Amateur Golf versus Securities Litigation in Federal Court

Not long ago I played a round of golf with a federal judge. I played fairly well, and when we finished the judge ask me for some playing pointers. I told him to lay off for six months and then quit. Our conversation got around to my practice of federal securities litigation. I asked for his advice. Guess what he told me. Right! Lay off for six months and then quit. He didn't really need to explain.[1]

When Congress enacted the Private Securities Litigation Reform Act (PSLRA), 15 USCA § 78-u(4), in 1995, over President Clinton's veto, I speculated that the federal courts would see an opportunity to eliminate the clumsy business of private securities litigation and take it.[2] Well, all I can say is that it took a little longer than anticipated. Confronted with mandatory sanctions for specifically pleading uncertain facts,[3] securities plaintiffs sought to establish a pleading foothold by basing their allegations on "information and belief." When predicated on that foundation the pleading was required by PSLRA to "specify each statement alleged to have been misleading and the reason or reasons why the statement was misleading." 15 USCA §78u-4(b)(1)(B). Further, for each such act or omission alleged to be false or misleading, the pleading must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 USCA §78u-4(b)(2). And because recovery under the federal securities laws generally required that a defendant act with scienter ("intent to deceive, manipulate, or defraud"), (see e.g. ***Ernst & Ernst v. Hochfelder,*** 425 U.S. 185, 193-94 n.12 (1976)), a "strong inference" must be pleaded demonstrating that the defendant's conduct conformed to that standard. The Supreme Court has not yet determined whether "recklessness" can establish scienter, although all lower courts that have considered the issue have found it sufficient. E.g. ***Baesa Sec. Litig***., 969 F.Supp. 238, 241 (SDNY 1997). So, for now, a strong inference of recklessness will also pass muster. The inference must be "cogent and compelling", not merely "reasonable" or "permissible." See ***Tellabs, Inc. v Makor Issues & Rights, Ltd.,*** ___ US ____, 127 S.Ct. 2499, 2510 (2007). BUT WAIT, THERE'S MORE. As will be shown *infra*, Plaintiff's information and belief must encompass each defendant, individually, with no group attribution, and may not be based on confidential sources. PSLRA also mandated that discovery be stayed when a Motion to Dismiss

[1]Just a story. No federal judge I know would ask for my advice on any subject.

[2] I also took occasion to point out that PSLRA was adopted at the behest of those who had violated the law and who baldly claimed that securities plaintiffs and their lawyers were coercing them to pay big bucks to settle frivolous lawsuits. I said "baldly" because I found not a single case where such an event actually occurred. See Ravkind, ***Liability of Third Party Professionals Under State and Federal Securities Laws,*** reprinted at *www.loyalaw.com/CM/Publications/LiabilityofThirdPartyProfessionalsFederalStateSecurities Laws.* In ***In re Philip Morris Sec. Litigation,*** 872 F.Supp. 97 (S.D.N.Y. 1995), the court summarily dismissed the obvious strike suit. That's as close I can find as support for the bald allegation.

[3] Congress mandated virtually mandatory sanctions under Rule 11 FRCP if plaintiff's proof failed to prove the allegations. See 15 USCA §78u-4(c).

was filed[4] which raised the all too real specter that limitations might commence because of general information contained in a news release published by the company and expire before a plaintiff could uncover facts sufficient to satisfy these heightened pleading requirements.[5] A recent Fifth Circuit decision demonstrates the futility of pursuing a federally founded securities misrepresentation claim except in the most egregious case.

The facts in ***Indiana Electrical Worker's Pension Trust Fund IBEW v Shaw Group, Inc.,*** 537 F.3d 527 (5th Cir 2008), were fairly straight forward and can be simplistically stated. Shaw projected earnings from its construction contracts based upon a percentage of completion formula which in turn relied upon certain proprietary software that it had developed. Plaintiffs' information and belief allegations were that software was faulty, that defendants knew it was faulty, and that the completion estimates were significantly overstated which caused Shaw's earnings to be inflated.[6] In addition, according to the complaint, a senior officer of the company directed underlings to report higher levels of contract completions which would result in larger than justified income being reported. In addition, plaintiffs asserted that a major construction project was doomed from the outset and that the company inflated its backlog of contracts and slow-paid creditors to shore up its earnings report.[7] The class action plaintiffs were market purchasers of the stock during a three and a half year window who contended that they paid too much for it. Defendants were managing officers and directors of the company. The defendants filed the usual Motion to Dismiss under FRCP Rule 12(b)(6) – failure to plead a cause of action – which the District Court denied without opinion. The Fifth Circuit, after reviewing the pleading requirements necessary under PSLRA, reversed the District Court and dismissed the case. Plaintiffs had not, said the Court, pleaded facts sufficient to establish a "strong inference" that defendants acted with scienter. The Court conceded that a "possible" inference might be drawn from the stated facts that defendants intended to deceive the investing public. Indeed, the pleaded facts established that defendants had motive and opportunity to engage in the prohibited range of conduct. But neither

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[4] See 15 USCA §78u-4((b)(3).

