34 lawsuits in Texas state courts on behalf of approximately 1,200 alleged former Enron shareholders.[139] The Southern District of Texas had previously enjoined the Fleming firm from filing additional Enron-related lawsuits in state court without first obtaining leave from the federal court.[140] On October 14, 2005, Fleming sought leave to file the additional state court cases, which asserted claims for common law fraud, negligence, violations of the Texas Securities Act, and various other statutory and common law claims.[141]

The Fifth Circuit affirmed the district court's denial of leave to file claims with a two-year or three-year statute of limitations, but reversed the denial of leave to file claims having a four-year statute of limitations (which would not have been time-barred had Fleming filed a Texas state court petition as of the date when leave was sought).[142] The Fifth Circuit rejected the Fleming firm's arguments that the claims with shorter limitations periods were saved under various tolling theories, and that the district court exceeded the scope of its original injunction.[143] In particular, the court noted that Texas courts have not extended the federal *American Pipe* tolling doctrine to statutes of limitations for claims under Texas law.[144] Nonetheless, the Fifth Circuit held that whether the filing of a Texas petition "relates back" to the filing of the motion for leave in federal court, which if true would salvage the claims subject to a four-year statute of limitations, is a matter that should be addressed by the Texas state courts.[145]

The Fifth Circuit also rejected the financial institution defendants' alternative argument that SLUSA preempted all of Fleming's claims, noting that plaintiffs are permitted to "tailor a suit to avoid federal jurisdiction."[146] While the financial institutions asserted that the Texas state courts were likely to consolidate the 34 proposed cases into a single case that would meet the threshold for SLUSA preemption, the Fifth Circuit declined to speculate how the Texas courts would manage the litigation.[147] Accordingly, the Fifth Circuit reversed the denial of leave to assert the claims that were not time-barred on the day leave was sought.

In *SEC v. Gann*,[148] the Fifth Circuit affirmed a Northern District of Texas trial verdict in an SEC civil enforcement action against a stockbroker for allegedly violating section 10(b) and Rule 10b-5. The defendant was accused of engaging in deceptive trading activity to avoid detection by certain mutual funds that had rules against "market timing," a legal practice that many mutual funds nonetheless prohibit.[149] Market timing involves rapid buying and selling of mutual fund shares to take advantage of short-term differentials between a fund's value and the value of the securities it holds.[150] To combat market timing, mutual funds frequently issue "block notices" prohibiting brokers from making additional trades in the funds' shares under the identifier number cited in the notice, which can be the broker's registered representative number, the client's account number, or the number attached to a brokerage or its branch office.[151] The SEC asserted that the defendant fraudulently attempted to evade various block notices by switching the identifier number each time a notice was received, so they could continue engaging in market timing transactions involving the fund's shares (at least until a block notice was issued to the new identifier number).[152] The Fifth Circuit affirmed the district court's conclusion that the defendant's use of different and varying client account numbers to disguise the frequency and magnitude of HCM's trading in the various funds involved actionable misrepresentations under Rule 10b-5, and

that there was sufficient evidence to support the district court's finding that the defendant intended to mislead the mutual funds or was severely reckless.[153] The Fifth Circuit also affirmed the district court's permanent injunction against future violations of Rule 10b-5 and section 10(b) and found that the defendant waived his complaints regarding the district court's disgorgement order and $50,000 civil penalty.[154]

In *SEC v. Seghers*,[155] the Fifth Circuit affirmed in part and vacated in part a Northern District of Texas jury verdict in a civil SEC enforcement action asserting claims under section 10(b) of the Exchange Act, section 17(a) of the Securities Act, and sections 206(1) and 206(2) of the Investment Advisers Act.[156] The defendant, Conrad Seghers, allegedly offered and sold limited partnership interests in a set of hedge funds (the "Integral Funds").[157] The majority of the Integral Funds' assets, in turn, were invested in the Galileo Fund, L.P., a separate investment fund managed by the defendant's associate.[158] In mid-2001, an associate of Seghers discovered that the broker-dealer for the Integral Funds and Galileo Fund had made significant errors impacting the statement values for Galileo Fund's account, which led the broker-dealer to liquidate some of the Galileo Fund's assets through margin calls.[159]

The SEC alleged that as a result of these errors, the Integral Funds' account statements significantly overstated the value of the accounts from June 1, 2000, through November 30, 2000, and from March 1, 2001, through September 30, 2001.[160] Seghers allegedly failed to inform investors regarding the details or extent of the errors and the impact on the account values.[161] The Integral Funds ultimately collapsed after September 11, 2001.[162] A jury determined that Seghers knowingly made false statements and material omissions by providing account statements that misrepresented the true value of the accounts and by failing to disclose the details and extent of the broker-dealer's errors.[163] The district court entered judgment in favor of the SEC but declined to order disgorgement and limited the period of time covered by the jury verdict during which Seghers was mentally culpable for the alleged misstatements. Both Seghers and the SEC appealed.

