DOCKET NO. 19-132

IN THE

SUPREME COURT OF THE UNITED STATES

RED RIVER; JAMES WILSON

Petitioners,

v.

TEACHER RETIREMENT SYSTEM OF FORDHAM; FORDHAM MUNICIPAL RETIREMENT FUND, ET AL.

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTEENTH CIRCUIT

BRIEF FOR PETITIONERS

Team # P2

Counsel for the Petitioners

ISSUES PRESENTED

I. Whether Respondents adequately pleaded actionable statements under Section 10(b) that are material, not based in hindsight, and were made with scienter.

II. Whether Section 20(a) control person liability requires the control person to have been a culpable participant in the primary violation.

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STATEMENT OF CASE

James Wilson ("Wilson"), led Red River Exploration Company ("Red River") to its initial public offering in 1985. (R.2-3.) Pamela Thompson ("Thompson") and Sandra Grimes ("Grimes") then joined Red River as corporate executives, each well versed in regulatory compliance and public company disclosure requirements. (R.3.) Red River's annual and quarterly disclosures addressed the environmental risks and events common in fracking, emphasizing that they never materially impacted Red River. (R.4.)

Red River received three sets of phone calls from geologists from late 2017 to mid-2018 regarding low-level seismic activity in the Eagle Ford Shale. (R.5, 7.) The environmental compliance team was unconcerned by the calls. (R.5.) Also in late 2017, Wilson decided against expanding the wastewater storage facilities after discussing their capacity with the engineering team because the facilities were structurally sound, only coming close to reaching capacity on a few occasions. (R.5.) Wilson sought to soften the tone of Red River's disclosures, feeling they were imbalanced and painted Red River as a poor corporate citizen. (R.5-6.) He believed the disclosures focused too much on minor environmental mishaps and too little on compliance. (R.5.)

Red River revised its disclosures to emphasize its environmental compliance. (R.6.) The March 2018 Form 10-K made statements regarding Red River's environmental commitments (Stmts. 1 and 2, see Appendix), environmental and safety practices (Stmts. 3 and 4, see Appendix), and risks related to fracking (Stmt. 5, see Appendix). (R.6.) Understanding the broad

aspirational nature of his statements, Wilson opined on Red River's environmental practices at an investor conference on May 15, 2018 (Stmts. 6 and 7, see Appendix). (R.7.)

In early May after the second set of phone calls, Thompson raised concerns to Grimes and Wilson. (R.7.) The group decided to investigate in conjunction with the company's upcoming July environmental review, rather than prematurely disclose potentially market roiling information. (R.7.)

Red River received phone calls regarding an increase in the low-level seismic activity in the Eagle Ford Shale on May 20, 2018 but Thompson and Grimes decided not to disclose the activity until after the upcoming environmental review. (R.7.) Red River's June 1, 2018 Form 10-Q warned of risks to Red River's operations (Stmt. 8, see Appendix). (R.7-8.) Thirteen days later, a series of mid-level seismic shocks hit the Eagle Ford Shale, destroying the wastewater storage facility's structural integrity and allowing wastewater to infiltrate the groundwater and aquifers. (R.8.) The event became international news and Red River's stock fell from $126 to $94.50 by market close. (R.8.)

Environmental agency reports revealed Red River used excessive explosives in its fracking process but were inconclusive as to whether the blasting contributed to the seismic activity. (R.8.) Government agencies and the expert retained by Red River found fracking to be the proximate cause of the wastewater escaping the storage facilities. (R.8.) The reports found the wastewater facilities were filled beyond recommended capacity. (R.8.)

The Teacher Retirement System of Fordham and Fordham Municipal Retirement Fund ("Respondents") each purchased Red River shares days prior to the mid-level seismic event. (R.8.) Respondents filed a class action against Red River and Wilson ("Petitioners") in the District of Fordham. (R.8.) Respondents' alleged securities fraud against Red River under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and control person liability against Wilson under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). (R.9.)