[5] See ***Sudos Prop. v Terrebonne Parish***, 503 F3d 371, 376 (5th Cir 2007); ***Jensen v Snelling,*** 841 F2d 600, 607 (5th Cir 1988). These are cases where limitations was initiated because of inquiry notice, a rather illusive concept requiring the plaintiff to investigate further. If the plaintiff does nothing (the usual situation in a securities case), limitations commences on the date of that notice.

[6] The Fifth Circuit placed significant importance on plaintiffs' failure to plead the amount of the overstatement with any precision and their failure to plead that earning estimates were ever changed. It was also pointed out that the SEC never charged the defendants with a violation. The first two may be an important omission in evaluating loss causation in a Fraud on the Market case (see ***Oscar Private Equity Investments v Allegiance Telecom, Inc.***, 487 F.3d 261 (5th Cir. 2007)), but that was not the basis of the Court's opinion. The last was surely a throw away.

[7] It was also alleged that Shaw had misrepresented the value of assets (two companies) purchased in bankruptcy proceedings, but the Court provides little detail. It is possible, of course, that this was due to the lack of detail in the complaint.

was sufficient to satisfy the statutory pleading threshold. (***Id*** at 533) .

In reviewing its prior decisions, the Court pointed out (1) group pleading that would attribute written statements to the members of the group participating in the publication of the statements could not be used because the alleged facts must be attributed to each defendant specifically (***Id*** at 533); (2) motive and opportunity were insufficient to create a strong inference of scienter (***Id*** at 533); (3) any factual assertions attributed to confidential sources must identify the source by name or job title (so the source would no longer be confidential) and establish that he had a company or private position that gave him first hand access to the information (***Id*** at 539-540); (4) a violation of Generally Accepted Accounting Standards (GAAS) or its counterpoint, Generally Accepted Audit Procedures (GAAP), did not establish the strong inference (***Id*** at 534); (5) nor did defendants' Sarbanes-Oxley Act certification (Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745; 15 USCA §302) that falsely stated that the financial statements were properly prepared and presented (***Id*** at 545); (6) defendants' position and responsibility within the company did not establish their knowledge of the false information (***Id*** at 535); and (7) any inference of scienter must be based on facts that demonstrated that it was "cogent and compelling, not merely reasonable or permissible," although it might be less than certain (***Id*** at 533). While all seven impose substantial roadblocks to meeting the pleading requirements of PSLRA, it is the latter (of which the others are actually subgroups), as articulated by the Supreme Court[8], that is the most formidable.

In ***Shaw***, plaintiffs pleaded that defendants were involved in the day to day operation of the company; that a confidential source stated that defendants knew that the software program was faulty; that a confidential source stated that in June 2002 one defendant "screamed at a company financial analyst named Scott Roussell because Shaw's numbers were too low" and he "needed to do something to fix that." The source then heard Roussell call various operations centers in order to get them to increase their percentages of completions on Shaw's projects to "help with the numbers;"[9] and that generally accepted accounting standards required that income from uncompleted contacts not be reported until the contract was completed if a partial completion estimate was not accurately available. If, as the Court found, this is inadequate, just how do you

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[8] Whether the culpable inference of scienter is to be compared against all non-culpable inference collectively or compared against the non-culpable inference individually was not revealed by the Supreme Court. So the number of non-culpable inferences may reduce or may enhance the plaintiff's burden. For example, if there are two equally plausible opposing inferences then plaintiff has met his burden. (50% vs 50%). If there are three equally plausible inferences and two are non-culpable then the plaintiff fails if the evaluation is collective but prevails if the evaluation is individual. (33 1/3 vs 33 1/3 vs 33 1/3 or 33 1/3 vs 66 2/3). See Note, 121 Harv.L.Rev. 385, 390-392 (2007).