The Fifth Circuit affirmed the jury's verdicts against Seghers on all claims.[164] It overruled Seghers' evidentiary objections and held there was sufficient evidence that Seghers knowingly made false statements and material omissions.[165] In particular, Seghers' associate testified that he informed Seghers of the broker-dealer's errors in March 2001, and the SEC presented evidence of additional communications where Seghers was made aware of the errors' impact on the investors' account values.[166] The limited partnership memoranda furnished to investors also indicated that investors' accounts would be valued using market values for investments for which such information was available.[167] While Seghers contended that the statements accurately reflected the account's values based on the "amortization method" of accounting, the statements were misleading in light of the valuation criteria cited in the limited partnership memoranda (which implied that accounts would be valued based on the market value of investments at the time) and the wide disparity between the values listed in the investors' statements and the actual market values of their accounts.[168]

In response to the SEC's cross-appeal, the Fifth Circuit vacated the district court's determination that Seghers was not subject to disgorgement because he personally lost money when the Integral Funds collapsed.[169] While district courts have broad discretion whether to order disgorgement in SEC enforcement proceedings, a district court may not deny disgorgement merely because the defendant ultimately lost the ill-gotten proceeds he obtained from the fraud.[170] Rather, the issue is whether the defendant profited from the fraud, regardless of whether the defendant ultimately squandered the profits on other investments.[171] The Fifth Circuit also vacated the district court's judgment that Seghers did not act with scienter before June 6, 2001, holding that the evidence of pre-June 6, 2001 communications amply supported the jury's verdict as applied to the time period before that date.[172]

In *SEC v. Snyder*,[173] the Fifth Circuit reversed a Southern District of Texas jury verdict in a civil section 10(b)/Rule 10b-5 SEC enforcement action against Bruce Snyder, the former vice president and chief accounting officer of Waste Management, Inc. ("WMI").[174] The SEC alleged that Snyder filed "a materially false and misleading Form 10-Q for the first quarter of 1999 because it overstated income and included certain 'nonrecurring' adjustments to income without appropriate disclosure," and that Snyder engaged in insider trading by selling stock after filing the allegedly false Form 10-Q.[175]

The Fifth Circuit concluded that there was sufficient evidence to support the jury's finding that Snyder acted knowingly or with severe recklessness and engaged in insider trading.[176] In particular, there was testimony that the "nonrecurring adjustments" were sufficiently large such that "it would have been obvious to an accountant with Snyder's training that these adjustments . . . were material in the aggregate and were required to be disclosed in the Form 10-Q.[177] The SEC also introduced a document authored by Snyder that listed the adjustments at issue.[178] The Fifth Circuit nonetheless vacated the district court's judgment, holding that the court improperly instructed the jury regarding Snyder's argument that he relied on his accountants in preparing the Form 10-Q.[179] The jury's instruction improperly placed the burden on Snyder to prove that he reasonably relied on his accountant.[180] Because reliance on an accounting professional is not an affirmative defense, the jury instruction was erroneous, and the Fifth Circuit thus remanded for a new trial.[181]

In *United States v. Setser*,[182] the Fifth Circuit affirmed the securities fraud, money laundering, wire fraud, and conspiracy convictions against a brother and sister who allegedly ran a $173 million Ponzi scheme.[183] The scheme involved the solicitation of funds from religious groups for investments in nonexistent real estate and retail products and resulted in a parallel SEC investigation and the appointment of a receiver by the Northern District of Texas.[184] The Fifth Circuit rejected the defendants' challenge to certain evidence seized by the SEC-appointed receiver, holding that the receiver had

broad authority to seize the defendants' assets and that the fairness and integrity of the proceedings was not seriously compromised by the receiver's untimely bond submission.[185] The Fifth Circuit also rejected the defendants' challenges to the admission of expert testimony and various other evidentiary challenges.[186] The court likewise affirmed the 15-year sentence received by Deborah Setser, holding that the losses caused by money reinvested into the scheme after she became involved were properly included in the total loss-calculation determination at sentencing.[187]

In *Miller v. Nationwide Life Ins. Co.*,[188] the Fifth Circuit reversed a district court's dismissal of an annuity holder's breach of contract and Securities Act claim against Nationwide for allegedly charging improper fees and failing to provide a timely prospectus. The plaintiff filed suit in the Eastern District of Louisiana alleging that Nationwide breached his annuity contract by charging fees for transferring assets between the various sub-accounts underlying his annuities.[189] In reversing the district court's Rule 12(b)(6) dismissal, the Fifth Circuit rejected Nationwide's argument that the annuities' prospectuses demonstrated that the fees were charged by the underlying mutual funds and not by Nationwide itself.[190] The court observed that the complaint "cites specific instances of Nationwide billing and withdrawing money from his annuity account in payment of such fees, despite contractual guarantees to the contrary."[191] The Fifth Circuit also rejected Nationwide's alternative argument that the dismissal of a previous class action suit by the same plaintiff under the Securities Litigation Uniform Standards Act ("SLUSA") barred Miller's current suit under *res judicata* principles, holding that the SLUSA dismissal was jurisdictional and did not amount to a final judgment on the merits.[192]

