

**CLAIMS AND DEFENSES UNDER
THE TEXAS SECURITIES ACT
(WITH COMPARISONS TO FEDERAL LAW)**

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APPENDIX 1 Checklist for Texas Securities Act Claims

APPENDIX 2 Texas Securities Act vs. Federal Securities Law Selected Comparisons

I. INTRODUCTION: TEXAS SECURITIES ACT CLAIMS AS ALTERNATIVE TO FEDERAL SECURITIES LAW CLAIMS

Judicial and legislative developments in the last 20 years have made federal securities law claims less attractive to plaintiffs. As a result, claims for violations of state-law “blue sky” statutes have become an increasingly attractive alternative. Section 33 of the Texas Securities Act (the “TSA”), TEX. REV. CIV. STAT. ANN. art. 581-33, provides for civil liability of securities sellers and secondary actors who sell unregistered securities or sell securities by means of material misrepresentations or omissions.

Defrauded buyers of securities can bring claims under Section 33A(1) of the TSA, which provides in pertinent part:

A person who offers or sells a security . . . by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, is liable to the person buying the security from him, who may sue either at law or in equity for rescission, or for damages if the buyer no longer owns the security. However, a person is not liable if he sustains the burden of proof that either (a) the buyer knew of the untruth or omission or (b) he (the offeror or seller) did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

The source of this language is Section 12(2) (now amended to be Section 12(a)(2)), of the Federal Securities Act of 1933 (the “1933 Act”). The provisions in Section 12(2) are very similar to the terms of Section 33A(1), but an important difference is that the federal statute, Section 12(2), is limited to misrepresentations or omissions made in a “prospectus or oral communication.” The U.S. Supreme Court has construed this limitation to mean that Section 12(2) is only available to purchasers of securities in a public offering by an issuer or its controlling shareholder(s). *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). Furthermore, the Court construed “oral communication” as an oral communication *relating to a prospectus*. *Id.* at 567-59. These limitations significantly constrict the applicability of Section 12(2) and reduce the number of potential Section 12(2) claims, but federal cases construing Section 12(2) still provide persuasive authority for construction of the similar provisions of Section 33.

In federal court, Rule 10b-5 claims are far more common. Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”) prohibits the use of any “manipulative or deceptive device or contrivance” in connection with the purchase or sale of a security. Rule 10b-5 promulgated thereunder prohibits making an “untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”

Unlike Section 12(2), Rule 10b-5 is not limited to misrepresentations or omissions made in a prospectus or related oral communication. Claims for violating Rule 10b-5 are

therefore available in a much broader variety of cases. The downside for plaintiffs is that judicial and legislative developments have steadily made it more difficult to plead and prove a Rule 10b-5 claims. Among other things, the plaintiff must plead the alleged misrepresentations with particularity, plead and specific facts supporting a strong inference of scienter, prove reliance on the alleged representations, and prove loss causation. Most federal courts define scienter to mean, at a minimum, recklessness.

Section 33A(1) of the Texas Securities Act, in contrast, has no special pleading requirements, does not require the plaintiff to prove scienter, puts the burden on the defendant to show it was not negligent. In addition, Section 33A(1) may not require proof of transaction causation, reliance, or loss causation; Texas law is unresolved on these issues.

When litigating claims under the Texas Securities Act, lawyers for plaintiffs and defendants alike will need to understand the elements and defenses that apply under Section 33 and how Section 33 claims compare to claims for violation of federal securities law, particularly Section 12(2) and Rule 10b-5.

For the convenience of securities litigation practitioners, the attached **Appendix 1** contains a checklist concerning the major issues that counsel should consider when prosecuting or defending claims for violating Section 33 of the Texas Securities Act. The chart attached as **Appendix 2** outlines some of the more significant differences between securities fraud claims under Section 33 of the Texas Securities Act and federal securities fraud claims under Rule 10b-5. All of these issues are addressed in more detail below.

II. SECTION 33 OF THE TEXAS SECURITIES ACT

Section 33 of the Texas Securities Act provides for civil remedies with respect to the issuance or sale of securities.¹ The first generation of this civil liability appeared in 1941, and the language of Section 33 was based on language in the 1933 Act. The legislature later amended Section 33 on several occasions.

The 1977 amendments were especially important. The Committee on Securities and Investment Banking of the State Bar issued a detailed Comment to the 1977 amendments that is particularly helpful. *See* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. (Vernon 2010) (cited below as “1977 Comment”). The 1977 Comment highlights and explains major changes and additions, including changes to the reasonable care defense and the addition of buyer liability, control person liability, and aider liability, provisions that were all new in 1977. *See id.*

There are a few basic distinctions that are important for understanding Section 33:

¹ Also note that Section 33-1 of the TSA, adopted in 2001, has similar provisions for civil liability of investment advisors.

² The *Reves* court adopted the following list of instruments commonly denominated as notes that nonetheless

- First, there is a distinction between registration violations, which are governed by Section 33A(1), and fraud violations, which are governed by Section 33A(2).
- Second, Section 33 distinguishes between primary liability, which is governed by Section 33A, and secondary liability, which is governed by Section 33F.
- Third, there is a distinction between two types of secondary liability: "control person" liability versus "aider" liability.

Thus, the first step in assessing a client's potential TSA claims or evaluating TSA claims brought against a client is to understand what types of claims are at issue: registration vs. fraud, primary vs. secondary, and control person vs. aider. In some cases, the answer may be "all of the above."

III. PRIMARY LIABILITY FOR A REGISTRATION VIOLATION

A. Did the Plaintiff Buy a "Security"?

Perhaps the most fundamental question when evaluating a potential TSA claim is whether the transaction at issue involved the sale of a "security." Section 4A of the TSA defines a security in pertinent part as follows:

The term "security" or "securities" shall include any limited partner interest in a limited partnership, share, stock, treasury stock, stock certificate under a voting trust agreement, collateral trust certificate, equipment trust certificate, preorganization certificate or receipt, subscription or reorganization certificate, note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title, or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not. The term applies regardless of whether the "security" or "securities" are evidenced by a written instrument. . . .

TEX. REV. CIV. STAT. ANN. art. 581-4(A).

This definition includes the terms "investment contract" and "evidence of indebtedness." Construed literally, these terms could include anything from an ordinary promissory note to a credit card receipt. But lawyers need to consider how both the

federal and Texas courts have construed these terms before determining if the transaction at issue involves a security.

The TSA definition of “security” is similar to the definition in the Federal Securities Act of 1933. Therefore, Texas courts often look to federal cases for guidance on what constitutes a “security.” *Thomas v. State*, 65 S.W.3d 38, 42 (Tex. Crim. App. 2001).

1. “Investment Contract”: The *Howey* Test

In the *Searsy* case, the Texas Supreme Court adopted the federal *Howey* test for construing the term “investment contract.” Under *Howey*, “[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637 (Tex. 1977) (quoting *SEC v. Howey Co.*, 328 U.S. 293, 301 (1946)). The *Howey* test thus has four elements: (1) investment of money; (2) a common enterprise; (3) expectation of profits; (4) solely from the efforts of others. *Id.* There is an extensive body of federal case law construing these elements. For a helpful overview, see Chapter 2 of MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW (4th ed. 2007).

2. “Notes”: The *Reves* “Family Resemblance” Test

Like the term “investment contract,” the term “note” in the TSA’s definition of a “security” could expand the definition to many instruments that would not ordinarily be considered securities. To avoid this, Texas courts will not construe “note” literally but will apply the federal *Reves* test to determine whether a particular type of note is a security. *Grotjohn Precise Connexiones Int’l, S.A. v. JEM Fin., Inc.*, 12 S.W.3d 859, 868-70 (Tex. App.—Texarkana 2000, no pet.); *Campbell v. C.D. Payne & Geldermann Secs., Inc.*, 894 S.W.2d 411, 417-19 (Tex. App.—Amarillo 1995, writ denied); *Chrysler First Fin. Servs. Corp. v. Kimbrough, Carson & Woods*, No. 01-90-01047-CV, 1991 WL 207128, at *2-3 (Tex. App.—Houston [1st Dist.] Oct. 17, 1991, writ denied) (unpublished).

In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the U.S. Supreme Court rejected the application of the *Howey* test for purposes of determining whether an instrument constituted a “note” under the federal Securities Act, explaining that to “hold that a note is not a security unless it meets a test designed for an entirely different variety of instrument would make the Act’s enumeration of many types of instruments superfluous.” *Reves*, 494 U.S. at 64 (quotations omitted). Instead, the court adopted the Second Circuit’s “family resemblance” test.

The *Reves* family resemblance test is a rebuttable presumption that all notes are securities. See *Reves*, 494 U.S. at 64-7. This presumption can be rebutted by analyzing the note in the context of four factors and using the four factors to determine whether the note bears a family resemblance to a note on a non-exhaustive list of different types of notes

previously held not to be securities. *Id.*² If the note bears this family resemblance, then the note is not a security subject to the Securities Act. *See id.* at 67. Further, even if the note does not bear this family resemblance, courts are permitted to use the same four-factor test to decide whether another category of notes should be added. *See id.*

The four factors used to determine whether a note bears a family resemblance are: (1) examination of the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it; (2) examination of the plan of distribution of the instrument; (3) examination of the reasonable expectations of the investing public; and (4) examination of whether some factors such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary. *See Reves*, 494 U.S. at 66-7. There is a more extensive discussion of these factors contained within the *Reves* decision, along with citations to other federal cases. *See also Grotjohn Precise Connexiones Int'l, S.A. v. JEM Fin., Inc.*, 12 S.W.3d 859, 868 (Tex. App.—Texarkana 2000, no pet.) (applying the *Reves* test).

3. “Evidence of Indebtedness”

The definition of “securities” in the TSA also includes “evidence of indebtedness.” In *Searsy*, the Texas Supreme Court construed “evidence of indebtedness” broadly to include “all contractual obligations to pay in the future for consideration presently received.” *Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637 (Tex. 1977) (citing *U.S. v. Austin*, 462 F.2d 724, 736 (10th Cir. 1972)). The Texas Supreme Court has not limited or clarified this potentially expansive definition.

More recently, the Texas Court of Criminal Appeals addressed the *Searsy* definition of “evidence of indebtedness” in *Thomas v. State*, a case that generated multiple appellate opinions. The court followed the *Searsy* definition of “evidence of indebtedness,” holding that it applies in criminal cases. *Thomas v. State*, 919 S.W.2d 427, 432 (Tex. Crim. App. 1996) (“**Thomas I**”). However, in a subsequent appeal, the Court of Criminal Appeals cautioned that the *Searsy* definition should not be applied too literally. *Thomas v. State*, 65 S.W.3d 38, 46 (Tex. Crim. App. 2001) (“**Thomas II**”).

The defendant in *Thomas v. State* persuaded an acquaintance to invest in a venture called United Media Group but used the money to pay personal living expenses. After a jury convicted the defendant of a criminal TSA violation, the defendant argued on appeal that the agreement was not a “security.” *Thomas I*, 919 S.W.2d at 428.

In ***Thomas I***, the Court of Criminal Appeals held that the *Searsy* definition of “evidence of indebtedness” – “all contractual obligations to pay in the future for

² The *Reves* court adopted the following list of instruments commonly denominated as notes that nonetheless fall outside the security category: note delivered in consumer financing; note secured by a mortgage on a home; short-term note secured by a lien on a small business or some of its assets; note evidencing a character loan to a bank customer; short-term note secured by an assignment of accounts receivable; or a note which simply formalizes an open-account debt incurred in the ordinary course of business. *See Reves*, 494 U.S. at 65.

consideration presently received” – applies in criminal cases. *Thomas v. State*, 919 S.W.2d at 432. The court viewed the phrase "evidence of indebtedness" as "expanding upon the grouping 'note, bond, debenture, mortgage certificate.'" The court emphasized that the definition is "limited by the purposes of the Act itself and by the context in which it appears" and stated that "an evidence of indebtedness is a similar *type* of security as a note, bond, debenture, and mortgage certificate." *Id.* at 432. The Court then remanded the case to the court of appeals to consider whether an "evidence of indebtedness" requires a writing.

The narrower issue in *Thomas II* was whether an "evidence of indebtedness" requires a written instrument. Looking to Texas and federal cases, the court found no case where an oral agreement alone was characterized as an "evidence of indebtedness." 65 S.W.3d at 43. Based on case law, the language and purpose of the definition, securities law treatises, and the definition of evidence of debt in Black's Law Dictionary, the court held that a written instrument is required for an "evidence of indebtedness" under the TSA. *Id.* at 43-45.

Notably, the court rejected the argument that the term "evidence of indebtedness," read literally, does not require a writing. "As for a literal reading of the definition of 'evidence of indebtedness,'" the court said, "we observe that not only do cases criticize a literal interpretation of the *Austin/Searsy* definition, there are also other authorities that caution against a literal interpretation of the term itself." *Id.* at 46. The court cited cases and a securities law treatise criticizing a literal application of "evidence of indebtedness" that would turn all bilateral contracts into securities despite having a commercial instead of an investment character. Although these cases did not address the writing requirement, "they do stand for the proposition that courts are reluctant to apply the *Austin/Searsy* definition literally." *Id.*

Plaintiffs arguing for a broad application of the *Austin/Searsy* definition will continue to cite *Searsy*, while defendants seeking to avoid an expansive construction of "evidence of indebtedness" can cite *Thomas II* in opposition to a literal reading of the broad definition. However, defendants should be wary of citing *Thomas II* for the proposition that a writing is required, because two years later the legislature amended the definition of "security" to expressly provide that a security does *not* have to be evidenced by a written instrument. Acts 2003, 78th Leg., ch. 108, § 1, eff. May 20, 2003.

4. Some Recent Cases Applying the Definition of "Securities"

Recent applications of the *Howey* and *Reves* tests include *Griffitts v. Life Partners*, No. 10-01-00271-CV, 2004 WL 1178418, at *2-3 (Tex. App.—Waco May 26, 2004, no pet.) (unpublished), which held that viatical settlements³ are not securities for purposes of the

³ "A viatical settlement is an investment contract pursuant to which an investor acquires an interest in the life insurance policy of a terminally ill person—typically an AIDS victim—at a discount of 20 to 40 percent, depending upon the insured's life expectancy. When the insured dies, the investor receives the benefit of the insurance. The investor's profit is the difference between the discounted purchase price paid to the insured

TSA. The court reasoned that viatical settlements are not "investment contracts" under the *Searsy/Howey* test and are not "notes" under the *Reves* test. *Id.*

In *Caldwell v. State*, 95 S.W.3d 563, 567 (Tex. App.—Houston [1st Dist.] 2002, pet. ref'd), the court held that joint venture agreements were "investment contracts" where the agreements allotted certain powers to investors, but those powers could not be described as "essential managerial efforts which affect the failure or success of the enterprise."