[9] The Court's treatment of this allegation as failing to raise an strong inference of scienter is probably the most troubling part of the opinion. Obviously Roussell inferred that he had been instructed to get inflated numbers from the field agents and did so. The Court, however, found this inference less cogent than an inference that the officer was merely seeking to obtain correct information.

plead and/or prove scienter? To my thinking, if a defendant's statement is false and other evidence shows that the defendant knew it was false, there is no leap in faith to conclude that the defendant intended to make a false statement. The Court's hang-up seems to be whether the defendants' intent in making the statements sprung from a desire to achieve an unlawful purpose. In ***Shaw,*** it was alleged that the company published false financial data. It was alleged that the defendants knew the data was false. It was further alleged, and indisputably true, that intentionally publishing false financial data violated the law. Finally, it can not be disputed that an efficient market or a knowledgeable investor would rely on published financial data. Viewed as a Fraud on the Market claim, where reliance is not necessary, or one that requires proof of reliance, what more can be require? If the law directs that a person intends the natural and probable consequences of his acts (obviously an inference), does the ***Shaw*** court mean to say this "inference" is not sufficiently "strong" to satisfy PSLRA? Stated another way, may it be strongly inferred that the defendant intended that purchasers of the stock rely on the false statement – a probable consequence? If not, and I can't think of any other explanation, the result in ***Shaw*** turns securities law on its deaf ear and would certainly cause Cardozo to twist in his grave.[10] Even in criminal cases where the

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[10] Probably the most well established inference that the law and human experience provides. Indeed, in times past a defendant would generally be held responsible for the consequences of an intentional act even if they were not probable or foreseeable. "There is a distinction, we think, between the case of an injury inflicted in the performance of a lawful act and one in which the act causing the injury is in itself unlawful or is, at least, a wilful wrong. In the latter case the defendant is liable for any consequence that may flow from his act as the proximate cause thereof, whether he could foresee or anticipate it or not; but when the act is lawful, the liability depends not upon the particular consequence or result that may flow from it, but upon the ability of a prudent man, in the exercise of ordinary care, to foresee that injury or damage will naturally or probably be the result of his act." ***Drum v Miller***, 135 N.C. 2004, 2008, 47 S.E. 421 (N.C. S. Ct. 1904). The usual law school example relates to someone intentionally starting a fire who is held legally responsible for all consequences. The more modern version requires that the result be a "probable" consequence of the act. ***N.M. v Daniel E.***, 173 P.3d 566, 569 (Utah S. Ct. 2008), recites the generic rule: "An effect which is the natural and probable consequence of an act or course of action is not an accident, nor is it produced by accidental means. It is either the result of actual design, or it falls under the maxim that every man must be held to intend the natural and probable consequence of his deeds." Cardozo authored a host of cases involving economic damages in which a variation of this inference was the key element. See ***Ultramares Corp. v George A Touche***, 255 N.Y. 170 (N.Y. Ct of App 1922) ("The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true (Hadcock v. Osmer, supra; Lehigh Zinc & Iron Co. v. Bamford, 150 U.S. 665, 673; Chatham Furnace Co. v. Moffatt, 147 Mass. 403; Arnold v. Richardson, 74 App. Div. 581). We think the triers of the facts might hold it to be false.") In that case the accountant had certified that the balance sheet was prepared in accordance with GAAS and that books of accounts supported the balance sheet entries. Cardoza had no difficulty in concluding that it was for a jury to decide whether the accountant knew of the falsity or did not know the truth or whether the accountant was simply negligent in failing to notice the error. Compare this pronouncement with the Fifth

defendant's intent is frequently the decisive jury issue an instruction embodying this presumption-inference passes muster if the jury is instructed that the inference is permissive only. This restriction (permissive only) is required in criminal proceedings to prevent dilution of the government's burden to prove guilt beyond a reasonable doubt. See ***United States v Chiantese***, 560 F.2d 1244, 1254-1255 (5th Cir 1977). In civil cases I find no similar restriction on the inference. The decision in ***Shaw*** establishes that it is easier to convict a wrongdoer of a crime than it is to make him recompense the victims in civil proceedings. Surely the Court does not mean to say that the presumption-inference is available at trial just not at the pleading stage. In any event, the Court held that something more was required in a misrepresentation claim under the federal securities law. Just what that may be and how you can plead it are challenging questions.

My conclusion is that the Court adopted "severe recklessness plus" as the only standard by which scienter can be proved unless there is a confession or overwhelming and patent evidence of fraud. And that's the problem. "Severe recklessness" is "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that presents a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." ***Shaw*** at 533 (internal citations omitted). What constitutes "a highly unreasonable omission or misrepresentation" and what is meant by a danger being known or obvious are questions that can seldom be answered from generally available factual information. Indeed, these are quintessentially questions of fact to be determined by a jury. And the "plus" is the requirement that the plaintiff specifically plead the facts and circumstances from which a conclusion that the defendant acted with extreme recklessness can be strongly inferred. Except in the most obvious case, a plaintiff will never have, without discovery, sufficient facts to satisfy this requirement. Oh well. As to the other alleged misdeeds, plaintiffs' pleading was less compelling in that a confidential source may have known the major construction contract was in trouble from the outset but there was no specific pleading that this source reported the information to any defendant and the alleged overstatement of contract backlog was too indefinite to withstand analysis.