The appellate court also reversed the district court's dismissal of Miller's Securities Act claim based on the alleged untimely prospectus.[193] The district court had dismissed the claim on *res judicata* grounds based on the dismissal of the earlier lawsuit.[194] The Fifth Circuit held that the prior lawsuit could not be *res judicata* because the Securities Act claim before the court was premised on facts arising after the prior lawsuit had concluded.[195] Accordingly, the court reversed the district court's dismissal.[196]

In *Affiliated Computer Services, Inc. v. Wilmington Trust Co.*,[197] the Fifth Circuit affirmed a summary judgment of the Northern District of Texas in a case involving the alleged breach of an indenture agreement between The Bank of New York Trust Company and Affiliated Computer Services, Inc. ("ACS") in connection with corporate bonds issued by ACS.[198] Wilmington Trust Company, which later substituted for The Bank of New York under the indenture agreement, claimed that ACS breached the indenture by failing to file a timely Form 10-K with the SEC due to a pending internal investigation into the company's historical stock option granting practices.[199] The indenture provided that ACS "shall file with the Trustee, within 15 days after it files the same with the SEC, copies of the annual reports and the information, documents and other reports . . . that [ASC] is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. [ACS] shall also comply with the provisions of [Trust Indenture Act] 314(a)."[200] Section 314(a) of the Trust Indenture Act contains a similar requirement that the issuer "file with the indenture trustee copies of the annual reports and of the information, documents, and other reports . . . which such obligor is required to file with the Commission . . . ."[201]

The district court granted summary judgment in favor of ACS, finding that it was not in default under these provisions.[202] The Fifth Circuit affirmed, holding that section 314 of the Trust Indenture Act and the provision of the indenture agreement cited above do not impose an independent requirement that ACS must file annual reports with the SEC.[203] Instead, these provisions merely require ACS to deliver annual reports to the indenture trustee if and when such reports are filed with the SEC.[204] Because the provisions do not impose an independent requirement on ACS to file anything with the SEC, ACS was not in breach of the indenture.[205]

In *Tifford v. Tandem Energy Corp.*,[206] the Fifth Circuit reversed a summary judgment granted by the Western District of Texas in a case involving the alleged conversion of a stock certificate in the plaintiff's possession.[207] The dispute arose from a "corporate deal gone wrong," in which the owners of Tandem Energy Corporation ("Tandem Colorado") agreed to conduct a "reverse merger" in which Tandem would be sold to a nonpublic Texas company ("Tandem Texas") that would be purchased by a public shell company called Tandem Energy Holdings, Inc. ("Tandem Nevada").[208] A consultant named Lyle Mortensen had purchased a public shell company, renamed it Tandem Nevada, appointed himself as its president, secretary, and sole director, and issued 20 million shares of Tandem Nevada to himself.[209] After the merger, Mortensen reissued 17 million to the sellers of Tandem Colorado and new investors and 3 million shares to Mortensen's consulting firm.[210] The defendants contended that Ron Williams, whom defendants alleged was a convicted securities fraud felon and disbarred former attorney who was hired by the buyers to facilitate the transaction, engaged in a fraudulent pump-and-dump scheme with Mortensen.[211] In August 2005, the new board of directors of Tandem Nevada purportedly cancelled the 20 million shares that had been reissued.[212]

In April 2006, Mortensen transferred a stock certificate to the plaintiff (Tifford) purporting to represent shares of Tandem Nevada.[213] These shares were among those purportedly cancelled by Tandem Nevada in 2005.[214] Tifford asserted that he did not know of Tandem Nevada's efforts to cancel the shares.[215] After Tandem Nevada refused to reissue the shares, Tifford filed suit, alleging that Tandem Colorado and Tandem Nevada converted his shares.[216] The district court granted summary judgment in favor of defendants on all claims, and Tifford appealed.[217]

The Fifth Circuit reversed.[218] It held that Tifford raised triable issues of fact on the four elements of his conversion claim: (i) whether he legally possessed the shares; (ii) whether the defendants wrongfully exercised control or dominion over the shares; (iii) whether the plaintiff demanded return of the property; and (iv) whether the

defendants refused the plaintiff's demand.[219] Texas law allows a shareholder to sue a corporation for conversion of shares.[220]

Because Tandem Nevada is a Nevada corporation, the court looked to Nevada law to determine whether Tifford had a legal right to the shares.[221] The Fifth Circuit concluded that there was a fact issue as to whether Tifford knew the shares were worthless when he acquired the certificate, rejecting the argument that Tifford had "constructive" knowledge of a defect in the shares due to Williams' alleged poor reputation.[222] Tiffin testified that he never received notice of the board's cancellation.[223] The Fifth Circuit also held that there was a fact issue as to whether Tandem Nevada validly cancelled the shares, noting that a company may cancel shares under the relevant Nevada statute if the shares were issued "illegally," "fraudulently," or "without authority."[224] Because there was no conclusive evidence that the shares were issued in such a manner, the defendants were not entitled to summary judgment that the shares were validly cancelled.[225] For similar reasons, the Fifth Circuit concluded that Tiffin raised fact issues as to the other elements of conversion and on his conspiracy claim.[226]