The District Court dismissed the claims, finding the Section 10(b) claim failed because Respondents did not allege materiality and scienter as required by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). (R.10.) Respondents' Section 20(a) claim failed because they did not plead culpable participation. (R.10.) The Fourteenth Circuit Court of Appeals reversed; finding materiality, scienter, and control person liability. (R.15, 22, 26.) The United States Supreme Court granted certiorari on February 1, 2019. (R.37.)

SUMMARY OF ARGUMENT

Respondents' allegations under Section 10(b) are inactionable because they are grounded in hindsight, as the statements were not false at the time they were made. The claims further fail because they plead corporate mismanagement and puffery, which are immaterial as a matter of law. Furthermore, Respondents failed to plead with particularity that Petitioners acted with the requisite intent to deceive and thus do not meet the scienter element of a Section 10(b) claim. Respondents failed to allege a valid Section

20(a) control person liability claim because they failed to plead culpable participation. Section 20(a)'s text, legislative history, and workability; require that culpable participation be a prima facie element. For these reasons, this Court should reverse the decision of the Fourteenth Circuit Court of Appeals.

ARGUMENT

Section 10(b) of the '34 Act makes it unlawful to "use or employ . . . any manipulative device" in connection with the sale or purchase of a security. 15 U.S.C. § 78j(b) (2018). SEC Rule 10b-5 implements Section 10(b) by imposing liability for making "any untrue statement of material fact" or omission of a "material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 17 C.F.R. § 210.10b-5. Here, only the materiality and scienter elements are at issue. *See Tellabs, Inc. v. Makor Issues & Rights*, 551 U.S. 308, 322 (2007).

In order to plead control person liability under Section 20(a), a plaintiff must allege that (1) the controlled person committed a primary violation, (2) the controlling person had control over said violator, and (3) the controlling person was somehow culpable for the fraud committed by the violator. *S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d 1996) ("*First Jersey*").

I. RED RIVER'S STATEMENTS WERE NOT ACTIONABLE UNDER SECTION 10(b) AND RULE 10b-5.

Plaintiffs must satisfy the Rule 9(b) and PSLRA heightened pleading standards when alleging securities fraud. *See Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 239 (5th Cir. 2009); *Tellabs*, 551 U.S. at 322. Rule 9(b) requires

that a party "state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9(b). The PSLRA incorporates and enhances the Rule 9(b) standard by requiring that plaintiffs (1) specify the allegedly misleading statements and the reasons for which they are misleading and (2) state the particular facts related to each misleading act or omission that give rise to a strong inference of scienter. 15 U.S.C. §§ 78u-4(b)(1), (b)(2).

Red River's disclosures do not amount to Section 10(b) actionable statements because Respondents rely on fraud by hindsight but cannot support findings of materially misleading and scienter.

A. Respondents Inappropriately Relied on Fraud by Hindsight to Allege Fraudulent Misrepresentations.

A statement cannot be found actionable because of subsequent events. *See Isquith v. Middle South Utils. Inc.*, 847 F.2d 186, 204 (5th Cir. 1988). "Fraud by hindsight" is therefore inactionable. *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000). Fraud by hindsight can arise in both materiality and scienter analyses. Mitu Gulati et. al., *Fraud by Hindsight*, 98 Nw. U. L. Rev. 773, 790 (2004). As the Tenth Circuit observed, "[s]ecurities fraud cases often involve some more or less catastrophic event occurring between the time the complained-of statement was made and the time a more sobering truth is revealed." *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1124 (10th Cir. 1997).

Fraud by hindsight can address how statements would be viewed by shareholders after the occurrence of an adverse event, placing undue emphasis on statements with the knowledge of the subsequent damaging events. *See*

Grossman, 120 F.3d at 1124. The Fourteenth Circuit correctly stated that "[w]hen Red River made public statements about its environmental commitments and practices, those statements were required to be complete and accurate." (R.17) (citing *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 366 (2d Cir. 2010)). However, the court below disregarded the requirement that the statements must be complete and accurate based on the information known to Red River *at the time the statements were made*. *See Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991). The Fourteenth Circuit erred in employing fraud by hindsight to find Stmts. 3, 4, and 5 material. In March 2018, Red River had little reason to be concerned by sporadic reports of low-level seismic activity and structurally sound wastewater facilities. Stmts. 3, 4, and 5 reflected Red River's confidence in its compliance program because they were consistent with the information provided by Red River's engineers and environmental team.