In *Stroud v. Meister*, No. Civ.A.3:97-CV-0860-L, 2001 WL 282764, at *6 (N.D. Tex. March 16, 2001) (unpublished), the court held that joint venture agreements were true joint ventures rather than investment contracts, where the success of the joint venture depended primarily on market forces rather than the skill and experience of the venturers.

These examples illustrate that determining whether a particular instrument is a "security" under the TSA can be a fact intensive question that requires case-by-case analysis.

5. "Security" a Question for the Jury?

When the parties dispute whether the contract or instrument at issue was a "security," it remains unclear whether that issue is for the judge or the jury to decide. Applying the TSA's definition of "security" and the applicable case law to a given set of facts is a job for the judge. *See Grotjohn Precise Connexiones Int'l, S.A. v. JEM Fin., Inc.*, 12 S.W.3d 859, 868 (Tex. App.—Texarkana 2000, no pet.) (holding that note was a security as a matter of law under the *Reves* test); *Campbell v. C.D. Payne & Geldermann Secs., Inc.*, 894 S.W.2d 411, 417-19 (Tex. App.—Amarillo 1995, writ denied) (holding that whether instruments were securities was a question of law for the trial court). *See also Ahrens v. American-Canadian Beaver Co.*, 428 F.2d 926, 928 (10th Cir. 1970) (whether contracts at issue were securities was a question of law that should not have been submitted to the jury).

On the other hand, it seems any factual disputes relevant to the question should be submitted to the jury. This can present a thorny issue in Texas Securities Act litigation.

The Texas Supreme Court has not directly addressed this issue. In *Searsy*, the court appeared to analyze whether the contracts at issue were "securities" as a question of law. *See Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637, 638 (Tex. 1977) (stating that "the question to be decided" was whether certain commodity options were "securities" under the TSA). But the *Searsy* court did not specifically address whether the issue should have been decided by the trial court or the jury.

State v. Bailey, 201 S.W.3d 739 (Tex. Crim. App. 2006), illustrates some of the practical problems this issue poses for litigants. In that case, the defendant was charged

and the death benefit collected from the insurer, less transaction costs, premiums paid, and other administrative expenses." *SEC v. Life Partner, Inc.*, 87 F.3d 536, 537 (D.C. Cir. 1996).

with violations of the TSA based on the sale of unregistered certificates of deposit issued by an offshore bank. *Id.* at 741. The defendant argued that the CDs did not constitute "securities" and asked the trial judge to decide the issue as a matter of law. The State agreed to this request. Outside the presence of the jury, the State presented expert testimony that the CDs qualified as securities under the TSA's definitions of "evidence of indebtedness" and "investment contracts." *Id.* The trial court judge sided with the State and instructed the jury that the CDs were securities under the TSA. *Id.* at 742.

The defendant argued on appeal that the CDs were not securities as a matter of law, while the State argued that the CDs *were* securities as a matter of law. *Id.* The court of appeals disagreed with both sides, holding that whether the CDs were "securities" was a fact question that should have been submitted to the jury with appropriate instructions. *Id.* But the Court of Criminal Appeals found that the court of appeals erred by addressing an issue not presented to the trial court or raised by the parties on appeal. *Id.* at 743-44. The Court of Criminal Appeals did not address whether the CDs were securities, nor did it address the broader question of how that determination should be made in the trial court.

6. "Security" an Issue for Expert Testimony?

A related question is whether the trial court should allow expert testimony that an instrument is or is not a "security" under the TSA. *State v. Bailey* held that the jury should have been instructed on the definition of a "security" and allowed to hear testimony from an expert witness who "provided the necessary context, substance, and reality surrounding the sale." *State v. Bailey*, No. 08-02-00423-CR, 2004 WL 1933222, at *4 (Tex. App.—El Paso Aug. 31, 2004) (unpublished), *rev'd on other grounds*, 201 S.W.3d 739 (Tex. Crim. App. 2006).

On the other hand, the *Greenberg Traurig* decision from the Houston Court of Appeals weighs against allowing expert testimony on the "security" issue. In that case, the court held that it was improper for the trial court to allow a former Texas Supreme Court justice and a law professor to testify as to their understanding of the law. *Greenberg Traurig of New York, P.C. v. Moody*, 161 S.W.3d 56, 94-95 (Tex. App.—Houston [14th Dist.] 2004, no pet.). Although the court did not address the expert testimony relating to the Texas Securities Act claims (because it found that the TSA did not apply), its opinion reflects a skeptical view of testimony from legal experts. "It is not the role of the expert witness to define the particular legal principles applicable to a case; that is the role of the trial court," the court reasoned. *Id.* at 95.

While the case law on this issue remains unclear, proponents of expert testimony regarding the definition of "securities" can draw some lessons from *State v. Bailey* and *Greenberg Traurig*. First, the party who wants to offer expert testimony should frame the questions it plans to submit to the jury regarding whether the instrument at issue is a "security" and then have the expert focus on facts relevant to those questions. If all the expert does is apply the law to a given set of facts, the court is more likely to see the testimony as impermissibly addressing a question of law.

The second question the lawyer should consider is whether a “battle of experts” on whether there is a “security” is likely to benefit the client.

Third, the proponent of the expert testimony should think carefully about what type of expertise is relevant to the questions to be submitted to the jury. A law professor or former judge may be well qualified to explain the definition of “securities” and apply it to a given set of facts, but there is a risk that this type of expert will be seen as simply giving a legal opinion. In some cases it may be a better option to designate a witness with expertise in the particular type of business or transaction at issue. These strategic decisions must be made on a case-by-case basis.

B. Was the Defendant a “Seller” of Securities?

The TSA addresses primary liability, i.e. liability of a seller, in Section 33A, while it addresses secondary liability, i.e. liability of control persons and aiders, in Section 33F. Notwithstanding the availability of Section 33F, a plaintiff will sometimes assert a primary liability claim against a secondary actor who was not in privity with the plaintiff. The plaintiff will argue that the defendant was a “seller” because it was a “link in the chain” of the sale of securities. Recent cases have tended to reject this theory, but the issue has not been resolved by the Texas Supreme Court.

“Liability of Sellers” under Section 33A of the TSA applies to a “person who offers or sells” a security. In *Brown v. Cole*, 291 S.W.2d 704, 708 (Tex. 1956), the Texas Supreme Court defined “seller” broadly to include any person who is a “link in the chain of the selling process.”

Since that decision, the legislature has significantly amended the TSA twice. In the 1977 amendments, the legislature adopted a new section, 33F, to address liability for control persons and aiders. The 1977 Comment states that “*Brown v. Cole* should have no application to the new law, since §33F provides quite specifically who, besides a person who buys or sells, is liable, and the criteria for such liability.” The 1977 Comment also states that Section 33A “is a privity provision, allowing a buyer to recover from his offeror or seller.”

Based on these comments and the structure of the revised statute, the Fourteenth Court of Appeals held in *Frank v. Bear, Stearns* that the “link in the chain” standard from *Brown v. Cole* no longer applies. *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 383 (Tex. App.—Houston [14th Dist.] 2000, pet. denied). At least two federal district courts have agreed. See *Millcreek Associates, L.P. v. Bear, Stearns & Co.*, 205 F. Supp. 2d 664, 676, 682 (W.D. Tex. 2002) (Section 33A(2) requires privity between buyer and seller); *In re Sterling Foster & Co. Secs. Litig.*, 222 F. Supp. 2d 289, 309 (E.D.N.Y. 2002) (clearing broker that cleared trades after sale was complete could not be held liable as a seller).

On the other hand, some cases have continued to cite the "link in the chain" standard without addressing the effect of the 1977 amendments. *See, e.g., Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 775 (Tex. App.—Houston [1st Dist.] 2001, pet. denied) (citing "link in chain" test and rejecting argument that brokerage firm was not a seller, where the buyer bought the stock in the public market but dealt directly with the brokerage firm).

In a large securities fraud suit arising from the collapse of Enron, the federal district court initially cited the "link in the chain" test but concluded in a later opinion that the test no longer applies. *See In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 258 F. Supp. 2d 576, 602-3 (S.D. Tex. 2003) (link in the chain test no longer applies); *In re Enron Corp. Secs., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 566 (S.D. Tex. 2002) (citing link in the chain test).

Initially, Judge Harmon wrote in *Enron* that Section 33 allows primary liability to be imposed on any defendant who is a "link in the chain of the selling process," citing *Brown v. Cole* and other state court cases. 235 F. Supp. 2d at 566. The court revisited this issue in a subsequent opinion, discussing the effect of the 1977 amendments to the TSA. 258 F. Supp. 2d at 602-3 (S.D. Tex. 2003). Citing *Frank*, the district court concluded that the *Brown v. Cole* "link in the chain" test is "no longer necessary or appropriate." *Id.* at 603. "To impose seller liability," the court stated, "a plaintiff must be in privity with the defendant, i.e., the plaintiff must have bought his securities from the defendant whom the plaintiff is suing." *Id.*

The *Enron* court went on to discuss the federal interpretation of "seller" under Section 12 of the 1933 Act. The court concluded that the *Pinter* rule—limiting seller status to one who solicits the transaction or passes title to the securities—also applies to seller liability under Section 33A(2) of the TSA, which is based on Section 12(2) of the 1933 Act. *Id.* at 604-6 (citing *Pinter v. Dahl*, 486 U.S. 622, 647 (1988)). Applying these principles, the court found that the lead plaintiff had not alleged facts demonstrating privity between the outside directors and the lead plaintiff or that the outside directors had solicited the sale of securities to the lead plaintiff. *Id.* at 644.

The First Court of Appeals has also adopted the federal *Pinter* standard for determining "seller" status under the TSA. *Highland Capital Mgmt., L.P. v. Ryder Scott Co.*, 402 S.W.3d 719, 742 (Tex. App.—Houston [1st Dist.] 2012, no pet) (opinion on reh'g). The court cited *Frank* for the proposition that privity is required but noted that *Frank* did not define the nature of the privity required. *Id.* at 741. Seeking to harmonize the TSA with federal securities law, the court looked to Section 12 of the Securities Act as interpreted in *Pinter*. *Id.* (citing *Pinter v. Dahl*, 486 U.S. at 646-47). Applying *Pinter*, the *Highland Capital* court held that a "seller" for Section 33A(2) purposes can include not only the person who passes title, but also "[a] person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner," such as a broker. *Id.* at 742. The court found that the defendant had not conclusively proven that the brokers at issue were not "sellers." *Id.*

Citing *Frank* and *Enron*, the Texas Pattern Jury Charge refers to Section 33 as requiring “privity” between the buyer and seller. TEXAS PATTERN JURY CHARGES PJC 105.12, cmt. on “Source of instruction” (2010 ed.). There seems to be a consensus that privity, as construed in *Pinter*, is required. But until the Texas Supreme Court addresses the issue, some plaintiffs may argue that the *Brown v. Cole* “link in the chain” test continues to apply.

Placing privity limitations on what defines “seller” status under the TSA is also consistent with other federal case law seeking to maintain the distinction between primary liability and secondary liability by limiting by definition those persons or entities who can be primarily liable. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), is instructive on this point.

The question in *Janus* was, who is the “maker” of a statement for purposes of determining Rule 10b-5 liability? The Supreme Court held that “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” *Id.* at 2302. The Supreme Court rejected a broader reading of “make,” which would cause aiders and abettors to be “almost nonexistent” and “substantially undermine” federal case law holding that aider and abettors may not be pursued in private actions. *Id.*

The *Janus* decision was essentially a “nail in the coffin” for those still hoping to pursue secondary actors for alleged primary violations of Rule 10b-5. Plaintiffs who want to assert primary securities fraud claims against secondary actors based on a “link in the chain” theory will have to turn to the Texas Securities Act, and even then the theory probably no longer applies.

C. Was the Security Registered? If Not, Does an Exemption Apply?

Assuming there is a “security” and the defendant is a “seller” of the security, determining whether the security was sold in violation of the registration provisions of the TSA, *i.e.* was unregistered, is a seemingly simple question to answer. But the question can be more complicated than it initially seems.

The starting point is easy: is the security registered with the Texas State Securities Board? The Board makes this somewhat painless by providing a searchable database on its website at <http://www.ssb.state.tx.us/public/Index.php>. If the particular security is listed, then you can safely assume it was properly registered. But if the security is not registered, the inquiry does not end there. You **cannot** assume that the sale of an unregistered security was in violation of the TSA, because there are numerous types of transactions and securities that are exempt from the registration requirements of the TSA.

Sections 5 and 6 contain a list of exempt transactions and exempt securities respectively, and Chapters 109, 111, and 139 of the Board’s rules contain additional

exemptions available to issuers. TSA Sections 5 and 6 can be found at the following website:

http://www.ssb.state.tx.us/Texas_Securities_Act_and_Board_Rules/The_Texas_Securities_Act_09-01-2003.php,

Chapters 109, 111, and 139 can be found here:

[http://info.sos.state.tx.us/pls/pub/readtac\\$ext.ViewTAC?tac_view=3&ti=7&pt=7](http://info.sos.state.tx.us/pls/pub/readtac$ext.ViewTAC?tac_view=3&ti=7&pt=7).

Some of the most common exemptions are: private offerings; oil and gas limited offerings; offerings to “Accredited Investors”; and any security, which at the time of sale, was fully listed on a recognized national stock exchange. Exemptions, including those listed here, can be quite complicated, so careful analysis is required.

For example, a private offering can be exempt under Section 5.I(a) of the TSA. Section 5.I(a) exempts the sale of any security by an issuer thereof so long as the total number of security holders of the issuer thereof does not exceed 35 persons. *See* TSA § 5.I(a). Further, Rule 109.13(a) of Chapter 109 of the Texas Administrative Code requires that the purchasers be either “sophisticated” and “well-informed,” or “well-informed” with a relationship to the issuer, for the Section 5.I(a) exemption to apply. The terms “sophisticated” and “well-informed” are defined in Rule 109.13(a).

In addition to the potential state exemptions, practitioners must also consider the National Securities Markets Improvement Act of 1996 (“NSMIA”). NSMIA provides for federal preemption of certain covered securities. *See* 15 U.S.C.A. § 77r(a). If a security is a covered security as defined by NSMIA, then NSMIA preempts state blue sky laws and the security is exempt from state registration. *See* 15 U.S.C.A. § 77r. For example, a security is a “covered security” and thus exempt from state registration if the security is “listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities).” 15 U.S.C.A. § 77r(b)(1)(A). While this is similar to the TSA exemption discussed above, there are other covered securities, and careful analysis under NSMIA is required.