In the Fifth Circuit the rejection of "group pleading" is predicated on the requirement that allegations of fraud be defendant specific: The" who" of the required who, when, what, why and where allegations required by Rule 9(h) FRCP. It was thought that the allowance of group pleading would undermine this requirement. See ***Southland Sec. Corp. v INSpire Ins. Solutions, Inc.***, 365 F3d 353, 366 (5th Cir. 2004). Other courts have allowed group pleading in order that the plaintiff have an opportunity to conduct discovery to ferret out who the actual author was although specific pleading had to show that the particular officer or director named as a defendant held a position or had responsibility that established a probable link as a source of the misinformation. See ***In re Baan Co. Sec. Litigation***, 103 F.Supp.2d 1, 17 (D.D.C.); ***In re PETsMART, Inc. Sec. Litig.***, 61 F. Supp. 2d 982, 988 (D. Ariz. 1999) ("Although pleading securities fraud after the PSLRA can no longer be described as merely 'notice pleading,' courts must be careful not to set the hurdles so high that even meritorious actions cannot survive a motion to dismiss. Such a regime would defeat the remedial goals of the federal securities laws."). Congressional intent to

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Circuit's conclusion that a false statement in a Sarbane-Oxley Act certification does not impose liability for the resulting loss. ***Shaw*** at 545 .

preserve the right of a plaintiff to seek recompense for securities fraud was the cited justification for this contrary view. See Note, 79 ***Tul. L. Rev***. 1101, 1105 (2005). Indeed the Fifth Circuit seemingly endorsed this rationale when the publication in question was unsigned. See ***INSpire*** at 365. The question in my mind is what this has to do with an inference of scienter, strong or otherwise. If we don't know who did it (no group pleading), the motive of the unknown person is irrelevant. See ***In re BankAmerica Corp. Sec. Litig.***, 78 F.Supp.2d 976, 988 (E.D. Mo. 1999)("The doctrine has nothing to do with scienter.").

More disturbing was the Court's conclusion that the Sarbanes-Oxley Act's requirement that certain officers swear to the accuracy of financial statements was not a basis for inferring that the signatories had acted with scienter if the statements were incorrect. (***Id*** at 545). The Court imposed the requirement that the signatories have "reason to know" or "should have suspected" misstatements due to the presence of glaring accounting irregularities or "other red flags" that the financial statements contained material misstatements or omissions in order for an inference of scienter arise.[11] (***Id*** at 545). Thus severe recklessness. But the signatories are required by SOA to certify that the financial statements were prepared in accordance with GAAP and that the underlying data was generated with adequate safe guards to insure accuracy.[12] If the signatories don't actually know, and their certification was false, why should a court require that there be glaring errors to put them on notice of the false information in order for an inference of scienter to arise? Cardozo did not think this was necessary (see note 9), and I'm sure he would be pleased to know that neither do I. Congress clearly intended to do away with the "head in the sand" defense which, prior to SOA, permitted a financial statement signatory to avoid personal liability unless there were glaring errors or red flags.[13] This holding in ***Shaw*** resurrects that defense from its ashes.

We could debate (intellectually speaking) when and whether confidential sources must be identified. A mandatory requirement has apparently been imposed based on the Supreme Court's directive in ***Tellabs, Inc. v Makor Issues & Rights, Ltd.,*** ___ US ____, 127 S.Ct. 2499, 2509 (2007), that opposing inferences must be evaluated in determining whether a "strong inference" of culpability is pleaded. So it is thought necessary that the source of the confidential information be

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[11] The Court does not discuss this question at any length, and I believe the Court misinterpreted Congress's intent when it imposed the certification requirement on senior officers. For an excellent discussion of this issue see Everitt, ***Sarbanes-Oxley's Officer Certification Requirements - Has Increased Accountability Equaled Increased Liability?***, 6 DePaul Bus. & Comm. L.J. 225 (2008), although I respectfully disagree with the author's conclusion.

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See generally, John W. White, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Executive Compensation Disclosure and the Important Role of CFOs (Oct. 3, 2006) (transcript available at http://www.sec.gov/news/speech/2006 /spch100306 jww.htm).