Fraud by hindsight can also misconstrue whether an event was so likely to occur at the time a company made a statement that failing to make a more accurate forecast amounted to severe recklessness. *See Tellabs*, 551 U.S. at 320. In hindsight, Red River's decision to investigate seismic activity risks during its July review was an unfortunate decision. Nevertheless, allegations that Red River should have anticipated an adverse future event, and should have disclosed risks earlier than they did, do not constitute securities fraud.

As the Second Circuit said, "[c]orporate officials need not be clairvoyant; they are only responsible for revealing those material facts reasonably available

to them." *Novak*, 216 F.3d at 309. To decide otherwise, as the Fourteenth Circuit did, would employ fraud by hindsight. The decision to put off disclosure until after Red River had the opportunity to investigate the reports was made only thirteen days before the mid-level seismic event. (R.7-8.) The short timeframe between the decision to investigate and seismic activity exemplifies the Tenth Circuit's "catastrophic event" not constituting securities fraud. Red River's decision to not act immediately does not amount to severe recklessness because it was reasonably based on information available at the time.

Respondents fail to allege particularized facts demonstrating requisite materiality or scienter; instead they make bald assertions relying on vague, anonymous, and anecdotal reports of seismic activity; that Red River's decision to conduct a review one month later amounted to deliberate indifference. The record supports the conclusion that Red River would make an immediate disclosure if the July review uncovered any material risks. Respondents' contrary conclusion is complete conjecture stilted by cherry-picked facts. *Lopez v. Ctpartners Exec. Search Inc.*, 173 F.Supp.3d 12, 39 (S.D.N.Y. 2016). The statements were accurate and truthful at the time they were made.

B. Respondents Failed to Allege Any Material Statements.

Under Rule 10b-5, a statement is misleading if it misrepresents a material fact necessary to make the statement. 17 C.F.R. § 240.10b-5. But to be actionable, the statement must be material. *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011). That a statement is false or incomplete is insufficient "if the misrepresented fact is otherwise insignificant." *In re*

Burlington Coat Factory Sec. Lit., 114 F.3d 1410, 1432 (3d Cir. 1997). Materiality is an objective standard, that asks whether a reasonable investor would rely on the misrepresentation in making an investment decision. *See Matrixx*, 563 U.S. at 44. That a shareholder would find information to be of interest is insufficient for finding materiality. *Milton v. Van Dorn Co.*, 961 F.2d 965, 969 (1st Cir.1992).

Materiality is context specific; depending on the "total mix of information made available." *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). The Court has cautioned against setting an unnecessarily low materiality standard, fearing that management would "bury the shareholders in an avalanche of trivial information." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). Generally, materiality is a question of fact, but where omissions or statements that "are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality," dismissal as a matter of law is appropriate. *Klein v. General Nutrition Cos.*, 186 F.3d 338, 342 (3d Cir.1999). Certain classes of statements, those that are obviously unimportant or too general or vague, are immaterial as a matter of law. *See Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479-80 (1977); *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014).

1. Stmts. 2-4 are inactionable corporate mismanagement.

In creating the private securities cause of action, Congress intended only to prohibit conduct involving deception or manipulation; not to provide shareholders with an avenue for relief against companies for mismanagement.

Santa Fe, 430 U.S. at 473-74, 478. Therefore, statements that "constitute no more than internal corporate mismanagement" are not actionable under Rule 10b-5. *Santa Fe*, 430 U.S. at 479-80. Courts will dismiss 10b-5 claims where allegations are based on inadequate procedures or incompetence by management, because the "central thrust" of such conduct is mismanagement. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 289 (7th Cir. 1981).