The key point is to be careful not to assume that the sale of a security is in violation of the registration provisions of the TSA simply because the security is not listed as registered on the Texas State Securities Board’s website. Further research and analysis may be required to determine if the security or transaction at issue was exempt from registration.

D. Was Suit Filed Within Three Years of the Sale?

The TSA has its own statute of limitations in Section 33H.⁴ Different provisions apply depending on whether the claim is for a registration violation or a fraud violation.

The statute of limitations for a registration claim is three years after the sale. TSA § 33H(1). There is no discovery rule for registration violations. *See Weisz v. Spindletop Oil & Gas Corp.*, 664 S.W.2d 423, 425-26 (Tex. App.—Corpus Christi 1983, no pet.) (refusing to apply equitable tolling theory to three-year limitations period for registration violations); *see also Bailey v. Reliance Trust Co.*, No. 1:04-CV-0340-JOF, 2006 WL 740158, at *3 (N.D. Ga. Mar. 23, 2006) (unpublished) (following *Weisz* and holding that the three-year period for registration violations is not subject to equitable tolling).

IV. PRIMARY LIABILITY FOR A FRAUD VIOLATION

As discussed above, Section 33A(1) of the TSA provides a cause of action for registration-related violations, while Section 33A(2) provides a cause of action based on an “untruth or omission.” Although Section 33A(2) does not use the word fraud, it could be called the “fraud” section of the TSA because it essentially imposes liability on a seller who sells a security by means of a fraudulent representation. The elements of primary liability for a fraud violation are addressed below.

A. Did the Plaintiff Buy a “Security”?

As a threshold matter, a buyer asserting a claim for a fraud violation against a seller must prove that there was a sale of a “security.” This is no different than when a buyer asserts a registration claim, so the same analysis of what constitutes a “security” in Section III-A above applies.

B. Was the Defendant a “Seller” of the Security?

A buyer asserting a primary claim for a fraud violation must also prove that the defendant was a “seller” of the security. See the discussion of “seller” status in Section III-B above.

C. Did the Defendant Make a Material Misrepresentation of Fact?

Section 33A(2) provides for liability of a person who offers or sells a security “by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.” As the text of this section indicates, the alleged misrepresentation must be *material*, and it must be a misrepresentation of *fact*.

⁴ Section 33H also has specific statute of limitations provisions that apply when a rescission offer is made pursuant to Section 33I.

1. Materiality

The TSA does not define materiality. In federal securities litigation under Rule 10b-5, a representation is material if there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Under this standard, the buyer is not required to show that he would have made a different investment decision if the information had been accurately disclosed. *TSC Industries*, 426 U.S. at 449.

Texas courts have tended to assume that the federal standard for materiality also applies to a claim under Section 33A(2) of the TSA. For example, the court in *Anheuser-Busch* simply cited the federal materiality standard from *TSC Industries* without analyzing whether it applies to the TSA. See *Anheuser-Busch Cos. v. Summit Coffee Co.*, 858 S.W.2d 928, 936 (Tex. App.—Dallas 1993), *vacated on other grounds*, 514 U.S. 1001 (1995).

At least two other Texas cases have cited *Anheuser-Busch* for the same materiality standard. *Duperier v. Texas State Bank*, 28 S.W.3d 740, 745 (Tex. App.—Corpus Christi 2000, pet. dism’d by agr.); *Weatherly v. Deloitte & Touche*, 905 S.W.2d 642, 649 (Tex. App.—Houston [14th Dist.] 1995, writ dism’d w.o.j.), *abrogated on other grounds by Tracker Marine, L.P. v. Ogle*, 108 S.W.3d 349, 351-52 (Tex. App.—Houston [14th Dist.] 2000, pet. denied).

Similarly, the Texas PJC includes a definition of “material” that tracks the federal standard. TEXAS PATTERN JURY CHARGES PJC 105.12 (2010 ed.).

2. Omissions

Under Section 33A(2), an omission of a material fact is actionable if the omission rendered the seller’s statements misleading. However, in the only Texas Supreme Court case construing Section 33A(2), the court seemed reluctant to rely on an omission as a ground for a TSA claim. See *Geodyne Energy Income Production P’ship I-E v. Newton Corp.*, 161 S.W.3d 483, 489 (Tex. 2005). In *Geodyne*, the seller represented at an auction that it was selling a 10% gross working interest in an offshore oil and gas lease. *Id.* at 486. Arguably, this statement omitted the material fact that the lease had expired, and the Dallas Court of Appeals held that the seller misrepresented that it was selling a 10% interest in a *valid* lease. *Id.* at 487.

The Supreme Court reversed, emphasizing that nothing in the sale documents represented that the lease had not expired. *Id.* at 489-90. The court said nothing about whether the seller had made an actionable *omission* when it stated it was selling a 10% interest without stating that the lease had expired. Thus, the *Geodyne* opinion suggests that the Supreme Court is likely to construe the omission provision of Section 33A(2) narrowly.

On the other hand, the *Geodyne* opinion focused on the fact that the lease interest was sold by quitclaim deed in an industry auction where a knowledgeable buyer had to sign a document with numerous disclaimers in order to participate. *Id.* at 486-88. The court seemed primarily motivated by the desire to allow the efficient use of quitclaim deeds in the sophisticated mineral interest auction market. *Id.* at 489-90. In a case where such factors are not present, a material omission theory may be more viable.

3. Opinions/Predictions

A pure expression of opinion, including an opinion regarding value, generally will not support an action for fraud. *Transport Ins. Co. v. Faircloth*, 898 S.W.2d 269, 276 (Tex. 1995). Texas courts have applied this common law principle to fraud claims under the TSA. See, e.g., *Murphy v. Reynolds*, No. 02-10-00229-CV, 2011 WL 4502523, at *8 (Tex. App.—Fort Worth Sept. 29, 2011, no pet. h.) (unpublished) (“statements of opinion, including opinions about a security’s value, are generally not actionable under article 581-33”).

These are some examples of cases applying these principles:

- A stock broker’s statements that the price of the security was going to go up, the company was purchasing several unspecified acquisitions, he knew the company’s principals, and he thought the shares would be listed on NASDAQ were non-actionable opinions that “amounted to nothing more than puffing or dealers’ talk.” *Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App.—Houston [1st Dist.] 2001, pet. denied).
- Statements that notes were a safe and suitable investment and that there was no realistic chance that the yield on the notes would fall to zero were opinions that were not actionable in themselves. *Duperier v. Texas State Bank*, 28 S.W.3d 740, 749 (Tex. App.—Corpus Christi 2000, pet. dismissed by agr.). However, when considered in light of numerous omissions made by the defendants, these statements supported the jury’s verdict that the defendant violated the TSA. *Id.* at 749-51.
- Statements regarding the future movement of interest rates were only expressions of opinion or prediction and therefore were not actionable. *In re Westcap Enters.*, 230 F.3d 717, 728 (5th Cir. 2000).

In *Paull v. Capital Resource*, the Austin Court of Appeals considered a number of exceptions to the general rule that statements of opinion are not actionable under the TSA. Under Texas common law, an opinion can support a fraud claim if (1) the speaker knows the statement is false, (2) the speaker expresses an opinion as to the happening of a future event, or (3) the opinion is based on past or present facts. *Paull v. Capital Res. Mgmt., Inc.*, 987 S.W.2d 214, 220 (Tex. App.—Austin 1999, pet. denied) (citing *Trenholm v. Ratcliff*, 646 S.W.2d 927, 930 (Tex. 1983)).

Circumstances relevant to the second and third categories include the statement's specificity and the comparative levels of the speaker's and the hearer's knowledge. *Paull*, 987 S.W.2d at 220 (citing *Faircloth*, 898 S.W.2d at 276). A statement of opinion can be fraudulent when the speaker purports to have special knowledge of the facts or when the underlying facts are not equally available to both parties. *Id.* (citing *Trenholm*, 646 S.W.2d at 930).

The *Paull* court also considered Fifth Circuit law holding that a predictive statement made in connection with a securities sale implies at least three factual assertions: (1) the speaker believes the statement is accurate; (2) there is a reasonable basis for that belief; and (3) the speaker is unaware of any undisclosed facts that would tend to seriously undermine the accuracy of the statement. *Id.* (citing *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994)). The Pattern Jury Charge for TSA claims includes this exception. TEXAS PATTERN JURY CHARGES PJC 105.13 (2010 ed.).

The defendant in *Paull* characterized an investment in an oil and gas venture as "low risk" and represented that a well could reasonably be expected to produce large revenues for a long time. *Paull*, 987 S.W.2d at 218. The court held that these expressions of opinion were not actionable, where the information forming the basis of the opinions was equally available to both parties, and the plaintiff did not prove that the prediction had no reasonable basis. *Id.* at 220-21.

The Fifth Circuit engaged in a similar analysis of predictions in *In re Westcap Enterprises*, 230 F.3d 717, 728 (5th Cir. 2000). The defendant allegedly misrepresented the future movement of interest rates and resulting profitability of the securities. *Id.* The Fifth Circuit cited *Paull* for the proposition that "in considering whether an expression of opinion can be actionable, Texas courts look to the statement's specificity and the relative knowledge of the speaker and the recipient." *Id.* at 726. "Among the relevant circumstances," the court added, "are the statement's specificity, the speaker's knowledge, the comparative levels of the speaker's and the hearer's knowledge, and whether the statement relates to the present or the future." *Id.* at 726-27 (citing *Transp. Ins. Co. v. Faircloth*, 898 S.W.2d 269, 276 (Tex.1995)).

Applying these principles, the *Westcap Enterprises* court held there were no material misrepresentations of fact, where the defendant did not represent he had special knowledge of the movement of interest rates, and the buyer could be reasonably expected to know that no one can predict the movement of interest rates with certainty. *Id.* at 727-28.

Statements of opinion were also addressed in *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. filed), *review granted, judgment set aside, and remanded by agreement* (Jan. 11, 2013). The Court of Appeals applied the same analysis to common law fraud and TSA fraud claims, citing the three *Faircloth* exceptions to the general rule that opinions are not actionable as fraud. *Id.* at 370. Furthermore, while predictions are generally not actionable in fraud, the court said that

“[p]redictions are actionable if the speaker purports to have special knowledge of facts that will occur or exist in the future.” *Id.* The court held that predictions regarding future oil production could be actionable where they were based on and interrelated with a factual representation regarding the present state of drilling technology and experience on other wells. *Id.* at 373-74.

In a recent case in federal court, investors brought TSA claims based on allegations that the defendants misrepresented that the majority of the issuer’s investments, including an independent film entitled *Tekken*, “were sound and financially healthy.” *Small Ventures USA, L.P. v. Rizvi Traverse Mgmt., LLC*, No. H-11-3072, 2012 WL 4621130, at *2 (S.D. Tex. Oct. 2, 2012). The defendants allegedly concealed the fact that the film’s own producer considered it “really bad,” the film received poor reviews at the Cannes Film Festival, and it was behind on its production schedule. *Id.* at *1-2. While the court considered some of these allegations mere opinions or “puffing,” it found the investors’ allegations sufficient to state a claim, especially considering the allegation that investors were provided spreadsheets representing that the film was being carried at full value when it should have discounted or written down. *Id.* at *8.

4. Does the “Bespeaks Caution” Doctrine Apply?

When a seller of securities couples optimistic projections with cautionary language, the “bespeaks caution” doctrine from federal securities law may come into play. Under that doctrine, a representation that seems material in isolation may not be material when read in conjunction with the cautionary language. *See Rubinstein v. Collins*, 20 F.3d 160, 167 (5th Cir. 1994). Defendants may want to argue that the same principles should apply to materiality under the TSA. Whether and how the doctrine applies to a TSA claim remains unsettled.

In *Duperier v. Texas State Bank*, 28 S.W.3d 740, 752 (Tex. App.—Corpus Christi 2000, pet. dism’d by agr.), the court declined to apply the bespeaks caution doctrine to fraud claims under the TSA:

Under the bespeaks caution doctrine, when “forecasts, opinions, or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements did not affect the total mix of information” provided investors. The doctrine addresses “situations in which optimistic projections are coupled with cautionary language—in particular, relevant specific facts or assumptions—affecting the reasonableness of the reliance on and the materiality of those projections.” Materiality is judged in light of the surrounding context.

Given the facts of this case and the prospectus at issue, we decline to adopt the bespeaks caution doctrine. We further hold that the trial court did not err

by refusing to give the jury an instruction on a doctrine not recognized by the statutory or case law of this state.

Id. (internal citations omitted).

More recently, the First Court of Appeals cited the bespeaks caution doctrine favorably but found that the doctrine did not negate the materiality of the alleged misrepresentations in that case. *Highland Capital Mgmt., L.P. v. Ryder Scott Co.*, 402 S.W.3d 719, 746 (Tex. App.—Houston [1st Dist.] 2012, no pet.) (opinion on reh'g). Explaining that cautionary language can be relevant to the materiality of a statement, the court noted that the bespeaks caution doctrine “merely reflects the unremarkable proposition that statements must be analyzed in context.” *Id.* at 744 (citing *Rubinstein v. Collins*, 20 F.3d at 167). The specific question was whether a proved reserve estimate concerning an oil field was material when accompanied by clear and prominent cautionary language. Reasoning that the proved reserve estimate would be a “preeminent consideration” to an investor in the oil and gas company, the court held that the cautionary language merely raised a fact issue concerning the materiality of the estimate. *Id.* at 744-45.

5. Disclaimers / “As Is” Clauses

In some cases, the documents accompanying a securities transaction will contain disclaimers designed to avoid fraud liability. Plaintiffs may seek to avoid such disclaimers by citing Section 33L, which provides that any agreement to waive compliance with any provision of the TSA is void. *See Aegis Ins. Holding Co. v. Gaiser*, No. 04-05-00938-CV, 2007 WL 906328, at *5 (Tex. App.—San Antonio Mar. 28, 2007, pet. denied) (mem. op.) (holding that investors’ written disclaimer of reliance on representations did not bar fraud claim under the TSA).

However, it is possible for disclaimers in the transaction documents to negate an allegation of an actionable misrepresentation. *See Geodyne Energy Income Prod. P’ship I-E v. Newton Corp.*, 161 S.W.3d 483, 486-89 (Tex. 2005) (construing sale document as enforceable “quitclaim” deed). In *Geodyne*, the buyer purchased an interest in an oil and gas lease at an industry auction. *Id.* at 485. The sale document contained an “as is” clause and a disclaimer of warranties. In addition, the buyer warranted that he had substantial experience in the oil and gas business, signed a document containing numerous disclaimers, and knew the well had no production. *Id.* at 487-88. The buyer later discovered the lease had already expired. The Supreme Court construed the sale instrument as a “quitclaim” deed and held that under the circumstances there was no actionable misrepresentation. *Id.* at 487-89. “The deed and documents here show that—viewing the entire transaction in context—there was no representation.” *Id.* at 489.