[13] See 148 Cong. Rec. H5463, H5472 (daily ed. July 25, 2002) (statement of Rep. Jackson-Lee); Pres. George W. Bush, Speech on Corporate Responsibility (July 9, 2002) (transcript available at http://www.pbs.org/newshour//bb/business/july-dec02/bush 7-9.html)).

identified in order to evaluate the strength of the resulting inference. See ***Higginbotham v Baxter Corp***., 495 F.3d 753 (7th Cir. 2007). In ***Shaw***, the Court apparently abandoned the less preemptive approach it stated in ***ABC Arbitrage Plaintiffs Group v Serje Tchuruk,*** 291 F.3d 336, 343 (5th Cir 2002):

"We align this circuit with the Second Circuit and adopt the reasoning and holding of *Novak*, rejecting the rule of *Silicon Graphics*. Under the interpretation of section 78u-4(b)(1) we adopt today, a plaintiff must "plead with particularity sufficient facts to support" their allegations of false or misleading statements made on information and belief. In determining whether this requirement has been met we see no reason to embroider the multi-step analysis of the Second Circuit and accept it as stated:

(1) if plaintiffs rely on confidential personal sources and other facts, their sources need not be named in the complaint so long as the other facts, i.e., documentary evidence, provide an adequate basis for believing that the defendants' statements or omissions were false or misleading;
(2) if the other facts, i.e., documentary evidence, do not provide an adequate basis for believing that the defendants' statements or omissions were false, the complaint need not name the personal sources so long as they are identified through general descriptions in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source as described would possess the information pleaded to support the allegations of false or misleading statements made on information and belief;
(3) if the other facts, i.e., documentary evidence, do not provide an adequate basis for believing that the defendants' statements or omissions were false and the descriptions of the personal sources are not sufficiently particular to support the probability that a person in the position occupied by the source would possess the information pleaded to support the allegations of false or misleading statements made on information and belief, the complaint must name the personal sources."

The Court obviously did not engage in this three step analysis. Be that as it may, the Supreme Court did not say or even imply that such identification was necessary. Justice Ginsburg seemingly went to great lengths to maximize the notion that all the alleged facts and inferences (including those that were equivocal or negative) must be evaluated and to minimize the notion that there was some magic formula to accomplish this task. One writer has "cogently" argued that the imposition of this requirement will severely hamper the pre-suit investigation of a complaint. After all, how many inside informants will come forward if their identity will be made known to the company at the very outset of the litigation. See Wohl, ***Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure***, 12 Fordham J. Corp. & Fin. L. 551 (2007). Wohl also points out that many inside informants will only provide information if their identity remains anonymous. ***Id*** at 559-560. The Second Circuit clearly recognized this problem in ***Novaks v Kasaks***, 216 F.3d 300, 316 (2nd Cir 2000). That being the case, it seems unlikely that the Supreme Court intended to abolish this available information without at least considering some other way to satisfy the requirements of disclosure without sacrificing the source[14]. Anyway, here's the bottom line in the Fifth Circuit: Unless the corporate officer or director admits that he made a

[14] Wohl suggests that the plaintiff should immediately file a Motion for Protective Order under FRCP Rule 26c, and raise the informant privilege. These steps will insure, at least, that the trial court will focus on the "need to know" versus the "need for protection." See Wohl at 580-583. Protective Orders have been granted in NLRA and FLSA cases (see ***Mitchell v Roma***, 265 F.2d 633, 637 (3rd Cir 1959)), but Congress has not imposed strict pleading requirements for those areas of law.

false statement in order to deceive investors,[15] either publically or to a highly placed informant who is willing to face the firing squad without a blindfold, or unless the plaintiff and his lawyer are willing to aver suspected facts that would demonstrate that the corporate officer or director acted with extreme recklessness, and thereby run the almost certain risk of Rule 11 sanctions if the proof does not measure up, there is really no way to meet the imposed pleading requirements. Discovery after suit is not an option. Defendants will always file the Rule 12(b)(6) Motion before any meaningful discovery is accomplished, and it doesn't take Rogers and/or Hart to add words to the music – Farewell to Federal Securities Litigation. My friend, the judge, offered to hum it for me, but I told him it wasn't necessary.

So what does a Fifth Circuit lawyer do to get recompense for his defrauded client. In Texas, in a non-class action context at least[16], he can prosecute the claim under this State's Blue Sky Law, the Texas Securities Act (***TSA***). Tex Rev Civ Stat Anno, art 581-1, et seq. Misrepresentations under ***TSA*** do not require proof a scienter to be compensable. And the fraud pleading requirements of Rule 9(h) and PSLRA do not apply. So much is clear from ***Dorsey v Portfolio Equities, Inc.***, 540 F3d 333 (5th Cir. 2008), and cases cited, decided ten days after ***Shaw***. It may be of passing interest that the Court in ***Dorsey*** also found that the corporate position held by one defendant in that case was adequate under the circumstances to create a strong inference of scienter in connection with plaintiffs common law fraud claim that was sufficient to satisfy Rule 9(h) and even PSLRA. ***Id*** at 343-44. This represents one of those rare cases where the supporting allegations were found adequate even though there was no confession of wrong-doing. The limited circumstances under which a "strong inference" is available were not explained in any detail, except the Court observed that the narrow range of available company products, the fact that the defendant was the CEO of the company, and that the company was small were important considerations. ***Id*** at 342-43. In many respects ***Dorsey*** is at odds with ***Shaw***, but that's a confrontation the plaintiff will lose in my judgment.