Within the realm of corporate mismanagement, poor business judgments are not actionable under securities fraud regulations. *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000) (citing *Santa Fe*, 430 U.S. at 479). For example, a district court found allegations that an energy company attempted to put the "best face" on diversification efforts in public disclosures, despite knowing the ventures had significant shortcomings, to be bare assertions of corporate mismanagement. *In re Delmarva Sec. Litig.*, 794 F.Supp. 1293, 1304 (D. Del. 1992) ("*Delmarva*"). Specifically, statements that the company over-expanded by acquiring "questionable and speculative businesses" were found to be "quintessential allegations of corporate mismanagement." *Id.* at 1307, n.22.

The Fourteenth Circuit incorrectly found that Stmts. 2-4 were misleading in light of the information revealed by the post-event reports. This information, unavailable to Red River until after both the seismic event and the agency investigation, cast doubt on Red River's prudency in deciding not to expand the wastewater facilities and to delay disclosing low-level seismic activity until after an investigation was conducted. Respondents second-guess Red River's business decisions, just as plaintiffs in *Delmarva* disagreed with the energy

company's decision to diversify its assets. But where the decisions to acquire businesses were regarded as corporate mismanagement claims, so too are Respondents claims regarding Red River's course of action after receiving unsubstantiated and inconclusive information.

2. Stmts. 1, 2, and 4 through 7 are inactionable puffery.

Corporate statements regarding "reputation, integrity, and compliance with ethical norms" are too vague or general to be considered materially misleading because a reasonable investor would not rely on them. *City of Pontiac*, 752 F.3d at 183 (citing *ECA, Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009) ("*ECA*"). Therefore, courts are likely to find "loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker" to be immaterial as a matter of law because they are too commonly heard by corporate management for a reasonable investor to rely upon. *Gavish v. Revlon, Inc.*, No. 00 Civ. 7291(SHS), 2004 WL 2210269, at *20 (S.D.N.Y. Sept. 30, 2004). Whether optimistic or aspirational statements are actionable often depends on the breadth or specificity of the challenged statements and the context in which the statements are made. *Novak*, 216 F.3d at 315.

Statements regarding a company's reputation and compliance with norms are the "quintessential examples" of inactionable puffery. *City of Pontiac*, 752 F.3d at 183. Descriptions of "'quality' or 'best' . . . are too squishy, too untethered to anything measurable, to communicate anything that a reasonable person would deem important to a securities investment decision."

City of Monroe Emp. Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 671 (6th Cir. 2005). Reasonable investors would not take such statements regarding integrity and risk management into account when making investment decisions. *See ECA*, 553 F.3d at 206.

In *ECA*, plaintiffs alleged an investment bank's statements regarding risk management were misleading because the bank's sparse investment discipline led to its involvement in the Enron scandal. *Id.* at 205. Statements included that the bank's "risk management processes are . . . designed to preserve the integrity of the risk management process," that it "set the standard for integrity," and described the bank's commitment to financial discipline. *Id.* The court found a bank's statements inactionable as they were too general for a reasonable investor to rely upon. *Id.* at 206. The court further cautioned would-be litigants against conflating an institution's statements with its reputation, because reputation does not per se render statements material. *Id.*

The District Court and Fourteenth Circuit correctly held Stmts. 1 and 6, as corporate puffery. However, the Fourteenth Circuit erred in holding Stmts. 2 and 4 were not. Where the *ECA* commitment statements pointed to continued efforts to focus on financial discipline, Stmt. 2 indicated Red River's continued effort to drill consistent with environmental regulations. Just as the *ECA* statements emphasized the bank's commitment to financial discipline and integrity, Stmt. 4 describes Red River's commitment to minimize environmental impact. If such generalized descriptions in *ECA* could not amount to material misstatements, Red River's statements regarding its environmental

commitments cannot be considered anything more than vague and generalized corporate statements that no reasonable investor would rely upon.