But what about the anti-waiver provision of Section 33L? The *Geodyne* court held it did not apply, reasoning that there must first be some evidence of a misrepresentation before this section comes into play. *Id.* at 488-89. The court did acknowledge the “tension” between quitclaim deeds and the blue sky laws but reasoned that the legislature did not

intend the TSA to prohibit the use of quitclaim deeds. Citing a 1983 amendment to the statement of the TSA's purpose, the court reasoned that "[c]onstruing the TSA to outlaw quitclaim deeds would have serious consequences for jobs, markets, issuers, and small businesses." *Id.* at 489. The court also emphasized the sophisticated nature of the mineral interest auction market. *Id.* at 490. Thus, depending on the specific factual circumstances, a seller may still be able to effectively disclaim liability in the transaction documents, despite the anti-waiver provision in Section 33L.

D. Can the Defendant Prove It Did Not Knowingly or Negligently Make the Actionable Misrepresentation?

In federal securities litigation under Rule 10b-5, the plaintiff has the burden to plead and prove the defendant's culpable mental state, i.e. **scienter**. Negligence alone is insufficient to establish scienter for a Rule 10b-5 claim. *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 n.7 (5th Cir. 2001) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). At a *minimum*, the plaintiff must prove recklessness, or even "severe recklessness," which the Fifth Circuit has described as "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 present 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." *Nathenson*, 267 F.3d at 408 (citing *Broad v. Rockwell*, 642 F.2d 929, 961-62 (5th Cir. 1981)).

With respect to scienter, Section 33A(1) of the TSA is significantly better than Rule 10b-5 for plaintiffs in two respects: (1) negligence is a sufficient basis for liability, and (2) the burden of proof is on the *defendant*.

The TSA does not require the plaintiff to prove scienter in support of a fraud claim. Rather, a defendant can claim *lack* of scienter as an *affirmative defense*. Specifically, section 33A(2) allows a seller to avoid liability by proving that either "(a) the buyer knew of the untruth or omission or (b) he (the offeror or seller) did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." In contrast, in a claim for materially *aiding* a TSA violation, the plaintiff has the burden of proof on scienter. See the discussion of *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835 (Tex. 2005), in section V-B below.

There is a corresponding affirmative defense for buyers in Section 33B. The Pattern Jury Charge questions on this defense track the language of the statute. TEXAS PATTERN JURY CHARGES PJC 105.14, 105.15 (2010 ed.).

Note that Section 33A has an exception to the affirmative defense for sellers: a non-government issuer cannot assert the lack of knowledge defense with respect to certain types of prospectuses or "a writing prepared and delivered by the issuer in the sale of a security."

E. Was the Security Sold “By Means Of” the Actionable Statement or Omission?

Section 33A(2) provides in pertinent part: "A person who offers or sells a security . . . **by means of** an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, is liable . . ." (emphasis added). Thus, to establish a fraud violation under the TSA, the plaintiff must prove the security was sold "by means of" the alleged misrepresentation or omission.

Texas law is unclear on the meaning of the “by means of” requirement. Federal securities law on causation and reliance is comparatively well developed. It is clear that the elements of a Rule 10b-5 claim include (1) a connection between the alleged misrepresentation or omission and the sale of a security, (2) reliance on the misrepresentation or omission, also referred to as transaction causation, and (3) loss causation. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011).

It seems clear that the “by means of” element of a Section 33A(2) claim requires *some* connection or “nexus” between the alleged misrepresentation or omission and the sale of the security. But what is the required nexus? Is causation required? Does the buyer have to offer proof of reliance? If reliance is required, must the plaintiff prove the buyer would not have bought the security but for the misrepresentation?

The answers to these questions can be dispositive in TSA litigation. The reliance issue is especially important in proposed class actions, where a requirement of proving individualized reliance will usually prevent class certification. *See, e.g., Perrone v. Gen. Motors Acceptance Corp.*, 232 F.3d 433, 440 (5th Cir. 2000) (holding that a class may not be certified where individual reliance is necessary to prove actual damages). As discussed below, the Texas case law is unclear on whether causation and/or reliance are required.

1. Cases Holding that “By Means Of” Means Causation and/or Reliance

In *Nicholas v. Crocker*, 687 S.W.2d 365, 368 (Tex. App.—Tyler 1984, writ ref’d n.r.e.), the Tyler Court of Appeals construed “by means of” to require that the alleged misrepresentation relate to the security and induce the buyer to purchase the security. The Fifth Circuit and some Texas Courts of Appeals have cited *Nicholas v. Crocker* favorably and reached the same conclusion. *Crescendo Invs., Inc. v. Brice*, 61 S.W.3d 465, 475 (Tex. App.—San Antonio 2001, pet. denied); *Pitman v. Lightfoot*, 937 S.W.2d 496, 531 (Tex. App.—San Antonio 2001, pet. denied); *Calpetco 1981 v. Marshall Exploration, Inc.*, 989 F.2d 1408, 1419 (5th Cir. 1993); *see also 1993 GF P’ship v. Simmons & Co. Int’l*, No. 14-09-00268-CV, 2010 WL 4514277, at *8 (Tex. App.—Houston [14th Dist.] Nov. 9, 2010) (mem. op.) (citing *Pitman* and holding that alleged misrepresentations occurring after sale could not be the “means” by which securities were sold). In effect, these courts have required the plaintiff to prove causation and reliance, without expressly holding that “reliance” is an element of the claim.

These decisions are consistent with federal cases construing similar language in Section 12(2) of the Securities Act of 1933. Some federal courts have construed "by means of" as requiring the plaintiff to show a causal relationship between the allegedly misleading communication and the sale complained of. *See, e.g., Jackson v. Oppenheim*, 533 F.2d 826, 830 (2d Cir. 1976) ("some causal relationship" required). The Second Circuit requires a plaintiff to show that the alleged misrepresentation was "instrumental" in the plaintiff's decision to purchase the security. *Id.* at 829-30.

On the other hand, Texas courts seem to be in agreement that the plaintiff is *not* required to show he would not have purchased the security if he had known of the alleged adverse material facts. *Summers v. WellTech, Inc.*, 935 S.W.2d 228, 234 (Tex. App.—Houston [1st Dist.] 1996, no writ); *Anheuser-Busch Cos. v. Summit Coffee Co.*, 858 S.W.2d 928, 936 (Tex. App.—Dallas 1993, writ denied), *vacated on other grounds*, 514 U.S. 1001 (1995).

This principle comes from the materiality standard adopted in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976):

[The standard] does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

Id.

2. Cases Holding that "By Means Of" Does Not Require Proof of Reliance

In contrast to *Nicholas v. Crocker* and *Pitman v. Lightfoot*, some Texas courts have held that reliance is *not* an element of a fraud claim under Section 33. *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779, 783-84 (Tex. App.—Dallas 2003), *rev'd on other grounds*, 161 S.W.3d 482 (Tex. 2005); *Hendricks v. Thornton*, 973 S.W.2d 348, 360 (Tex. App.—Beaumont 1998, pet. denied); *Weatherly v. Deloitte & Touche*, 905 S.W.2d 642, 648-49 (Tex. App.—Houston [14th Dist.] 1995, writ *dism'd w.o.j.*), *abrogation on other grounds recognized by Tracker Marine, L.P. v. Ogle*, 108 S.W.3d 349, 351-52 n.9 (Tex. App.—Houston [14th Dist.] 2003, no pet.).

A recent example is *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 386 (Tex. App.—Houston [1st Dist.] 2012, pet. filed), *review granted, judgment set aside, and*

remanded by agreement (Jan. 11, 2013). In that case, the Houston Court of Appeals simply stated that reliance is not an element of a fraud claim under the TSA, citing *Summers v. WellTech*, 935 S.W.2d at 234, but the court did not even address the Texas cases that reached the opposite conclusion.

The cases holding that the TSA does not require reliance tend to confuse the issues of materiality and causation. They cite the *TSC Industries* principle—that the plaintiff is not required to prove he would not have purchased the security but for the misrepresentation or omission—in support of the different proposition that the plaintiff is not required to prove reliance. *E.g.*, *Geodyne Energy*, 97 S.W.3d at 783-84; *Weatherly*, 905 S.W.2d at 648-49.

3. Case Acknowledging That Reliance Is an Unsettled Issue

In *Gutierrez v. Cayman Islands Firm of Deloitte & Touche*, 100 S.W.3d 261, 275 (Tex. App.—San Antonio 2002, pet. dismiss'd by agr.), the court initially stated that reliance is not an element of a TSA claim, but the court later issued a supplemental clarification opinion, stating that Texas law "is not clear whether reliance is an element of a cause of action based on a violation of the Texas Securities Act," and explaining that its prior statement was dicta. *Id.*

4. The Texas Supreme Court Declines to Address Causation and Reliance in *Geodyne Energy*

In *Geodyne Energy*, The Texas Supreme Court declined an opportunity to address whether the TSA requires proof of causation and/or reliance. *Geodyne* involved an auction of an interest in an oil and gas well. The seller argued that the buyer did not rely on any misrepresentation or omission, but the Court of Appeals held that the TSA does not require the buyer to prove reliance. *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779, 783-84 (Tex. App.—Dallas 2003), *rev'd on other grounds*, 161 S.W.3d 482 (Tex. 2005).

The seller also argued that its alleged misrepresentation or omission did not cause the buyer to purchase the security, i.e. there was no "transaction causation." *Id.* at 784. The Court of Appeals disagreed, viewing the argument as an impermissible attempt to require the plaintiff to prove reliance. "Because reliance by the buyer on the misrepresentation or omission is not required under the TSA," the court reasoned, "a buyer is not required to prove the misrepresentation or omission caused him to purchase the security." *Id.* at 784.

The court acknowledged *Pitman v. Lightfoot*, 937 S.W.2d 496, 531 (Tex. App.—San Antonio 1996, writ denied), and *Nicholas v. Crocker*, 687 S.W.2d 365, 368 (Tex. App.—Tyler 1984, writ ref'd n.r.e.), cases holding that the alleged misrepresentation must relate to the security and induce the purchase. However, the *Geodyne* court construed *Pitman* and *Nicholas* narrowly as standing only for the proposition that "a statement made by the seller after the purchase of a security is not the 'means' by which the security was sold." *Id.*

The Court of Appeals in *Geodyne* also addressed cases interpreting Section 12(2) of the Securities Act of 1933 to require a causal relationship between the misrepresentation or omission and the sale of the security. The court distinguished these cases as addressing "whether (1) the conduct of a defendant that was not the actual seller of the security was sufficiently connected to the sale to impose liability or (2) the communication was made at the time a sale was contemplated." *Id.* (internal footnotes omitted).

The Court of Appeals held that the buyer was only required to prove that (1) the defendant was the seller of the security, and (2) the alleged misrepresentation or omission was made in connection with the sale of the security prior to the sale. "This is the only 'causal connection' required by the TSA," the court said. *Id.* In effect, the *Geodyne* court construed the "by means of" language of Section 33A(2) to mean "in connection with" the sale of the security.

The seller in *Geodyne* also argued that the alleged misrepresentation or omission was not the cause of buyer's loss, i.e. there was no "loss causation." The Court of Appeals rejected this argument as well, holding that Section 33A(2) "does not require the buyer to prove the misrepresentation or omission caused his injury." *Id.* at 785. The court cited *Duperier v. Tex. State Bank*, 28 S.W.3d 740, 753 (Tex. App.—Corpus Christi 2000, pet. dismiss'd), which held that loss causation is not an element of a Section 33A(2) claim. *Id.* The court also noted that, historically, loss causation was not an element of a federal claim under Section 12(2). Although Congress amended Section 12(2) in 1995 to add a loss causation requirement, the court pointed out Section 33 of the TSA has not been similarly amended. Thus, in bringing a claim under Section 33A(2), "a buyer of a security is not required to prove the misrepresentation or omission of material fact caused his injury." *Id.*

The Texas Supreme Court later reversed the decision of the Dallas Court of Appeals, but on narrower grounds focusing on disclaimers in the sale documents (see Section C-5 above). Thus, the Texas Supreme Court declined an opportunity to address the causation and reliance issues, and it remains to be seen how the court will construe the "by means of" nexus required by Section 33A.

5. Could Loss Causation Also Be Required?

Some defendants may argue that Section 33A(2) requires proof of transaction causation *and* loss causation. This would harmonize the TSA with current federal securities law. See 15 U.S.C.A. § 771(b) (establishing loss causation requirement for Section 12(2) claims); 15 U.S.C.A. § 78u-4(b)(4) (codifying loss causation requirement for Section 10b-5 claim); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345-46 (2005) (discussing loss causation requirement).

However, the loss causation requirement in federal cases is now statutory, and the TSA, in contrast, contains no express requirement of loss causation. See *Duperier v. Texas State Bank*, 28 S.W.3d 740, 753 (Tex. App.—Corpus Christi 2000, pet. dismiss'd by agr.)

(holding that loss causation is not an element of a claim under Section 33A(2) of the TSA). As discussed above, this was one of the reasons the Court of Appeals in *Geodyne Energy* held that loss causation is not an element of a Section 33A(2) claim. *See also Anheuser-Busch v. Summit Coffee*, 858 S.W.2d at 937 (the fact that the failure of the issuer had nothing to do with the alleged misrepresentations would not bar the claim).

F. Was Suit Filed Within Three Years from Discovery and Within Five Years from the Sale?

The statute of limitations for a TSA fraud claim is "three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence," or "five years after the sale." TSA § 33H(2) (emphasis added).

The five-year limitation functions as a statute of repose. It is an absolute bar that is not subject to any discovery rule. *Williams v. Khalaf*, 802 S.W.2d 651, 654 n.3 (Tex. 1990); *Pitman v. Lightfoot*, 937 S.W.2d 496, 528 (Tex. App.—San Antonio 1996, pet. denied); *Hanley v. First Investors Corp.*, 793 F. Supp. 719, 721 (E.D. Tex. 1992); *see also* 1977 Comment (explaining that the 1977 amendment added a five-year "cutoff" to the limitations period); *FDIC v. Goldman Sachs & Co.*, No. A-14-CA-129-SS, 2014 WL 4161567, at *9 (W.D. Tex. Aug. 18, 2014) (holding that the FDIC Extender statute, which preempts only state law statutes of limitations, not state statutes of repose, does not affect the TSA's five-year statute of repose).

Also, note that the First Court of Appeals has held that the three-year period begins to run when the plaintiff discovered or should have discovered the untruth or omission, even if that date is prior to the sale of the security. *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 401-3 (Tex. App.—Houston [1st Dist.] 2012, pet. filed).