Whether ***TSA*** covers a situation where the misrepresentation in not communicated to the plaintiff directly – like when there is Fraud on the Market – was not addressed in ***Dorsey***, and there is scant Texas authority on this question. It is reasonably clear that ***TSA***'s misrepresentation proscription is applicable to sales in the securities markets, like OTC or NASDQ or NYSE, although I find no

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[15] The Court states that no strong inference may be drawn from the fact that erroneous financial information was reported. ***Shaw*** at 534.

[16] The Securities Litigation Uniform Standards Act (SLUSA) nullifies a state's securities laws in a class action context, including claims of more than 50 investors consolidated in a single proceedings, where the gist of the complaints are misrepresentations in connection with the purchase or sale of a "covered security." See Securities Litigation Uniform Standards Act, 15 USCA §78bb (SLUSA); ***Merrill, Lynch ** v Dabit***, 547 U.S. 71 (2006). In general, a "covered security" is one traded on a national securities exchange, although it includes other types as well. See 15 USCA § 77r(b). SLUSA's application, however, is limited to securities traded on national exchanges and securities issued by registered investment companies. See 15 USCA §78bb(f)(5)(E).

case that directly determines the issue.[17] In ***Texas Capital Securities, Inc. v Sandefer***, 58 S.W.3d 760 (Tex App--Houston (1st Dist.) 2001, review denied), a down the line stock promoter was found potentially liable under ***TSA*** for sales occurring on a securities market. In ***Newby v Enron Corp.***, 388 F.Supp.2d 780 (SD Tex 2005), the court found potential Aider liability under ***TSA*** where the stock sales occurred on a national securities exchange. Since Aider liability must be predicated on an underlying violation of ***TSA*** it seems reasonable to conclude that the court found that the underlying sales were also within the ambit of the Act. In ***In re Enron Corp***., 235 F.Supp.2d 549 (S.D. Tex. 2002), Judge Harmon denied Motions to Dismiss filed by lawyers, banks and accountants directed at plaintiffs' claims under ***TSA***, as well as the Federal Acts. The sales in question were accomplished on the NYSE and the OTC, and these defendants were obviously not in privity with the plaintiffs. Her opinion is a masterful dissertation on state and federal securities laws and is required reading for any erstwhile securities lawyer, although I believe her conclusions about "control liability" under Texas law were too narrow. I can't tell, however, whether the defendants actually raised this precise issue. The court did focus on the expansive interpretation that a defendant need only be a link in the selling process, discussed *infra*, and that is the tether that would impose liability of third parties, like lawyers, bankers and accountants, so maybe the issue was settled, but maybe not. Judge Harmon did not evaluate the impact of SLUSA on class actions and multi-plaintiff litigation.[18]

Fraud on the Market is a concept announced in ***Basic v Levinson***, 485 U.S. 224, 247 (1988), where the absence of reliance to establish a fraud cause of action was excused because misrepresentations impact the market price of a security being traded in an efficient market,[19] and the plaintiff as a market purchaser might well not know about it. In this respect, Fraud on the Market was placed in the same category as Omitted Material Facts where reliance is also not required as an element of proof unless the defendant presents evidence that the market price of the security did not actually respond to the misinformation. See ***Affiliated Ute Citizens v United States***, 406 U.S. 128, 153 (1972). Of course a misrepresentation case under TSA does not require proof of reliance or proximate cause. All that is required is that the plaintiff prove that defendant made a misrepresentation of a material fact that a reasonable investor would want to know in making an investment decision. This is an objective standard and causation is subsumed in the question.[20] Does this mean that Fraud on the Market is a viable theory under TSA? Maybe, but

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[17] While sales by a registered broker of stock listed on a national securities exchange are exempt securities and exempt transactions under ***TSA*** (arts. 531-5(O)(9) and 531-6(F)), this exclusion does not apply to actionable misrepresentations. See art. 531-33(A)(2).

[18] See note 14. Enron was an Oregon corporation with its principal place of business in Texas. Whether SLUSA exempted Enron from its protection is beyond the limited scope of this article. See 15 USCA §78bb(f)(3)(A)(1)(exempting the law of the state of incorporation from its nullifying effects)

[19] An efficient market supposedly factors all available information into the market price.