In *Whitcraft v. Brown*,[227] the Fifth Circuit affirmed a contempt finding by the Northern District of Texas against an attorney for knowingly aiding and abetting his client in violating a temporary restraining order freezing his client's assets, but reversed a similar finding as to the client's mother.[228] The attorney allegedly assisted the client in selling a Picasso painting hanging in the client's bedroom for $500,000.[229] To avoid the freeze order, the attorney opined that the transaction would be legal so long as the client maintained that the painting was owned by his mother.[230] The painting was sold for $431,161, and the sale proceeds were wired into the mother's account but made available for the client's use.[231] The district court found the client, the attorney, and the client's mother in contempt.[232] The Fifth Circuit affirmed the contempt finding as to the attorney, noting that the attorney had been served with the order and knew the painting was in the client's possession when the order was entered.[233] It reversed the contempt finding as to the client's mother because there was insufficient evidence that she understood the details of the freeze order.[234]

ENDNOTES

1 *Gerard Pecht is a partner in the Houston office of Fulbright & Jaworski L.L.P., and Peter Stokes is a senior associate in the Austin office of Fulbright & Jaworski, L.L.P.*

2 127 S. Ct. 2499 (June 21, 2007).

3 565 F.3d 200 (5th Cir. Apr. 8, 2009). The authors of this article served as counsel of record for TXU and Wilder during the litigation and on appeal.

4 *Id*. at 203.

5 *Id*.

6 *Id*. at 205.

7 *Id*.

8 *Id*.

9 *Id*. at 209-10.

10 *Id*.

11 *Id*.

12 *Id*. at 203.

13 *Id*. at 210-13.

14 *Id*.

15 *Id*. at 211.

16 *Id*. at 213.

17 *Id*.

18 *Id*.

19 *Id*. at 213-14.

20 560 F.3d 292 (5th Cir. Feb. 17, 2009).

21 *Id*. at 293-94.

22 *Id*. at 293-96.

23 *Id*.

24 *Id*. at 296.

25 *Id*.

26 *Id*.

27 *Id*. at 297.

28 *Id*. at 298.

29 *Id*.

30 540 F.3d 333 (5th Cir. Aug. 11, 2008).

31 *Id*. at 337.

32 *Id*.

33 *Id*.

34 *Id*. at 337-38.

35 *Id*. at 338.

36 *Id*.

37 *Id*.

38 *Id*. at 344.

39 *Id*. at 340.

40 *Id*. at 343.

41 *Id*. at 342.

42 *Id*.

43 *Id*.

44 *Id*. at 341-42.

45 *Id*. at 343-44.

46 *Id*. at 344.

47 565 F.3d 228 (5th Cir. Apr. 9, 2009).

48 *Id*. at 321-32.

49 *Id*. at 233-34.

50 *Id*.

51 *Id*.

52 *Id*.

53 *Id*. at 234.

54 *Id*.

55 *Id*. at 234-35.

56 *Id*.

57 *Id*. at 235.

58 *Id*.

59 *Id*.

60 *Id*. at 239.

61 *Id*. at 234-36.

62 *Id*.

63 *Id*. at 236.

64 *Id*.

65 *Id*. at 238.

66 *Id*.

67 *Id*. at 238-39.

68 *Id* Id.. at 243-48.

69 *Id*. at 247.

70 *Id*. at 248-49.

71 *Id*. at 250-55.

72 *Id*. at 254.

73 *Id*.

74 *Id*. at 259-68.

75 *Id*. at 260.

76 *Id*. at 261-62.

77 *Id*. at 267-68.

78 *Id*. at 264.

79 *Id*. at 267.

80 *Id*. at 268.

81 292 Fed. Appx. 311 (5th Cir. Sept. 8, 2008).

82 *Id*. at 312.

83 *Id*.

84 *Id*.

85 *Id*. at 314.

86 *Id*.

87 *Id*.

88 *Id*. at 314-15.

89 *Id*. at 315-16.

90 *Id*.

91 *Id*.

92 *Id*.

93 *Id*. at 316.

94 __ F.3d __, 2009 WL 1740648 (5th Cir. June 19, 2009).

95 *Id*. at *1.

96 *Id*. at *2.

97 *Id*.

98 *Id*.

99 *Id*.

100 *Id*. at *3.

101 *Id*.

102 *Id*.

103 *Id*.

104 *Id*.

105 *Id*.

106 *Id*. at *4.

107 *Id*. at *5.

108 *Id*. at *6-9.

109 *Id*. at *6.

110 *Id*. at *8.

111 *Id*. at *9.

112 *Id*.

113 *Id*. at *11.

114 *Id*.

115 *Id*. at *11-12.

116 *Id.*

117 *Id.* at *12.

118 *Id.*

119 *Id.*

120 554 F.3d 529 (5th Cir. Jan. 6, 2009).

121 *Id.* at 535-42.

122 *Id.* at 542.

123 *Id.*

124 *Id.*

125 *Id.* at 543-46.

126 *Id.* at 546.

127 *Id.*

128 *Id.* at 547-50.