V. SECONDARY LIABILITY: "AIDER"

A key feature of the TSA is the availability of a private cause of action for "aiding and abetting" under Section 33F. In contrast, the U.S. Supreme Court has been hostile to attempts to hold secondary actors liable for securities fraud violations. In *Central Bank of Denver*, the Supreme Court held that there is no private cause of action for "aiding and abetting" a violation of Section 10(b) of the Exchange Act. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994).⁵

Some plaintiffs tried to get around this bar by asserting primary claims against secondary actors who participate in making misrepresentations, but the Supreme Court raised the bar very high for such claims in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (discussed earlier in the context of who is a "seller"). *Janus* held that corporate affiliates who participated in the preparation of the issuer's prospectus

⁵ The SEC can still seek relief against a secondary actor who "knowingly or recklessly provides substantial assistance" to another person in violation of the Exchange Act or any rule or regulation thereunder. 15 U.S.C.A. §78t(e).

did not “make” the statements in the prospectus and therefore could not be held liable under Rule 10b-5. *Id.* at 2302. “For purposes of Rule 10b-5,” the Court held, “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” *Id.* If a defendant that participated in preparing the alleged misrepresentation cannot be held liable, the viability of a Rule 10b-5 claim against any secondary actor seems highly doubtful.

In contrast, the TSA provides a private cause of action against any person who “materially aids” another person who commits a primary violation. *See* TSA § 33F(2). The statute requires the plaintiff to prove that the aider acted “with intent to deceive or defraud or with reckless disregard for the truth or the law.” *Id.*

Texas courts have stated that a TSA “aiding” claim has four elements: (1) a primary violation occurred; (2) the defendant had “general awareness” of its role in the violation; (3) the defendant rendered “substantial assistance” in the violation; and (4) the defendant either (a) intended to deceive plaintiff or (b) acted with reckless disregard for the truth of the representations made by the primary violator. *E.g., Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied).

Under this formulation, elements 2 and 4 have become redundant, because the Texas Supreme Court has construed “reckless disregard” as requiring “general awareness” (see discussion below). Thus, assuming there was a primary violation, the two key issues for any aiding claim are (1) whether the aider’s assistance was material and (2) whether the aider acted with the required mental state, i.e. scienter.

A. Was the Defendant’s Aiding Material?

The materiality requirement of an aiding violation means that third parties who merely render incidental assistance to the primary violator will not be liable. To prove that the defendant materially aided the primary violator, the plaintiff must prove the defendant provided “substantial assistance” in the violation. *Navarro v. Grant Thornton, LLP*, 316 S.W.3d 715, 720-21 (Tex. App.—Houston [14th Dist.] 2010, no pet.) (citing *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied)).

Of course, “substantially assist” is just another way of saying “materially aid,” so the “substantial assistance” formulation adds little to the statutory language. The PJC question on aider liability simply uses the language “materially assisted,” without reference to “substantial assistance.” TEXAS PATTERN JURY CHARGES PJC 105.18 (2010 ed.).

One way Texas courts could construe “material aid” or “substantial assistance” would be to require that the alleged aiding be a **proximate cause** of the violation, i.e. cause in fact plus foreseeability. This is how “substantial assistance” is defined under New York law. *See In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 761 F. Supp. 2d 504, 539 (S.D. Tex. 2011) (citing *Cromer Fin. Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001)). Under this standard, “but for” causation is insufficient; the injury must directly or foreseeably

result from the alleged assistance. *Id.* Texas courts, in contrast, have not adopted any particular test for “substantial assistance” instead addressing it on a case-by-case basis.

Although there is relatively little Texas case law construing “substantial assistance,” the cases suggest a few general principles. First, there must be a sufficient nexus between the alleged “substantial assistance” and the *violation* of the TSA; assistance to a company that is not connected to the company’s specific violation will not suffice. *See Crescendo Invs., Inc. v. Brice*, 61 S.W.3d 465, 473 (Tex. App.—San Antonio 2001, pet. denied) (“even if they knew Scott was absconding invested funds, the Brices did not substantially assist the violation i.e., the fraud”).

So, for example, in *Crescendo Investments* there was insufficient evidence of substantial assistance where the alleged aiders did not assist the primary violator in selling fraudulent securities or diverting money. *Id.* *But see Darocy v. Abildtrup*, 345 S.W.3d 129, 139 (Tex. App.—Dallas 2011, no pet.) (finding sufficient evidence of substantial assistance where defendant was an officer of the violating company, had control and access to its bank accounts, and told investors problems would be addressed).

Second, where an alleged aider has no duty to disclose, evidence of the aider’s failure to disclose cannot be used to prove “substantial assistance.” *Navarro v. Grant Thornton, LLP*, 316 S.W.3d 715, 721-22 (Tex. App.—Houston [14th Dist.] 2010, no pet.). Thus, evidence that an accounting firm failed to disclose information to investors or regulators could not be considered, where there was no evidence the accounting firm had a duty to disclose. *Id.*

Third, courts tend to focus more on the alleged aider’s level of intent than the materiality of the assistance rendered. *See, e.g., Darocy*, 345 S.W.3d at 139 (mentioning “substantial assistance” but focusing on whether the defendant intended to deceive investors or acted with reckless disregard for the truth of the primary violator’s representations). As a practical matter, if the court is persuaded that the aider was aware of the primary violator’s wrongdoing, the courts seem more likely to find the assistance “substantial” or “material.”

B. Did the Defendant Act with “Reckless Disregard”?

Under Section 33F(2), the alleged aider is only liable if it acted “with intent to deceive or defraud or with reckless disregard for the truth or the law.” The “truth” refers to the truth of the primary violator’s alleged misrepresentations, while the “law” seems to refer to the law requiring securities to be registered.

Lawyers will always dream of finding the “smoking gun” email (e.g. “Dear billion-dollar investment bank, we just wanted you to know we’re going to lie to these suckers to get them to invest”). But it is usually difficult for plaintiffs to find direct evidence that a secondary actor *intended* to deceive or defraud investors. More often, plaintiffs will attempt to show that a secondary actor acted recklessly by rendering assistance to the

primary violator while ignoring “red flags,” “sticking its head in the sand,” “looking the other way,” etc. Often the key legal question is whether the evidence establishes mere negligence or rises to the level of “reckless disregard for the truth or the law.”

1. The *Sterling Trust* “General Awareness” Requirement

In *Sterling Trust*, the Texas Supreme Court clarified—and arguably added to—the “reckless disregard” requirement. The court held that the requirement of “reckless disregard for the truth or the law” means that an alleged aider is subject to liability “only if it rendered assistance to the seller in the face of a **perceived risk** that its assistance would facilitate untruthful or illegal activity by the primary violator.” *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 837 (Tex. 2005) (emphasis added). In order to perceive such a risk, the alleged aider must possess a “**general awareness** that his role was part of an overall activity that is improper.” *Id.* at 842 (emphasis added) (citing *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 780 (3d Cir. 1976)).

“This standard does not mean that the aider must know of the exact misrepresentations or omissions made by the seller,” the *Sterling* court explained, “but it does mean that the aider must be subjectively aware of the primary violator's activity.” *Id.* at 837. Thus, the mere failure to conduct a minimal investigation and inquiry before rendering assistance with a securities transaction does *not* suffice to show “reckless disregard.” *Id.* at 841.

The *Sterling* court also explained the different scienter provisions that apply to sellers, aiders, and control persons under the TSA. The investors in *Sterling* asserted both primary and secondary TSA claims against Sterling, a company that served as a trustee for the invested funds. In response to the primary claim, Sterling invoked the affirmative defense provided by Section 33A(2): a seller is not liable if he proves that he “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.” The jury found in favor of Sterling on this issue. *Id.* at 845-46. However, for purposes of the secondary claim, the investors submitted a jury question tracking the language of Section 33F, asking whether Sterling acted with “reckless disregard for the truth or the law.” On this issue, the jury found against Sterling, and the trial court entered judgment against Sterling on the secondary liability claim. *Id.* at 839, 842-43.

Sterling argued that it could not be held liable as an aider because the jury found that Sterling did not know and could not have known of the misrepresentations or omissions made by the seller. *Id.* The Texas Supreme Court rejected this argument, holding that the affirmative defense cited by Sterling applies only to *primary* violations. *Id.* at 843-45. The court explained that the TSA provides different knowledge requirements for three different classes of defendants:

- Alleged **sellers** may assert the Section 33A(2) affirmative defense: “a person is not liable if he sustains the burden of proof that either (a) the buyer knew of the untruth or omissions or (b) he (the offeror or seller) did not know, and

in the exercise of reasonable care could not have known, of the untruth or omission.” *Id.* at 843-44.

- Alleged **control persons** have a slightly different affirmative defense under Section 33F(1). They can avoid liability by proving that they did not know, and in the exercise of reasonable care could not have known, of “the existence of the facts by reason of which the liability is alleged to exist.” *Id.* at 844.
- The TSA does not provide alleged **aiders** with any affirmative defense, but the plaintiff has the burden to prove the aider acted “with intent to deceive or defraud or with reckless disregard for the truth or the law.” *Id.* at 844-45. The legislature chose to establish a standard for aider liability that departs from the Uniform Securities Act standard, allowing a broader class of persons to qualify as aiders but imposing a stricter scienter standard. *Id.* Given the legislature's balancing of these considerations, the *Sterling* court “decline[d] to imply an additional defense not offered to aiders under the text of the statute.” *Id.* at 845.

Sterling argued that giving sellers an affirmative defense but failing to imply the same affirmative defense for aiders would render the statute illogical. The court disagreed, saying “the different standards make sense in light of the facts that these parties may reasonably be expected to know.” The standard for primary violators focuses on whether they knew specific misrepresentations were untrue, while the standard for aiders focuses on knowledge that the primary violator is engaging in improper activity. *Id.* at 845. “Because the finding referred specifically to knowledge ‘of the untruth or omission,’” the court concluded, “this finding does not establish whether *Sterling* knew of [the seller’s] improper activity in general, and therefore does not necessarily trump the jury’s finding that *Sterling* acted ‘with intent to deceive or defraud or with reckless disregard for the truth or the law.’” *Id.* at 845-46.

2. Application of the “General Awareness” Requirement

What kind of evidence is sufficient to prove that an alleged aider had subjective “general awareness” of the seller’s improper activity? The following cases are instructive.

Goldstein v. Mortenson

In *Goldstein v. Mortenson*, a case decided prior to *Sterling Trust*, the Austin Court of Appeals held there was sufficient evidence to support aider liability where the defendant assisted the primary violator in obtaining a loan intended to conceal investor losses. *Goldstein v. Mortenson*, 113 S.W.3d 767, 776-77 (Tex. App.—Austin 2003, no pet.).

Consistent with the Texas Supreme Court's later decision in *Sterling Trust*, the *Goldstein* court stated that one of the elements of aider liability was “general awareness” of the aider's role in the violation. *Id.* at 776. The plaintiffs offered sufficient evidence of “general awareness” through the testimony of the seller's chief operating officer that the

defendant was explicitly told that the purpose of the loan was to conceal a gap between the actual amount in the seller's account and the balance reported to investors. *Id.* at 777. Furthermore, by arranging the loan, the defendant provided "substantial assistance" that enabled the seller to continue to operate and to delay the Texas State Securities Board's discovery of wrongdoing. *Id.*

The *Goldstein* court also stated that the defendant's failure to conduct a minimal investigation and inquiry before assisting the seller with the loan showed "a reckless disregard for the truth or the law." *Id.* However, the Texas Supreme Court later disagreed with this portion of *Goldstein*, stating that the general awareness standard does not allow liability to be imposed for a mere failure to investigate. *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 841 (Tex. 2005).

Sterling Trust

After holding that "reckless disregard" requires a showing of "general awareness," the *Sterling* court found that the failure to include a requested "general awareness" instruction in the jury charge was harmful error, even though the jury question tracked the language of Section 33F. *Id.* at 842-43.

The primary violator in *Sterling* was an investment advisor, Cornelius, who encouraged the plaintiffs to invest their money in a company called Avalon that offered high yield promissory notes. *Id.* at 837-38. Because many of the investors used funds from their retirement accounts to invest in Avalon, they needed a third-party to hold their investments, and Sterling Trust agreed to serve as the trustee for the invested funds. *Id.* at 838. Cornelius allegedly misrepresented the risks of the investments and the use of the investment funds. *Id.*

The investors argued that Sterling played an essential role in the investment scheme and failed to inform the investors that too much of their net worth was held in risky investments. *Id.* The investors offered evidence that Sterling failed to comply with its own internal procedures. *Id.* at 839. They also offered evidence that Sterling was aware of commingling of investor funds, and that Sterling allowed Cornelius to unilaterally make transfers of the investors' monies into new investments. *Id.*

The investors submitted a jury question asking whether Sterling acted with "reckless disregard for the truth or the law." The jury found against Sterling on this issue, but the Texas Supreme Court was concerned that the evidence and arguments may have led the jury to apply the wrong standard:

In this case, the jury may well have thought that "reckless disregard" could be based on evidence of Sterling's negligent handling of accounts even if Sterling had no actual knowledge of Cornelius's improprieties; the plaintiffs themselves created such a risk of misinterpretation by arguing repeatedly at trial that Sterling "either knew fully what Cornelius was doing" or "exercised reckless disregard" by ignoring internal

procedures that would have brought Cornelius's activities to light. Ignoring internal procedures that might have alerted Sterling to Cornelius's scheme may be negligence, but it is not “reckless disregard for the truth or the law.”

Id. at 843. Given this risk of the jury applying a lesser standard than “general awareness,” the *Sterling* court held that failing to include the general awareness instruction was harmful error.

Ferne v. Merrill Lynch

The Austin Court of Appeals later applied the “general awareness” requirement in *Ferne v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 03-09-00566-CV, 2011 WL 2769838, at *13-15 (Tex. App.—Austin July 12, 2011) (op. on reh’g), *abated for settlement*, 2011 WL 4424491. The court held that Merrill Lynch’s knowledge that one of its employees had decided to sell his interest in two companies he owned was insufficient to establish that Merrill Lynch had general awareness of a *violation*, i.e. the sale of unregistered securities. *Id.* at *14. The court noted that there was no evidence that Merrill Lynch had knowledge of the specific transaction with the plaintiff. *Id.*

Highland Capital v. Ryder Scott

The First Court of Appeals applied *Sterling Trust’s* “general awareness” standard in *Highland Capital Mgmt., L.P. v. Ryder Scott Co.*, 402 S.W.3d 719, 735 (Tex. App.—Houston [1st Dist.] Dec. 6, 2012, no pet. h.) (opinion on r’hng). The plaintiffs in *Highland Capital* invested in an oil and gas exploration company in reliance on allegedly inflated proven oil reserve estimates. *Id.* at 723-24. They claimed that Chesapeake Energy perpetuated the misrepresentations regarding the reserve estimates by loaning the seller money to continue its operations. *Id.* at 725. Chesapeake moved for summary judgment on the ground that it did not have “general awareness” of its role in the alleged primary violations because it was not aware that the reserve estimates were inflated. *Id.* at 733-34. The plaintiffs offered evidence that Chesapeake conducted its own due diligence review of the reserve reports, along with expert testimony that any competent professional engineer who reviewed the reports would have known the reserves were over-estimated. *Id.* at 737-38.