[20] Some Texas courts have mistakenly used the federal definition of "material fact." See ***Duperier v. Texas State Bank***, 28 S.W.3d 740 Tex.App.-C.C. 2000, writ dism'd by agreement).

maybe not. Texas law requires only that the defendant be a "link in the selling process"[21] and that the plaintiff be a purchaser. See e.g. ***Brown v Cole,*** 291 S.W.2d 704, 708 (Tex 1956); ***Texas Capital Sec. Corp***., *supra*, 58 S.W.3d at 765-756. Just how thin this link may be has not been accurately measured. Most state courts have rejected ***Basic's*** underlying rationale as establishing a viable claim under a state's Blue Sky Laws. See ***Kaufman v I-Stat Corp.,*** 754 A 2d 1188 (N.J. Sup. Ct. 2000); Sanderson, ***A "Basic" Misunderstanding: How the United States Supreme Court Misunderstands Capital Markets,*** 43 S.Tex.L.Rev. 743 (2002). Utah, however, has taken a slightly different view pointing out that reliance is not a prerequisite to a Blue Sky recovery, although that State's requirement of privity, unlike Texas, would prevent the adoption of Fraud on the Market as a model for recovery. See ***Gohler v Wood***, 919 P2d 561 (Utah Sup. Ct. 1996). Will Fraud on the Market be relegated in Texas to a claim under Restatement (Second) of Torts § 531 (intentional or fraudulent misrepresentation) where only a limited number of specific purchaser will obtain relief? Again, maybe, but maybe not. I should point out that the Texas remedy under a Restatement theory (Texas has not adopted the Restatement as such) is just as illusory as a federal remedy under the securities laws and for similar, court imposed, reasons. In ***Ernst & Young LLP v Pacific Mut. Life Ins. Co.***, 51 S.W.3d 573, 579-580 (Tex 2001), the Texas Supreme Court declined to adopt § 531, as Texas law already recognized a cause of action for indirect fraud. The Court did, however, impose the Restatement requirements that the fraudfeasor have knowledge that the defrauded party be "especially likely" to rely on the false statement and that to establish "especially likely reliance" something more than foreseeabilty had to be demonstrated, although no Texas court had previously imposed such requirements. Subsequent cases have not contributed

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Because federal law proof requires foreseeability and proximate cause, that use was inappropriate. E.g. ***Geodyne Energy Income Production Partnership I E v Newton Corp***., 97 S.W.3d 779, 873-875 (Tex.App. Dallas 2003, petition denied); ***Tex. Capital Securities, Inc. v. Sandefer***, 58 S.W.3d 760, 776 (Tex.App.-Houston [1st] 2001, review dism'd); ***Duperier v. Tex. State Bank***, 28 S.W.3d 740, 753 (Tex.App.-CC 2000, petition dism'd); ***Hendricks v. Thornton***, 973 S.W.2d 348, 360 (Tex.App.-Beaumont 1998, petition denied); ***Weatherly v. Deloitte & Bache***, 905 S.W.2d 642, 649 650 (Tex.App.-Houston [14th Dist.] 1995, writ dism'd w.o.j.); ***Anheuser Busch Cos., Inc. v. Summit Coffee Co.***, 858 S.W.2d 928, 936 (Tex.App.-Dallas 1993, writ denied), remanded for reconsideration 514 U.S. 100 (1995), reaffirmed 934 S.W.2d 705 (Tex.App.-Dallas 1993, writ dism'd by agreement). In these cases the courts held that reliance was not an element of proof in a ***TSA*** case and approved or would approve an instruction of material fact that is perhaps easier for a jury to interpret: " A fact is material if a reasonably prudent investor would want to know about it in making an investment decision."

[21] One Court of Appeals has imposed a privity requirement on the relationship between seller and purchaser purporting to apply the legislative history of the 1977 amendments to TSA. See ***Frank v Bear Stearns & Co.,*** 115 S.W.3d 380, 393 (Tex App – Houston (14th Dist) 2000, review denied). That Court, however, relied on a Comment that was added to the legislative history after the amendments were adopted by the legislature. See Bromberg, ***Civil Liability Under Texas Securities Act §33 and Related Claims***, 32 S.W.L.J. 867, 891 (1978).

much to understanding the meaning of the phrase.[22] The Supreme Court has granted a petition for

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[22] In ***Prospect High Income Fund, et al v Grant Thornton, LLP***, 203 S.W.3d 602 (Tex App – Dallas 2006, petition pending), the court found it especially likely that bond investors would rely on Grant Thornton's audit of Epic Resorts' financial statement in which it certified that Epic's bank accounts, from which interest on the bonds was paid, was fully funded. According to the Dallas court ***Ernst & Young*** was distinguishable because the plaintiffs were already investors when the audit was issued. Id. at 612.