129 *Id.* at 550-51.

130 *Id.* at 554.

131 *Id.* at 554-590.

132 *Id.* at 580.

133 *Id.* at 578-79.

134 *Id.* at 579.

135 *Id.* at 593.

136 *Id.* at 595.

137 *Id.*

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139 *Id.* at 467.

140 *Id.*

141 *Id.*

142 *Id.* at 469-70.

143 *Id.* at 470-72.

144 *Id.* at 472.

145 *Id.* at 468-69.

146 *Id.* at 473-74.

147 *Id.* at 474.

148 565 F.3d 932 (5th Cir. Apr. 17, 2009).

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150 *Id.* at 934-35.

151 *Id.*

152 *Id.*

153 *Id.* at 936-39.

154 *Id.* at 939-40.

155 298 Fed. Appx. 319 (5th Cir. Oct. 28, 2008).

156 *Id.* at 321-22.

157 *Id.*

158 *Id.*

159 *Id.* at 322-23.

160 *Id.*

161 *Id.*

162 *Id.*

163 *Id.* at 323.

164 *Id.* at 324-35.

165 *Id.* at 328-35.

166 *Id.* at 329-30.

167 *Id.*

168 *Id.*

169 *Id.* at 336-37.

170 *Id.*

171 *Id.*

172 *Id.* at 335-36.

173 292 Fed. Appx. 391 (5th Cir. Sept. 16, 2008).

174 *Id.* at 394.

175 *Id.* at 393-94.

176 *Id.* at 399-404.

177 *Id.* at 402.

178 *Id.*

179 *Id.* at 406-07.

180 *Id.*

181 *Id.*

182 __ F.3d __, 2009 WL 1299562 (5th Cir. May 12, 2009).

183 *Id.* at *1.

184 *Id.*

185 *Id.* at *2-9.

186 *Id.* at *9-12.

187 *Id.* at *13.

188 No. 06-31178, 2008 WL 3086783 (5th Cir. Aug. 6, 2008).

189 *Id*. at *1-2.

190 *Id*. at *3.

191 *Id*.

192 *Id*. at *3-4; *see Miller v. Nationwide Ins. Co.*, 391 F.3d 698, 703 (5th Cir. 2004).

193 2008 WL 3086783, at *6.

194 *Id*.

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196 *Id*.

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198 *Id*. at 926.

199 *Id*. at 927.

200 *Id*.

201 15 U.S.C. § 77nnn(a).

202 565 F.3d at 928.

203 *Id*. at 928-32.

204 *Id*.

205 *Id*.

206 562 F.3d 699 (5th Cir. Mar. 11, 2009).

207 *Id*. at 702-03.

208 *Id*. at 703.

209 *Id*.

210 *Id*.

211 *Id*. at 703.

212 *Id*. at 703-04.

213 *Id*. at 704.

214 *Id*.

215 *Id*.

216 *Id*. at 704.

217 *Id*.

218 *Id*. at 705-09.

219 *Id*. at 705.

220 *Id*.

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222 *Id*. at 706.

223 *Id*.

224 *Id*.

225 *Id*.

226 *Id*. at 706-09.

227 *Id*__ F.3d __, 2009 WL 1492833 (5th Cir. May 29, 2009).

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230 *Id*.

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234 *Id*.

2008 Update Of Delaware Fiduciary Duty Law Concerning Limited Liability Companies

By Cindy Andrew[1]

Directors of limited liability companies formed under Delaware law should have some comfort from two decisions recently issued by Delaware courts concerning the viability of fiduciary duty claims asserted against directors of limited liability companies. The two opinions illustrate the willingness of Delaware courts to dismiss fiduciary claims when the plaintiff has failed to make a board demand and has failed to plead particularized facts to establish demand futility. While the two cases highlight the significant obstacles members must overcome to proceed beyond the initial pleading stage, a third decision suggests the readiness of Delaware courts to allow claims to proceed when the member-plaintiff has alleged specific facts that tend to show that the LLC director breached its fiduciary duties. In fact, relying upon principles stated in *In re USACafes*, the court in this third decision permitted the plaintiff to proceed with its fiduciary claims against an affiliate of the LLC's director.

I. Dismissal of Fiduciary Claims Upheld Where LLC Operating Agreement Provided Broad Exculpation for Directors

In *Wood v. Baum*,[2] the Delaware Supreme Court upheld the Court of Chancery's dismissal of the plaintiff's fiduciary claims. The court agreed with the Court of Chancery that the LLC's operating agreement exempted the directors of Municipal Mortgage & Equity, LLC ("MME") from all liability except in cases of fraud and illegal conduct. The plaintiff, according to the court, failed to plead with particularity any facts to support a claim of fraud, illegal conduct or bad faith breach of the implied duty of good faith and fair dealing. The plaintiff, therefore, failed to establish that the board faced potential personal liability, which meant that she also failed to show that the board would have been unable to exercise its business judgment had the plaintiff presented her demand.