The *Highland Capital* court held this evidence was insufficient. It only showed “what a competent professional engineer *should have known* from reviewing the reserve reports,” not “what Chesapeake Energy’s engineering staff in fact actually knew.” *Id.* at 738 (original emphasis). “At best,” the court said, the expert testimony “raised a fact question whether Chesapeake Energy’s engineers were negligent in their due diligence review of the reserve reports.” *Id.* Citing *Sterling Trust*, the court held that evidence that the defendant “should have known” does not satisfy the scienter requirement for aider liability under Section 33F. *Id.* at 738-39.

Darocy v. Abildtrup

In contrast to *Fernea* and *Merrill Lynch*, there was sufficient evidence of “general awareness” in *Darocy v. Abildtrup*, 345 S.W.3d 129, 139 (Tex. App.—Dallas 2011, no pet.). The issuer was an oil and gas venture that sold unregistered securities to investors promising returns of 400% or more, and there was testimony that the officers of the venture used investor funds to pay for extravagant non-business expenses such as casinos and jewelry. *Id.* at 133-35. It was undisputed that the issuer had violated the TSA, and the evidence was sufficient to support a finding that the defendant, an officer of the company with access to its bank accounts and awareness of the company’s problems, had “general awareness” of his role in the violation and provided “substantial assistance” to the company. *Id.* at 139.

C. Was Suit Filed Within the Applicable Limitations Period?

A secondary claim against an aider of a TSA violation is subject to the same limitations periods that would apply to the underlying primary claim. *See* TSA § 33H(1) and (2). Thus, a claim for aiding a fraud violation must be filed within three years of discovery and within five years of the sale, while a claim for aiding a registration violation must be filed within three years of the sale.

The three-year discovery rule for fraud claims can be problematic for material aider claims, because the clock may start ticking before the buyer knows the extent of the alleged aider’s involvement.

This was an issue in *Baxter v. Gardere Wynne Sewell LLP*, 182 S.W.3d 460, 461-62 (Tex. App.—Dallas 2006, pet. denied). Investors brought TSA claims against a law firm based on its representation of a failed investment advisor, alleging that the law firm helped the advisor “get away with” violating Texas securities laws. The law firm moved for summary judgment based on the three-year statute of limitations. *Id.* at 462-63. The investors argued that the limitations period did not begin to run until they knew or should have known of *the law firm's* involvement in causing their injury, regardless of when they learned of the primary actor's misconduct. *Id.* at 463. But the court held that the three-year period began to run when the investors learned of *their injury*, regardless of when they learned of the law firm's involvement. *Id.* at 463-64.

The *Baxter* court reasoned that “the Texas Supreme Court has clearly stated that the discovery rule delays accrual of a cause of action until the plaintiff knew or should have known of their *injury*, not the identity of the wrongdoer.” *Id.* Further, the court emphasized that the language of the TSA's discovery rule refers to “discovery of the untruth or omission.” Since it was undisputed that the investors learned of the investment advisor's alleged untruth or omission more than three years before filing suit, it made no difference when they learned of the law firm's role. *Id.* at 463-64. The court also said the investors could have discovered the law firm's existence and role through “minimal investigation.” *Id.* at 464.

VI. SECONDARY LIABILITY: “CONTROL PERSON”

As discussed below, both the TSA and federal law provide for control person liability, but in both cases the standard for such liability is unsettled.

A. “Control Person” Liability Under the TSA

“Control person” liability is the other type of secondary liability provided for in the TSA. Section 33F(1) provides: “A person who directly or indirectly controls a seller, buyer, or issuer of a security is liable under Section 33A, 33B, or 33C jointly and severally with the seller, buyer, or issuer, and to the same extent as if he were the seller, buyer, or issuer.” While control person liability requires an underlying primary violation, the plaintiff is not necessarily required to join the primary violator as a party to the suit against the alleged control person. *See Summers v. WellTech, Inc.*, 935 S.W.2d 228, 231 (Tex. App.—Houston [1st Dist.] 1996, no writ).

In contrast to aider liability, which requires the plaintiff to prove scienter, control person liability does not require the plaintiff to prove any intent, knowledge, or recklessness of the defendant. However, the statute provides an affirmative defense to alleged control persons. A control person is not liable if he “sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.” TSA § 33F(1); *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 844 (Tex. 2005).

Note that control person liability, like aider liability, does not supersede common law principles of vicarious liability. *See* 1977 Comment (“§ 33F is not intended to supersede the common law liability of a principal for an agent’s acts within the scope of authority”). Thus, an employer could be liable for an employee’s primary violation both under *respondeat superior* and as a “control person” under the statute.

The TSA does not define what kind of “control” is required to hold a defendant liable as a control person, but the 1977 Comment notes that “[d]epending on the circumstances, a control person might include an employer, an officer or director, a large shareholder, a parent company, and a management company.” TSA § 33F cmt. *See also Busse v. Pacific Cattle Feeding Fund No. 1, Ltd.*, 896 S.W.2d 807, 815 (Tex. App.—Texarkana 1995, writ denied) (stating categorically that major shareholders and directors are control persons); *but see Texas Capital Secs. Mgmt., Inc. v. Sandefer*, 80 S.W.3d 260, 268 n.3 (Tex. App.—Texarkana 2002, no pet.) (stating that *Busse* did not really mean that all major shareholders and directors are necessarily control persons).

In *Frank v. Bear, Stearns*, the court cited the 1997 Comment and stated that “control” under Section 33F is defined in the same terms as under federal securities law: “the possession, direct or indirect, of the power to direct or cause the direction of the management or policies of a person, whether through the ownership of voting securities,

by contract, or otherwise.” *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied). *Frank* adopted a two-prong test for control person liability. *Id.*; *Darocy v. Abildtrup*, 345 S.W.3d 129, 137 (Tex. App.—Dallas 2011, no pet.).

Two divergent standards have emerged in Texas Courts of Appeals:

(1) Under the *Frank* standard, the plaintiff must prove that the defendant (a) exercised control over the operations of the corporation in general and (b) had the power to control the specific transaction or activity upon which the primary violation is predicated. *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied).

(2) Under the *Sandefers* standard, the plaintiff must prove the defendant (1) "had actual power or influence over the controlled person" and (2) "induced or participated in the alleged violation." *Texas Capital Secs. Mgmt., Inc. v. Sandefers*, 80 S.W.3d 260, 268 (Tex. App.—Texarkana 2002, no pet.).

Both standards are taken from federal securities law, but they rely on different federal cases. *See Frank*, 11 S.W.3d at 384 (citing *Abbott v. Equity Group Inc.*, 2 F.3d 613, 620 (5th Cir. 1993)); *Sandefers*, 80 S.W.3d at 268 (citing *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990)).

The *Sandefers* standard sets a higher bar than *Frank* because it requires the plaintiff to prove actual participation in the primary violation, while the *Frank* standard only requires proof that the defendant had the *power* to control the primary violation. Arguably, the *Frank* standard is more consistent with the structure of Section 33, because *Sandefers*'s requirement that the control person participate in the violation seems to render control person somewhat redundant of aider liability.

But the Texas Supreme Court has not yet addressed this split in authority, and the Pattern Jury Charge Committee expressed no opinion about the proper definition of a control person because of the "uncertainty in the law." TEXAS PATTERN JURY CHARGES PJC 105.16, cmt. on definition of "control person" (2010 ed.).

In *Barnes v. SWS Financial Services, Inc.*, 97 S.W.3d 759 (Tex. App.—Dallas 2003, no pet.), the Dallas Court of Appeals adopted the less stringent *Frank* standard for control person liability. The court considered and rejected the test for "control person" liability followed in *Sandefers*, which requires proof that the defendant "induced or participated in the alleged violation." *Id.* at 763 (citing *Sandefers*, 80 S.W.2d at 268). The *Barnes* court reasoned that the *Sandefers* test for "control person" was based on a Fifth Circuit case that had since been disapproved, and that the *Sandefers* test improperly shifted the burden of proof to the plaintiff to show that the defendant participated in the particular violation. *Id.*

Instead, the court adopted the *Frank* test for control person liability: a defendant is a control person if it (1) exercised control over the operations of the corporation in general

and (2) had the power to control the specific transaction or activity upon which the primary violation is predicated. *Id.* at 764 (citing *Frank*, 11 S.W.3d at 384).

In *Fernea*, the Austin Court of Appeals cited *Barnes* and *Frank* and stated that the plaintiff must prove that the control person “(1) had actual power or influence over the controlled person, and (2) had the power to control or influence the specific transaction or activity that gave rise to the underlying violation.” *Fernea v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 03-09-00566-CV, 2011 WL 2769838, at *13-15 (Tex. App.—Austin July 12, 2011) (op. on reh’g), *abated for settlement*, 2011 WL 4424491.

While the *Fernea* formulation blends language from *Frank* and *Sandefur*, in effect it is closer to *Frank* because it does not require the plaintiff to prove the defendant induced or participated in the alleged violation. The *Fernea* court held that Merrill Lynch’s lack of knowledge and participation in the sale of securities to the plaintiff did not conclusively establish that Merrill Lynch lacked the *power* to control or influence the specific transaction. *Id.* at *16-18.

B. Comparison to “Control Person” Liability Under Federal Law

As previously mentioned, federal securities law also imposes joint and several liability for any person who controls any other person found liable under the 1933 Act or the 1934 Act. 15 U.S.C. § 77o (1933 Act); 15 U.S.C. § 78t (1934 Act). Like Section 33F(1) of the TSA, control person liability under federal securities law requires a primary violation by the controlled person. 15 U.S.C. § 77o; 15 U.S.C. § 78t.

The alleged control person has an affirmative defense under federal securities law: there is no liability if he (1) “had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist” (under the 1933 Act); or (2) “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action” (under the 1934 Act). 15 U.S.C. § 77o; 15 U.S.C. § 78t.

There is a split among the circuits as to whether the plaintiff must show that the alleged control person actually exercised control over the primary violator's general affairs, or rather, merely need show that the control person had the *power* to exercise such control. *See Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1306 n.8 (10th Cir. 1998) (and cases cited and discussed therein). In the Fifth Circuit, the prevailing view is consistent with the *Frank* approach discussed above: It is sufficient for the defendant to have the power to control the primary violator or to influence corporate policy; actual exercise of that control or participation in the alleged violation is not required. *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981). On the other hand, the Fifth Circuit not been entirely consistent on this issue. *See Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990) (citing *G.A. Thompson* but holding that plaintiff must prove control person had actual power or influence over the controlled person and induced or participated in the alleged violation).

VII. REMEDIES

If the plaintiff proves a primary or secondary violation of the TSA and the defendant fails to prove an applicable affirmative defense, what remedies are available? Section 33A allows the plaintiff to sue “either at law or in equity for rescission, or for damages if the buyer no longer owns the security.” Section 33D further provides for remedies of **rescission, damages, costs, and reasonable attorney’s fees**. Note that sub-sections 33D(1)-(4) specifically define the measures of damages for both rescission and damages as to both buyers and sellers. Also note that attorney’s fees are recoverable only “if the court finds that the recovery would be equitable in the circumstances.”

Similar remedies are available under federal securities law, which allows a plaintiff to sue either at law or in equity, in any court of competent jurisdiction, seeking rescission, damages, costs and/or reasonable attorneys’ fees. *See, e.g.*, 15 U.S.C.A. § 77l; 15 U.S.C.A. § 77k(e); 15 U.S.C.A. § 78r(a).

VIII. DO COMMON LAW DEFENSES APPLY TO THE TEXAS SECURITIES ACT?

It is open to debate whether a TSA claim is subject to common law defenses such as waiver, estoppel, ratification, and unclean hands. Texas courts have tended to hold that common law defenses do *not* apply to TSA claims. *See Aegis Ins. Holding Co. v. Gaiser*, No. 04-05-00938-CV, 2007 WL 906328, at *5 (Tex. App.—San Antonio Mar. 28, 2007, pet. denied) (mem. op.) (rejecting argument that investors’ breach of warranty constituted finding of “unclean hands” barring remedy of rescission); *Duperier v. Texas State Bank*, 28 S.W.3d 740, 753 (Tex. App.—Corpus Christi 2000, pet. dismissed by agr.) (common law defense of ratification does not apply to a TSA claim unless the subsequent conduct can be interpreted as a settlement). Also note that there is a specific anti-waiver provision in Section 33L of the TSA: “A condition, stipulation, or provision binding a buyer or seller of a security . . . to waive compliance with a provision of this Act or a rule or order or requirement hereunder is void.”

The applicability of common law defenses to alleged federal securities law violations is no clearer. In the Fifth Circuit case *Stephenson v. Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095, 1098, 1099 n.11 (5th Cir. 1988), the court sidestepped the issue of whether previously-recognized common law defenses to Rule 10b-5 claims were still applicable, holding on an alternative ground that the plaintiff’s claim was precluded. Securities commentators generally note that courts are increasingly reluctant to permit common law defenses to lessen the deterrent value of the securities laws. Further, with respect to the defense of waiver in particular, the federal securities laws contain a similar anti-waiver provision as that contained in the TSA: “Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.” 15 U.S.C.A. § 77n. *See also* 15 U.S.C.A. § 78cc(a).

IX. CHOICE OF LAW IN TEXAS SECURITIES ACT CASES

Many TSA cases involve transactions that cross state lines or international borders, so choice of law is often an important issue. Some courts have held that the TSA applies when any act in the selling process occurs in Texas, while others have applied modern choice of law principles to determine which state's securities laws should apply.

A. Cases Applying the “Most Significant Relationship” Standard

In *Greenberg Traurig*, the court held that the TSA did not apply where the conduct alleged to have caused the plaintiffs' injuries occurred outside of Texas and the defendant had no direct dealings with the Texas plaintiffs. *Greenberg Traurig of New York, P.C. v. Moody*, 161 S.W.3d 56, 74-76 (Tex. App.—Houston [14th Dist.] 2004, no pet.). The plaintiffs were Texas residents who invested in a Delaware company with its headquarters in Pennsylvania. *Id.* at 63. Greenberg Traurig, a national law firm based in New York, represented the company. *Id.* The investors claimed the law firm assisted management in defrauding the investors by failing to disclose numerous facts concerning the inability to make an initial public offering. *Id.* at 67. The jury found Greenberg Traurig liable for primary and secondary violations of the TSA, *Id.* at 67-68, but the law firm argued that the TSA did not apply because New York law governed all of the investors' fraud-based claims. *Id.* at 69.