In ***Exxon Corp. v Miesch***, 180 S.W.3d 299 (Tex App – C.C. 2005, petition granted), the court found it especially likely that royalty owners and a lessee, Emerald Oil & Gas Co., L.P., would rely upon false filings made by Exxon with the Railroad Commission which related to the continued economic viability of certain oil wells. The court concluded that it was irrelevant that Emerald Oil & Gas Inc. did not exist at the time the false filings were made because it was especially likely that a subsequent lessee like Emerald would rely on the filings. If Prospect High Income Fund is correctly decided then this case seems likely to avoid reversal by the Supreme Court.

In ***Ameristar Jet Charter, Inc. v Signal Composites, Inc***., 2001 U.S. Dist Lexis 14020 (N.D. Tex 2001), a fraud remedy was authorized where the original manufacturer of certain airline parts were misrepresented in a sale to a parts supplier who resold them to the plaintiff, a subsequent user. There was, said the Magistrate, an especial likelihood that the user would rely to its detriment on the misrepresentations from the initial sale to the parts supplier. While this might be characterized as an "indirect reliance" case, the nature of the misrepresentations was such that they continued after the initial sale.

In ***Great Plains Trust Co. v Morgan Stanley Dean Witter & Co.***, 313 F3d 305 (5th Cir 2002), Morgan Stanley was retained by Allwaste, Inc., to provide it with a fairness evaluation of a merger with Philip Services Corp.. The retention agreement stated that the purpose of the evaluation was to inform Allwaste's board of directors of the financial implications (fairness) of the proposed transaction. Plaintiffs were Allwaste debenture holders who were adversely affected by the merger. The Fifth Circuit had no difficulty in affirming a dismissal of the case. First, the Plaintiffs failed to put forward any compelling reason why the contractual limitations contained in the fairness opinion concerning its restricted use should not be enforced. Second, there was nothing to suggest that it was especially likely that the debenture holders would receive and rely on the fairness opinion. The fact that it may have been foreseeable that the Plaintiffs might receive the opinion and rely upon it was insufficient to satisfy the requirements of ***Ernst & Young***.

In ***Mid States Development, LLC v Fidelity National Title Insurance Co.***, 2001 U.S. Dist Lexis 15448 (In N.D. Tex 2001), Fidelity provide several banks (interim finance lenders) with assurances about the financial where with all of Alliance Mining, Inc., to provide permanent financing for projects being constructed by their interim borrowers like Mid States. When Alliance was unable to fund the necessary permanent financing, Mid States was forced to obtain alternative permanent financing and sustained damages in the switch. There was some evidence that Fidelity knew that interim borrowers from the banks would receive and rely on those assurances, and the review in ***Exxon Corp. v Miesch,*** 180 S.W.3d 299 (Tex App-C.C. 2005, petition granted), and the Court may take occasion to better explain what constitutes "especially likely." We'll see, although I am not hopeful that the explanation will be of any benefit to the plaintiffs.

As they say: "Pick your poison." Me? I may concentrate on golf.

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court concluded that this was sufficient to satisfy the especially likely standard. This case was cited by Judge Fish in the *Admiral* case, discussed below, but found inapposite.

In *Marshall v Kusch,* 84 SW3d 781(Tex App – Dallas 2002, petition denied), the seller of property failed to advise the purchaser that the land was infested with anthrax virus. The original purchaser then conveyed the property to the plaintiff. The original seller knew that his purchaser would resell the property, but the subsequent purchaser was not afforded a fraud remedy when anthrax infected his livestock because he did not know of or rely on the misrepresentation. This is another "indirect reliance" case that did not pass muster.

In *Admiral Ins. Co v Heath Holdings USA, Inc.*, 2004 U.S. Dist Lexis 9211 (N.D. Tex 2004), Heath Holdings made misrepresentations to Caliber One Indemnity Company that caused it to issue an insurance policy. Admiral was an excess carrier which issued its policy of insurance based upon the fact that Caliber One had issued a basic policy to Heath. Summary judgment was granted on the ground that Admiral did not rely on the misrepresentation itself. Of course, this was a correct result under Texas fraud law as "indirect reliance" does not create an actionable scenario. Judge Fish nevertheless points out the difficulty a plaintiff has in satisfying the especially likely standard in a direct reliance case. Quoting from *Ernst & Young*, 51 SW3d at 581, he observes that "even an obvious risk that a third person will rely on a misrepresentation is not enough to impose liability."(Slip opinion p. 22).