Operating from Baltimore, MME provided debt and equity financing, invested in tax-exempt bonds, and was a syndicator of low-income housing tax credits. After an investigation by the SEC and a restatement of the company's financials, Paddy Wood brought a derivative suit against the then-current Board. Wood alleged, among other things, that the Board breached its fiduciary duties by causing MME to violate GAAP and SEC standards and "failing properly to institute, administer and maintain adequate accounting and reporting controls, practices and procedures . . . ."[3] Before filing suit, Wood did not make a demand on the Board. She contended that demand was excused because the Board was incapable of properly exercising its business judgment due to "the substantial risk of personal liability" of Board members.

The defendants moved to dismiss Wood's claims under Court of Chancery Rule 23.1, for failure to make a pre-suit demand on MME's Board. A plaintiff is excused from making a demand if the plaintiff shows that demand on the board would have been futile. To establish futility, the plaintiff must "comply with stringent requirements of factual particularity . . . ."[4] The defendants maintained that Wood failed to meet these stringent pleading requirements. The Court of Chancery agreed. In dismissing Wood's claims, the court commented "though the complaint is 80-some pages long and is a model of prolixity, it fails to state any basis on which the Court could reasonably conclude that the demand futility standard is met."[5]

On appeal, the Delaware Supreme Court focused on the exculpation provision contained in MME's operating agreement. That provision provided:

> No director or officer of the Company shall be liable, responsible, or accountable in damages or otherwise to the Company or any Shareholders for any act or omission performed or omitted by him or her, or for any decision, except in the case of fraudulent or illegal conduct of such person.[6]

Given the broad exculpation provided to MME's directors, the court reasoned that MME's directors could be at "substantial risk of personal liability" only if Wood asserted non-exculpated claims—claims that were based on fraud, illegal conduct or the bad faith breach of the duty of good faith and fair dealing. Additionally,

under Delaware's stringent pleading requirement, Wood was required to support the non-exculpated claims with "particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had actual or constructive knowledge that their conduct was legally improper."[7]

After examining the factual allegations contained in Wood's complaint, the court found that the complaint contained only conclusory statements that the defendants engaged in deceit. The court held "[s]uch assertions are insufficient to state an actionable claim for fraud."[8] Having failed to state an actionable claim, Wood also failed to establish that the Board faced a substantial risk of personal liability that would have prevented the Board from properly exercising its business judgment had she presented her demand.

II. Board Deadlock Does Not By Itself Excuse Members from Making Board Demand

In *Spellman v. Katz*,[9] Vice-Chancellor Noble dismissed the defendant's breach of fiduciary duty counterclaim because the defendant did not establish that it would have been futile to submit his demand to the board, which consisted of only the plaintiff and the defendant. Even when the board is deadlocked, the court held that members must still plead particularized facts that evidence the board's inability to properly exercise its business judgment in responding to the demand.

In 1997, Drs. Spellman and Katz formed KSA, LLC. The construction of a medical office building was KSA's sole purpose. After completion of the construction project, KSA's operating agreement provided that the company would be dissolved. The doctors' relationship was tumultuous from the start and only deteriorated over time. When construction was completed, Spellman asked Katz to purchase Spellman's interest. Katz refused, and Spellman filed suit. Spellman sought a declaration of the dissolution of KSA under section 18-802 of the Delaware LLC Act.

Katz mounted a counter-attack. He asserted a derivative claim against Spellman for breach of fiduciary duty stemming from Spellman's refusal to assist with refinancing efforts of KSA's mortgage on the medical office property. Katz admitted that he did not make a pre-suit demand. He claimed that he was excused because "KSA is incapable of acting because, as stated above, its members are deadlocked. . . Further, Dr. Spellman will himself become a defendant in any action or other litigation instituted to address the aforesaid misconduct . . . ."[10] Katz offered no specific facts to support his claim that Spellman faced personal exposure for his refusal to renegotiate KSA's mortgage. Instead, Katz recited facts concerning the low interest rates that were available. From there, Katz surmised that "[s]ignificant savings in interest payments could have been achieved through the refinancing."[11]

The court began its analysis by flatly rejecting Katz' argument that demand is futile simply because the board is deadlocked. The court stated "[d]eadlock – an evenly divided control group—will not by itself satisfy the demand excusal standard."[12] From there, the court analyzed Katz' contentions that Spellman faced personal liability for his refusal to renegotiate KSA's mortgage. The court found Katz' allegations lacking. The allegations did not reference "the balance on the mortgage, the interest rate differential, a reasonable estimate of the potential savings, whether the interest to be saved would be material to KSA, and whether any potential liability would be material to Dr. Spellman."[13] The court found that Katz offered no factual basis from which the court could find that Spellman faced a substantial likelihood of personal liability. As a result, Katz did not establish that demand of the Board would have been futile. The court dismissed Katz' counterclaim and granted Spellman's request to dissolve KSA.