Applying the “most significant relationship” test to determine which state's law to apply to the fraud-based claims, the court focused primarily on where the allegedly wrongful conduct occurred, reasoning that “when evaluating fraud-based claims to determine governing law, the principal focus is where the conduct occurred.” *Id.* at 72. The court also emphasized the distinction between the alleged misconduct of the company and its principals, with whom the investors had personal contact and direct dealings, and the alleged misconduct of the law firm, with whom the investors had no contact and no direct dealings. “This important distinction greatly impacts the conflict-of-laws analysis,” the court said. *Id.*

To the extent the law firm made any misrepresentations, it made them from its offices in New York, and its representations were not directed to Texas. In short, “whatever Greenberg Traurig did, it did in New York.” *Id.* at 73. Some of the significant events occurred outside New York, but those events occurred in Pennsylvania, not in Texas. *Id.* Since the law firm's conduct occurred in New York and not in Texas, the court found that New York had a stronger interest in applying its own securities statutes and regulatory policies. *Id.* at 73-74.

Furthermore, since the law firm had no dealings with the Texas investors, “considerations of fairness and protection of the reasonable expectations of the parties point to the application of New York law.” *Id.* at 74. In addition, because the lawyers were not licensed to practice law in Texas, New York's strong interest in regulating the conduct of its lawyers outweighed any interest Texas might have. *Id.* at 75.

“While it is arguable that Texas has some relationship to the transactions at issue,” the court reasoned, “it does not have the dominant or most significant relationship necessary to displace the law of New York.” *Id.* Accordingly, the court held that New York law, not the Texas Securities Act, governed the investors' fraud-based claims. *Id.* at 75-76.

In *Grant Thornton LLP v. Suntrust Bank*, 133 S.W.3d 342, 361 (Tex. App.—Dallas 2004, pet. dismiss'd w.o.j.), the court applied the same “most significant relationship” test but reached the opposite result based on different facts. The court held that the TSA applied to all members of a class of investors, including non-Texas residents, where the issuer's headquarters was in Texas, the defendant accounting firm performed its audit in Texas, the registration statement with the alleged misrepresentations was prepared in Texas, and some of the class members were Texas residents. *Id.*

B. Cases Applying the “Act in the Selling Process” Standard

In contrast to the “most significant relationship” analysis in *Greenberg Traurig and Grant Thornton*, the federal district court in the *Enron* securities litigation relied on Texas cases that apply the TSA when any act in the selling process occurs in Texas. *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549, 691 (S.D. Tex. 2002)

In the *Enron* case, the Washington State Investment Board sued various defendants under the TSA based on their involvement in sales of certain Enron notes. *Id.* at 565. The defendants moved to dismiss the Board's claim under Section 33 of the TSA “for lack of a nexus between the sales of the securities and the State of Texas, i.e., an allegation that the sales occurred in Texas.” In response, the plaintiff argued that the alleged misconduct, including false statements to sell Enron debt, “occurred in and/or emanated from Texas in substantial part,” justifying application of the TSA.

The court denied the motion to dismiss, agreeing with the plaintiff that it “does not have to show that the sale of the securities was primarily linked to Texas because the statute applies if any act in the selling process of securities covered by the Act occurs in Texas.” *Id.* at 691 (citing *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 921-22 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.), and *Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App.—Houston [1st Dist.] 2001, pet. denied)).

X. FEDERAL PREEMPTION AND REMOVAL OF CLASS ACTIONS

For various reasons discussed above, many investors will be better off pursuing claims under the Texas Securities Act than filing federal securities law claims. But plaintiffs beware: many *class actions* asserting state law securities claims will be barred by federal law.

Given the advantages of the Texas Securities Act and state court procedure, plaintiffs' lawyers who want to file class actions will naturally want to consider whether

they can bring class actions premised on alleged violations of the TSA. After Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995, some plaintiffs tried to avoid its heightened pleading requirements by pursuing securities fraud class actions in state court. In 1998, Congress enacted the Securities Litigation Uniform Standards Act (SLUSA) in an effort to curb this practice. SLUSA has been interpreted broadly, so as not to “undercut the effectiveness” of the PSLRA. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 86 (2006).

While SLUSA is sometimes called a preemption provision, it does not actually preempt any state law causes of action. Rather, it precludes the plaintiff from using the class action device to pursue certain claims. *Dabit*, 547 U.S. at 87.

SLUSA has several key provisions to consider. SLUSA requires dismissal of a private party’s claim (1) involving a “covered class action” that is (2) based on state statutory or common law and (3) alleges “a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security,” or “that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.” 15 U.S.C.A. § 78bb(f)(1); *Dabit*, 547 U.S. at 83.

If a suit pending in state court meets all three of these provisions, then it is removable to federal court so that the federal court may dismiss the action. 15 U.S.C.A. § 78bb(f)(2).

A. “Covered Class Action”

A “covered class action” includes any single action in which damages are sought on behalf of more than 50 people or prospective class members, and questions of law or fact common to those persons or prospective class members (without reference to issues of individualized reliance on an alleged misstatement or omission) predominate over any questions affecting only individual persons or members. 15 U.S.C.A. § 78bb(f)(5)(B); *Dabit*, 547 U.S. at 83 n.8.

This definition encompasses not only traditional class actions, but also mass actions and any group of consolidated or joined lawsuits proceeding as a single action for any purpose on behalf of more than 50 persons. *Demings v. Nationwide Life Ins. Co.*, 593 F.3d 486, 493-94 (6th Cir. 2010).

The definition is interpreted broadly. Courts have deemed series of cases filed by the same plaintiffs’ counsel, on behalf of plaintiff groups that each number less than 50 persons but collectively exceed 50 persons, as a “covered class action,” if the cases have been consolidated or are proceeding as a single action—either before removal, in state court, or after removal, in federal court. *In re Enron Corp. Secs.*, 535 F.3d 325, 341-42 (5th Cir. 2008).

B. State Law Claim

It will be evident from the pleading itself whether the plaintiff's claim is based on state statutory or common law.

C. Alleged Fraud “in Connection With” the Purchase or Sale of a “Covered Security”

This provision is where much of the legal wrangling lies, in particular with respect to whether the plaintiff has alleged fraud or misrepresentation and, if so, whether the fraud or misappropriation is alleged “in connection with” the purchase or sale of a covered security.⁶

1. Alleged Fraud/ Misrepresentation

In determining whether the plaintiff's allegations sound in fraud, courts will look beyond the words and labels actually used in the complaint, to see “whether the complaint covers the prohibited theories, no matter what words are used (or disclaimed) in explaining them.” *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 311 (6th Cir. 2009) (citations omitted). *See also Miller v. Nationwide Ins. Co.*, 391 F.3d 698, 702 (5th Cir. 2004) (“preemption hinges on the content of the allegations-not on the label affixed to the cause of action”).

With respect to allegations of misrepresentation, omission, manipulative act or deceptive practice in connection with buying or selling securities, it is necessary only that these types of allegations be included in the complaint; it is not necessary for these allegations to be material to the asserted claims, or “essential legal elements” of the claims. *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 300 (3d Cir. 2005); *see also Segal*, 581 F.3d at 311-12. This means that even extraneous allegations of misrepresentations are sufficient to cause dismissal of a complaint under SLUSA.

A plaintiff should be mindful of the import of her allegations in this regard from the beginning. A plaintiff cannot “unring the bell” and avoid the preclusive effect of SLUSA by deleting misrepresentation-type allegations from her complaint, if the end effect nonetheless leaves the “covered concepts” in place. *Segal*, 581 F.3d at 310-11.

2. “In Connection With” Purchase or Sale

For SLUSA to apply, there must be an allegation that the alleged fraud was “in connection with” the sale or purchase of covered securities. When the plaintiff claims that a class of investors purchased a company's stock based on fraudulent representations made by the company to the public, then the representations are clearly “in connection”

⁶ Of note, while SLUSA expressly refers to allegations made in connection with the “purchase or sale” of a covered security, the statute has been interpreted to apply as well to *holders* of a covered security. *Dabit*, 547 U.S. at 87-89.

with the purchase, and the SLUSA bar applies (assuming the other elements). But application of the “in connection with” requirement becomes more difficult in less typical situations, such as Ponzi scheme cases where a company misrepresents what it is actually doing with the investors' money.

In *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1066 (2014), a case arriving from the multibillion dollar investment fraud perpetrated by Allen Stanford, the Supreme Court construed SLUSA’s “in connection with” language in favor of plaintiffs, holding that it requires more than just a misrepresentation that is tangentially related to the purchase or sale of securities. “A fraudulent misrepresentation or omission is not made ‘in connection with’ such a ‘purchase or sale of a covered security,’” the Court said, “unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a ‘covered security.’” *Id.*

Under the *Chadbourne* interpretation of “in connection with,” SLUSA will typically not bar a class action where the plaintiffs do not allege that they bought or sold (or attempted to buy or sell) a covered security. For example, in *Chadbourne* the plaintiffs alleged that they purchased certificates of deposit from the Stanford International Bank that were supposed to be backed by the bank’s ownership of highly marketable covered securities. *Id.* at 1065. These allegations did not trigger SLUSA because the plaintiffs did not allege that Stanford’s misrepresentations caused the plaintiffs to decide to purchase (or attempt to purchase) the covered securities. “At most,” the Court said, “the complaints allege misrepresentations about the *Bank’s* ownership of covered securities—fraudulent assurances that the Bank owned, or would own, or would use the victims’ money to buy *for itself* share of covered securities.” *Id.* at 1071.

3. Of a “Covered Security”

SLUSA defines a “covered security” as a security that satisfies the standards for a covered security as set forth in paragraphs (1) or (2) of section 18(b) of the Securities Act of 1933 [15 U.S.C.A. § 77r(b)] at the time during which the alleged misrepresentation, omission, or manipulative or deceptive conduct occurred. A “covered security” does not include any debt security exempt from registration under the Securities Act of 1933 [15 U.S.C.A. § 771, *et seq.*]. 15 U.S.C.A. § 78bb(f)(5)(E). This means that a “covered security” is a security issued by a registered investment company or traded on a national exchange. 15 U.S.C.A. § 77r(b)(1)-(2); *see also Dabit*, 547 U.S. at 83 (a “covered security” is “traded nationally and listed on a regulated national exchange”).

4. Does an Exception to SLUSA Apply?

SLUSA does contain tailored exceptions to its preclusion mandate. Perhaps most significantly, there is a limited savings clause, known as the Delaware carve-out, which reserves to the state court “actions brought by shareholders against their own corporations in connection with extraordinary corporate transactions requiring shareholder approval. . . .” *Madden*, 576 F.3d at 971.

Under this carve-out, a “covered class action” may be brought under the law of the state of the issuer’s incorporation, if it (1) involves purchase or sale of securities by the issuer or an affiliate, “exclusively” from or to holders of equity securities of the issuer; or (2) involves communications regarding the sale of an issuer’s securities or that are made by or on behalf of the issuer or an affiliate to holders of equity securities of the issuer, and concern decisions of those holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters’ or appraisal rights. *Id.* See also *Malone v. Brincat*, 722 A.2d 5, 13 n.42 (Del. 1998) (citing S. Rep. No. 105-182, at 11-12 (May 4, 1998)).

This carve-out applies to claims made in connection with stock buy-backs, rights offerings, corporate reorganizations, mergers and other corporate transactions requiring shareholder approval, tender offers and freeze-outs. This carve-out does not apply to the sale of securities on the open market. *G.F. Thomas Invs., L.P. v. Cleco Corp.*, 317 F. Supp. 2d 673, 682-83 (W.D. La. 2004), *aff’d*, 123 F. App’x 155 (5th Cir. 2005). Courts, in determining whether a SLUSA carve-out applies to the claims asserted, will interpret the exception to SLUSA narrowly. *Demings*, 593 F.3d at 492.

Other exceptions include actions brought by more than 50 named plaintiffs that are state agencies or state pension plans; actions under contracts between issuers and indenture trustees; and derivative actions brought by shareholders on behalf of a corporation. 15 U.S.C.A. §§ 78bb(f)(3)(A)-(C), (f)(5)(C). State jurisdiction also is preserved over state agency enforcement proceedings. 15 U.S.C.A. § 78bb(f)(4).

Plaintiffs evaluating the applicability of SLUSA may look to the Delaware carve-out and other exceptions as a means to pursue state law class actions. And in any event, SLUSA does nothing to deny an individual plaintiff, or any group of less than 50 plaintiffs, the right to enforce state law claims.

D. Overall Effect of SLUSA

The main lesson of SLUSA is that plaintiffs’ lawyers should not get *too* excited about the availability of the Texas Securities Act as an alternative to federal law. While the TSA has some clear benefits to plaintiffs, most *class actions* based on the sale of stock in public companies must still be filed under federal law. TSA claims will be most useful in cases involving privately held companies or individual claims by fewer than 50 investors. On the other hand, the Supreme Court’s decision in *Chadbourne* shows that some types of class actions—such as claims based on Ponzi schemes that misrepresent what is actually being done with the plaintiffs’ money—may be able to avoid getting ensnared in SLUSA’s net.

XI. SELECTED PROCEDURAL ISSUES IN TEXAS SECURITIES LITIGATION

When plaintiffs evaluate what type of securities claim to file and where to file it, there are important procedural differences between state and federal court to consider.

Defendants will sometimes need to evaluate whether to remove a case involving Texas Securities Act claims to federal court. As discussed below, federal court gives defendants the significant advantages of heightened pleading standards and the availability of a motion to dismiss. On the other hand, if the plaintiff expects personal jurisdiction to be contested, state court has some advantages.

A. Pleading Standards

It is more difficult to plead a securities fraud claim in federal court than in Texas state court. There are three main reasons: (1) the **PSLRA** establishes heightened pleading standards for federal Rule 10b-5 claims; (2) **Rule 9(b)** requires pleading fraud with particularity in federal court; and (3) federal courts must now follow the *Twombly/Iqbal* heightened pleading standard in all cases. In contrast, Texas courts still allow traditional “notice pleading,” there is no Texas equivalent to Federal Rule 9(b), Texas has no heightened pleading requirements for Texas Securities Act claims.

1. PSLRA Heightened Pleading Standards

Scienter is an essential element of a claim under Section 10(b) of the 1934 Act and Rule 10b-5. *See Tuchman v. DSC Comms. Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994). In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), which establishes heightened pleading requirements for 10b-5 claims. First, it requires pleading specific facts to establish a “strong inference” of scienter:

In any private action arising under this chapter in which the plaintiff may recover money damages on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (emphasis added).