III. Relying on *USACafes* Standard, Court Held That Member Pled Viable Fiduciary Claim Against Affiliate of a LLC Director

In *Bay Center Apartments Owner LLC v. Emery Bay PKI, LLC,* Vice-Chancellor Strine denied the defendants' Rule 12(b)(6) motion to dismiss, finding that the plaintiff sufficiently pled the elements for each of its asserted claims. Bay Center Apartment Owner, LLC ("Bay Center") and Emery Bay PKI, LLC ("PKI") formed Emery Bay Member, LLC ("Emery Bay") in 2005 to develop a condominium project in California. PKI was controlled by Alfred Nevis, PKI's sole equity holder. Emery Bay's operating agreement designated PKI as the managing member and provided for PKI to manage the project. A separate management agreement between an Emery Bay subsidiary and ETI (a PKI affiliate) detailed how the project was to be run. Neither PKI nor Nevis was a party to the management agreement.

Bay Center alleged that soon after the project commenced, Bay Center discovered that PKI, ETI and Nevis were grossly mismanaging the project. There were cost overruns of over $10,000,000, sales were below projections and construction was behind schedule. After making repeated document requests, Bay Center learned that Emery Bay was in default on one of its loans. And regarding another Emery Bay loan, Bay Center discovered that PKI and Nevis had diverted funds from other projects to pay the loan, which avoided triggering a provision that would have made Nevis personally liable on the loan.

By July 2007, Emery Bay was placed in receivership. Bay Center then filed suit, naming PKI, Nevis, Emery Bay and ETI. Bay Center asserted claims for breaches of fiduciary duty, contract, and the implied duty of good faith and fair dealing, aiding and abetting breach of fiduciary duty and fraud. The defendants filed a Court of Chancery Rule 12(b)(6) motion to dismiss all of Bay Center's claims except its breach of contract claims. Regarding the fiduciary claims, which were only asserted against PKI and Nevis, PKI argued that the operating agreement eliminated all fiduciary duties it may have owed to Emery Bay and Nevis contended that he owed no fiduciary duties to Emery Bay.

In support of its argument that Emery Bay exempted it from any fiduciary liability, PKI directed the court to a provision in Emery Bay's operating agreement that stated:

> Except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members . . . .[14]

Bay Center countered by pointing to another provision in the operating agreement, which stated:

> Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.[15]

Faced with two reasonable and differing interpretations of the operating agreement, the court relied on the standard under Rule 12(b)(6) in deciding whether PKI was entitled to dismissal. A defendant is entitled to dismissal when the plaintiff fails to plead sufficient facts to plausibly suggest that the plaintiff ultimately will be entitled to relief. When the asserted claim involves a contract provision, dismissal is proper if "the interpretation of the contract on which their theory of the case rests is the *only* reasonable construction as a matter of law."[16] The court found that PKI's interpretation was not the only reasonable construction of the operating agreement. Bay Center's interpretation was just as reasonable. Bay Center, therefore, had pled sufficient facts to *plausibly suggest* that it could recover on its fiduciary claim against PKI. As a result, PKI was not entitled to a dismissal.

The court had a more difficult time deciding whether Bay Center's fiduciary claims against Nevis should be dismissed. Nevis was neither a member nor an officer of Emery Bay. Facially, it did not appear that a fiduciary relationship existed between Nevis and Emery Bay such that he could be held liable for breach of fiduciary duty. However, under a line of cases that originated with *In re USACafes, L.P. Litig.*,[17] Delaware courts have held that an affiliate of a control person may owe fiduciary duties to a company if the affiliate exercises control over the company's property.

Bay Center contended that *USACafes* and its progeny applied to its claims against Nevis. It alleged extensive facts that demonstrated that Nevis exerted considerable control over Emery Bay's assets through PKI, ETI and other related entities. Additionally, Nevis used PKI's position as managing member of Emery Bay "to make cash sweeps to satisfy the renegotiated A&D Loan, which avoided a default on the Loan, and in turn, the triggering of Nevis' substantial Personal Guarantee."[18]

The court agreed with Bay Center that, under *USACafes*, an affiliate that exerts control over a company's assets may be found to have fiduciary obligations to the company. But the court declined to extend *USACafes* to all circumstances when an affiliate exercises control over a company's assets. Instead, the court held that fiduciary duties will be found only when the affiliate exerts control over company assets *and* the affiliate uses the assets to the affiliate's benefit and to the company's detriment. In limiting *USACafes*, the court remarked:

> Limiting the application of *USACafes* to this duty provides, in my view, a rational and disciplined way of protecting investors in alternative entities with managing members who are themselves entities, while not subjecting all the individuals who work for managing members to wide-ranging causes of action.[19]

The court applied the revised *USACafes* standard to Bay Center's factual allegations. The court found that Bay Center had sufficiently pled that Nevis used his control over Emery Bay's assets to avoid becoming personally liable on a loan. The court concluded that those facts were sufficient to create "a reasonable inference that Nevis used his control over Emery Bay's property to shield himself from monetary liability at the expense of Bay Center."[20] The court then denied Nevis' motion to dismiss.

ENDNOTES

1. Cindy W. Andrew is a solo practitioner in Dallas, Texas. She serves as outsourced general counsel for small businesses.
2. 953 A.2d 136 (Del. 2008).
3. *Id.* at 140.
4. *Id.* at 142 (quoting *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).
5. *Id.* at 141.
6. *Id.* at 139 n.1.
7. *Id.* at 144 (citing *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001).
8. *Id.*
9. C.A. No. 1838-VCN, 2009 LEXIS 18 (Del. Ch. Feb. 6, 2009).
10. *Id.* at *19.
11. *Id.*
12. *Id.* at *18.
13. *Id.* at *22.
14. *Id.* at *28-29.
15. *Id.* at
16. *Id.* (emphasis in original).
17. *Id.* at *36 (citing *In re USACafes, L.P. Litig.*, 600 A.2d 43, 49 (Del. Ch. 1991) (holding "those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.").
18. *Id.* at *39.
19. *Id.* at *37.
20. *Id.* at *39.

Gerard G. Pecht

Peter A. Stokes

Case Summary: *Somers v. Crane*

By Gerard G. Pecht and Peter A. Stokes[1]

Shareholder litigation is a frequent occurrence when a company announces a merger or acquisition. On March 26, 2009, the First Court of Appeals issued a major decision addressing the requirements for bringing a merger-related shareholder class action or derivative lawsuit involving a Texas corporation. The case is styled *Somers v. Crane*, __ S.W.3d __, 2009 WL 793751 (Tex. App.—Houston [1st Dist.] Mar. 26, 2009, pet. filed).

The *Somers* case involved separate class action and derivative lawsuits that were filed by alleged former shareholders of EGL, Inc. Both suits alleged that EGL's directors breached their fiduciary duties by negotiating and approving a merger agreement to sell EGL to a management-led buyout group at $38 per share in March 2007. The EGL board ultimately terminated the agreement and entered a new all-cash merger agreement at $47.50 per share with an Apollo Management LP portfolio company, which EGL's shareholders approved in July 2007. The plaintiffs asserted that the original merger agreement provided inadequate consideration to EGL shareholders, included "onerous deal protection devices" that allegedly limited EGL's ability to entertain superior offers, and resulted from an unfair process allegedly designed to benefit management at the expense of shareholders.[2] In particular, the plaintiffs complained that the original merger agreement contained a termination fee provision that required EGL to pay the management group $30 million after it terminated the original agreement. The class action claims were asserted directly against the directors on behalf of all EGL shareholders, while the shareholder derivative claims were asserted derivatively on behalf of EGL against the directors.

The First Court of Appeals affirmed the trial court's dismissal of both actions, which were by way of special exceptions and a motion to dismiss in the class action case and through a plea to the jurisdiction in the derivative case. With respect to the class action claims, the court held that the directors of a Texas corporation owe fiduciary duties to the corporation itself and do not owe fiduciary duties directly to the shareholders.[3] The court cited a long line of Texas cases holding that directors do not owe fiduciary duties directly to shareholders.[4] Recognizing that fiduciary relationships are of an "extraordinary nature," and observing that the relationship between EGL's directors and shareholders was "solely a corporate relationship," the court of appeals declined to recognize a direct fiduciary relationship between the directors and shareholders.[5] Accordingly, the court affirmed dismissal of the class action claims.

With respect to the shareholder derivative claims, the court of appeals affirmed the trial court's judgment that the plaintiff lacked standing to assert those claims because he "was not a shareholder at the time he filed suit."[6] The court held that under Tex. Bus. Corp. Act. Ann. Art. 5.14(B), "a plaintiff seeking to derivatively enforce the rights of a corporation must be a shareholder."[7] Because the derivative plaintiff did not file the derivative suit at issue on appeal until after the Apollo merger had closed and he was no longer an EGL shareholder, the court held that plaintiff lacked standing to bring the derivative claims.[8] The court also rejected the plaintiff's argument that he had standing under Article 5.03(M) of the Texas Business Corporation Act, which provides that Article 5 of the Act may not be construed to extinguish a shareholder's standing "[t]o the extent a shareholder of a corporation has standing to institute or maintain derivative litigation on behalf of the corporation immediately before a merger . . . ." The court held that Article 5.03(M) "does not confer standing on a former shareholder like [plaintiff] who otherwise lacks standing" and affirmed dismissal of the derivative claims.[9] The plaintiffs have filed a petition for review with the Texas Supreme Court, which is pending at the time of this writing.

ENDNOTES

1 Gerard Pecht is a partner in the Houston office of Fulbright & Jaworski L.L.P., and Peter Stokes is a senior associate in the Austin office of Fulbright & Jaworski, L.L.P.

2 2009 WL 793751, at *1-2.

3 *Id.* at *4.

4 *See id.* at *4 (citing *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders") and *Gearhart Indus., Inc. v. Smith Int'l Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (same)).

5 *Id.* at *5.

6 *Id.* at *6.

7 *Id.* at *7-8 (citing Zuaber v. Murray Sav. Ass'n, 591 S.W.2d 932, 935 (Tex. Civ. App.—Dallas 1979), writ ref'd per curiam, 601 S.W.2d 940 (Tex. 1980)).

8 *Id.* at *7-8 (noting that in an all-cash merger, the selling shareholder no longer has any equity interest in the surviving company).

9 2009 WL 793751, at *7-8.

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