The Fifth Circuit has held that the PSLRA does not alter the *substantive* standard for scienter but merely raises the bar for how scienter must be pled. *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001). Furthermore, the PSLRA does not mandate any particular method of establishing a strong inference of scienter. *Id.* at 411. Circumstantial evidence can support a strong inference of scienter, and allegations of motive and opportunity can be relevant to scienter, but merely pleading motive and opportunity is usually insufficient to establish the required “strong inference.” *Id.* at 410-412.

The PSLRA also codified a heightened standard for pleading misrepresentations or omissions with particularity:

In any private action arising under this chapter . . . the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is

made on information and belief, the complaint shall state with particularity all facts upon which that belief is formed.

15 U.S.C. § 78u-4(b)(2). This provision, at a minimum, incorporates the standard for pleading fraud with particularity under Federal Rule of Civil Procedure 9(b) (discussed below). *Nathenson*, 267 F.3d at 412.

The Texas Securities Act, in contrast, has no special pleading requirements.

2. Rule 9(b)

Federal Rule of Civil Procedure 9(b) requires pleading fraud with “particularity.” The Fifth Circuit construes Rule 9(b) as requiring the plaintiff “to specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.” *Nathenson*, 267 F.3d at 412. Even aside from the heightened pleading requirements of the PSLRA, Rule 9(b) sets the bar high for pleading any kind of securities fraud in federal court. This includes fraud claims under Section 33 of the Texas Securities Act. *See, e.g., Town North Bank NA v. Shay Fin. Servs., Inc.*, No. 3:11-CV-3125-L, 2014 WL 4851558, at *30-31 (N.D. Tex. Sept. 30, 2014) (dismissing Texas Securities Act claims that were not sufficiently pled with particularity)

The Texas Rules of Civil Procedure, in contrast, have no requirement of pleading fraud with particularity. *See* TEX. R. CIV. P. 47(a) (requiring only “a short statement of the cause of action sufficient to give fair notice of the claim involved”). Defendants in Texas state court can file special exceptions asking the court to require the plaintiff to plead specific facts in support of fraud claims. But as a practical matter, the trial court has broad discretion concerning special exceptions, and many state court judges will find the defendant has an adequate opportunity to obtain such information through discovery devices such as requests for disclosure and contention interrogatories. *See* TEX. R. CIV. P. 194, 197.

If a plaintiff decides to pursue Rule 10b-5 claims under the 1934 Act, then the difference in state and federal pleading requirements becomes academic, because federal courts have exclusive jurisdiction over such claims. *See* 15 U.S.C. § 78aa.⁷ But state and federal courts have concurrent jurisdiction over 1933 Act claims. *See* 15 U.S.C. § 77v. Thus, plaintiffs who decide to pursue Texas Securities Act claims and/or 1933 Act claims may, depending on the circumstances, have the option to pursue such claims in state court. If the Rule 9(b) requirement of pleading fraud with particularity is going to be a problem for the plaintiff, state court may be a better choice. As a practical matter, the real issue is not so much what the plaintiff must plead, but whether the defendant has a way to seek dismissal of the case at the pleading stage (see section B below).

⁷ Whether a *class action* asserting 1933 Act claims would be removable under SLUSA (see section X above) is a more complicated question.

3. *Twombly/Iqbal* Pleading Requirements for All Federal Cases

Even aside from the PSLRA and Rule 9(b), plaintiffs in all federal court cases must meet the heightened pleading requirements adopted by the U.S. Supreme Court in *Twombly v. Bell Atlantic Corp.*, 550 U.S. 544 (2007), and reiterated in *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). *Twombly* construed the Federal Rule 8(a) requirement of “a short and plain statement of the claim showing that the pleader is entitled to relief,” in order to “give the defendant fair notice of what the . . . claim is and the grounds upon which it rests.” *Twombly*, 550 U.S. at 555. Previously, plaintiffs would often plead generally and rely the principle that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.” *Conley v. Gibson*, 355 U.S. 41 (1957). *Twombly* rejected this principle.

Rule 8(a) does not require “detailed factual allegations” or “heightened fact pleading of specifics,” *Twombly* said, but it does require “more than labels and conclusions” or a “formulaic recitation of the elements of a cause of action.” *Twombly*, 550 U.S. at 555. Thus, the complaint must contain factual allegations that “raise a right to relief above the speculative level.” *Id.* A “naked assertion” is insufficient; there must be “some further factual enhancement” to cross the line from “possibility” to “plausibility” of entitlement to relief. *Id.* In other words, there must be “enough facts to state a claim to relief that is plausible on its face,” i.e. facts that nudge the claims “across the line from conceivable to plausible.” *Id.* at 570.

In *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), the Supreme Court reiterated and elaborated on the *Twombly* pleading standard. As *Iqbal* explained, *Twombly* requires more than an “unadorned, the defendant-unlawfully-harmed-me accusation.” *Iqbal*, 556 U.S. at 678. The Court requires “factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” *Id.* at 678. Thus, “[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements” are insufficient; there must be well-pleaded facts that permit the court to infer more than “the mere possibility of misconduct.” *Id.* at 678-79.

Given the fact that securities fraud claims are already subject to the heightened pleading requirements of the PSLRA and Rule 9(b), *Twombly* and *Iqbal* may have only a marginal effect on such claims. Both Rule 9(b) and the PSLRA already require the plaintiff to plead specific facts supporting allegations of fraud, and the PSLRA also requires pleading specific facts to establish a strong inference of scienter. On the other hand, the *Twombly/Iqbal* standard may allow a defendant to attack the sufficiency of the plaintiff’s pleading with respect to elements of the cause of action other than the misrepresentations and scienter, such as materiality or causation. At a minimum, *Twombly* and *Iqbal* underscore the fact that plaintiffs will typically find it easier to plead securities fraud claims in Texas state court.

B. Dispositive Motions

Lawyers from outside Texas are sometimes surprised to learn that Texas has no equivalent to a federal Rule 12(b)(6) motion to dismiss for failure to state a claim. For plaintiffs asserting Texas Securities Act claims or 1933 Act claims, this is another significant advantage of Texas state court.

Given the heightened pleading requirements in federal court (discussed in Section A above), the unavailability of a motion to dismiss in Texas state courts is especially important in securities fraud cases. Defendants will rarely, if ever, be able to seek dismissal of a securities case at the pleading stage in Texas state court. Usually the defendant will have to raise legal challenges to the plaintiff's securities fraud claims through a motion for summary judgment. The practical result is that defendants will typically have to endure *at least some* discovery before they will be able to obtain a ruling on a dispositive motion.

To assert a legal challenge to a securities claim early in a Texas state court case, the best option for a defendant may be to file an early motion for summary judgment (possibly set up by some focused special exceptions) and to ask the court to either stay discovery or phase discovery so that the motion can be ruled on before the defendant incurs significant discovery costs. Plaintiffs, on the other hand, will typically want to delay such a ruling until they have had an adequate opportunity for discovery, arguing that Texas courts generally does not favor piecemeal discovery. Trial court judges have broad discretion concerning the timing and sequence of discovery, so the outcome of this kind of battle will, of course, depend heavily on the orientation of the trial court judge.

C. Personal Jurisdiction

One procedural area where plaintiffs may be better off in *federal* court is personal jurisdiction. In many TSA cases, the parties must first litigate whether the defendant is subject to personal jurisdiction in Texas. The due process buzzwords for determining personal jurisdiction—minimum contacts, purposeful availment, specific vs. general jurisdiction, fair play and substantial justice, etc.—are no different in TSA cases than in other cases. But there are some recurring issues in personal jurisdiction cases involving securities claims.

In cases involving TSA claims, often the key jurisdictional issue is whether specific jurisdiction is established by a nonresident's sale of securities to a forum resident by means of misrepresentations directed to the forum resident. However, the trend in Texas state court is to hold that misrepresentations directed to a forum resident are an *insufficient* basis for specific jurisdiction, absent other evidence of purposeful contact with the forum.

Prior to 2005, it seemed generally accepted in Texas that a nonresident defendant's misrepresentation to a forum resident could be sufficient to establish specific jurisdiction in a suit asserting tort claims based on the misrepresentation. *See, e.g., Ahadi v. Ahadi*, 61 S.W.3d 714, 720 (Tex. App.—Corpus Christi 2001, pet. denied); *Shapolsky v. Brewton*, 56 S.W.3d 120, 134 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); *Mem'l Hosp. Sys. v.*

Fisher Ins. Agency, Inc., 835 S.W.2d 645, 650 (Tex. App.—Houston [14th Dist.] 1992, no writ). The theory was that the nonresident had engaged in “purposeful availment” by “directing a tort” at the forum.

Under this “directing a tort” theory, a nonresident defendant in a TSA case would typically be subject to specific jurisdiction if it allegedly made misrepresentations to Texas residents to induce them to purchase the securities at issue. *E.g., Santy v. McElroy*, No. 03-00-00368-CV, 2001 WL 838400, at *2, 6 (Tex. App.—Austin July 26, 2001, no pet.) (unpublished).

But in 2005 the Texas Supreme Court rejected the “direct a tort” theory of specific jurisdiction in *Michiana Easy Livin’ Country, Inc. v. Holten*, 168 S.W.3d 777, 790-92 (Tex. 2005). The court disapproved of the theory that specific jurisdiction is necessarily established by allegations or evidence that a nonresident committed a tort in a communication with a Texas resident from outside the state. *Id.* at 791-92. The proper question is whether the defendant had sufficient contacts with Texas reflecting “purposeful availment” of the benefits of doing business here. *Id.* at 784-85.

Michiana was not a TSA case, but it has clear implications for personal jurisdiction in cases involving TSA claims. In *Credit Commercial de France, S.A. v. Morales*, 195 S.W.3d 209, 221-22 (Tex. App.—San Antonio 2006, pet. denied), the court applied *Michiana* and held that allegations that a foreign bank aided and abetted a securities scheme in violation of the TSA were insufficient to establish jurisdiction where the defendant’s contacts with Texas did not reflect the required “purposeful availment” of the benefits and protections of Texas law.

Thus, misrepresentations to forum residents will not be sufficient *in themselves* to establish personal jurisdiction in TSA fraud cases. Whether the defendant is subject to specific jurisdiction will be a fact intensive question that depends on the level of the defendant’s contact with the forum.

Here are some of the personal jurisdiction factors that emerge from the pre- and post-*Michiana* cases involving TSA claims:

- Trips made to Texas by the defendant are a factor favoring jurisdiction, *see Santy*, 2001 WL 838400 at *5-6, but incidental trips that are not directly related to the plaintiff’s claim are less likely to support jurisdiction. *See Credit Commercial de France*, 195 S.W.3d at 221-22.
- A defendant who has no direct contact with the purchasers of the securities is less likely to be subject to jurisdiction. *Meader v. IRA Resources, Inc.*, 178 S.W.3d 338, 348-49 (Tex. App.—Houston [14th Dist.] 2005, no. pet.).
- In cases where an accounting firm is sued for aiding a TSA violation, offshore affiliates of the accounting firm are likely to be subject to jurisdiction if they

have direct involvement in audit work that occurs in Texas. *Deloitte & Touche Netherlands Antilles & Aruba v. Ulrich*, 172 S.W.3d 255, 263-64 (Tex. App.—Beaumont 2005, pet. denied); *Gutierrez v. Cayman Islands Firm of Deloitte & Touche*, 100 S.W.3d 261, 272-73 (Tex. App.—San Antonio 2003, pet. dismissed). Jurisdiction is even more likely to exist where the plaintiffs claim that they purchased securities in reliance on the accounting firm's audit reports. See *Gutierrez*, 100 S.W.3d at 273-74.

When it is questionable whether the defendant had sufficient contacts with Texas, plaintiffs may want to consider bringing their TSA claims in federal court, if there is diversity or some other basis for federal jurisdiction. Filing in federal court has some strategic advantages. First, in contrast to *Michiana*, there is Fifth Circuit case law that still supports the theory that a misrepresentation made to a forum resident is sufficient to establish specific jurisdiction (at least where the cause of action arises directly from the misrepresentation). See, e.g., *Lewis v. Fresne*, 252 F.3d 352, 355, 359 (5th Cir. 2001); *Wien Air Alaska, Inc. v. Brandt*, 195 F.3d 208, 213 (5th Cir. 1999); *Guidry v. United States Tobacco Co.*, 188 F.3d 619, 630 (5th Cir. 1999). In a recent case applying this theory, a defendant's mail, email, and phone communications with Texas investors were sufficient to establish specific jurisdiction where the alleged misrepresentations were made during those communications. *Small Ventures USA, L.P. v. Rizvi Traverse Mgmt., LLC*, No. H-11-3072, 2012 WL 4621130, at *5 (S.D. Tex. Oct. 2, 2012). On the other hand, overly general fraud allegations that do not meet the requirements of Rule 9(b) and *Twombly* will not support specific jurisdiction. See *Clemons v. WPRJ, LLC*, 928 F. Supp. 2d 885, 903 (S.D. Tex. 2013).

The second reason federal court may be better for establishing personal jurisdiction is that it is usually sufficient to establish a prima facie case for jurisdiction in federal court, which means any factual conflicts concerning jurisdiction will be resolved in favor of the plaintiff. See *Johnston v. Multidata Sys. Int'l Corp.*, 523 F.3d 602, 609 (5th Cir. 2008) (stating it is sufficient for the plaintiff to establish a prima facie case for personal jurisdiction if the court rules on a motion to dismiss without holding an evidentiary hearing).

Third, in federal court a defendant does not have the right to an interlocutory appeal on personal jurisdiction that it enjoys in state court. See TEX. CIV. PRAC. & REM. CODE § 51.014(a)(7) (providing for right to interlocutory appeal of denial of special appearance).

XII. CONCLUSION

As federal securities law continues to grow more defense-friendly, plaintiffs will increasingly look to state securities laws for relief. While state law claims are generally more favorable for plaintiffs, many issues under the Texas Securities Act that seem fundamental remain unresolved. The most fundamental issue—whether the instrument involved was even a “security”—will continue to perplex litigants and judges. Until the Texas Supreme Court settles the question, some plaintiffs will continue to argue that anyone who is a “link in the chain” of the selling process is a “seller.” Application of the various registration exemptions to new facts will continue to present a challenge.

With respect to fraud claims, the very basic issue of whether causation and reliance are required will continue to be disputed until definitively resolved by the Texas Supreme Court. Aiding and abetting claims are likely to increase, especially given the state of federal securities law, and the level of proof required to prove “general awareness” and “reckless disregard” will often be disputed. These and other issues raised by Texas Securities Act litigation present both opportunities and challenges for litigators.