Opinion statements are actionable if a speaker does not "genuinely or reasonably believe them," phrase them as guarantees, or are "supported by specific statements of facts." *In re Int'l Business Machines Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998). "Corporate optimism" is also inactionable. *San Leandro Emergency Medical Grp. Profit Sharing Plan v. Phillip Morris Co.*, 75 F.3d 801, 811 (2d Cir. 1996). Courts may find opinion statements inactionable where the record lacks facts indicating the speaker did not genuinely believe their opinions to be accurate. *Faulker v. Verizon Communications, Inc.* 189 F.Supp.2d 161, 173 (S.D.N.Y. 2002); *In re AES Corporation Securities Litigation*, 825 F.Supp. 578, 588 (S.D.N.Y. 1993) ("*AES*"). In *AES*, shareholders alleged an energy company's statements about its commitment to ethical and environmental standards were materially misleading in light of revelations that employees intentionally falsified reports to comply with regulations. 825 F.Supp. at 583, 588. Though it conceded that wastewater reports were intentionally altered, the company maintained the statements at issue were just corporate opinions. *Id.* However, the prospectus included factual statements about the company's record that were rendered false because they failed to disclose the falsified wastewater reports. *Id.* The court found these statements actionable. *Id.*

The Fourteenth Circuit erred in finding Stmt. 7 material and not puffery because Wilson made the statement believing it to be true based on the

information available to him. Unlike *AES,* the facts here do not implicate intentionally falsified compliance reports or concealment of bad acts. Wilson and Red River paid attention to its fracking activities and had little reason to believe a large environmental disaster would occur because of their activities. (R.5.) Wilson made Stmt. 7 based on the information he had available to him. Furthermore, the statement contains hyperboles that no reasonable investor could rely on as a guarantee. Therefore, Stmt. 7 is an opinion made in good faith and of too exaggerated a nature to be material.

There are statements of "such a dubious significance that insistence on its disclosure may accomplish more harm than good." *TSC Industries*, 426 U.S. at 448-49. An "avalanche" of unimportant information that may cause greater harm to a company than good is neither required by law nor beneficial to shareholders in their decision-making. *See Basic*, 485 U.S. at 231-32. The mere existence of reports of adverse events did not require a company to disclose all the adverse reports. *Matrixx*, 563 U.S. at 44. Instead, according to the Court, "[s]omething more is needed," such as looking to the source, content, and context of the report" to determine whether disclosure or omission of such disclosure is actionable as misleading. *Id.*

In *In re Union Carbide Class Action Securities Litigation*, the district court found immaterial a chemical company's omissions regarding a hazardous product, despite a devastating chemical disaster at one of its plants. 648 F.Supp. 1332, 1327 (S.D.N.Y. 1986) ("*Union Carbide*"). The court found information regarding the hazardous chemical was "anything but trivial" in

light of the disaster. *Id.* However, requiring the company to include specifics regarding the properties and risks of the chemical at issue and all the other chemicals defendant produced, would only serve to overwhelm investors with facts "not conducive to informed decisionmaking (sic)." *Union Carbide*, 648 F.Supp. at 1327.

The Fourteenth Circuit erred in finding Stmts. 5 and 8 materially misleading. These statements point to potential risks where more detail would overwhelm investors and do more harm than good. To require more statements regarding the risks of Red River's fracking activities would produce the overwhelming effect of information warned of by the court in *Union Carbide.* At the time of the filings, the only information regarding the seismic activity was sporadic. (R.5, 7.) Information regarding the low-level seismic activity was only revealed after investigation. (R.8.) Red River's disclosures reflect the risks it was aware of and believed warranted concern. Red River was not required to disclose more than it knew at the time of disclosure that would have overwhelmed investors while adding little value. For these reasons, Respondents' allegations fail because they are immaterial as a matter of law.

C. Respondents Misused Alleged Circumstantial Evidence to Artificially Surpass the PSLRA's Pleading Standard for Scienter.

To adequately plead scienter under Section 10(b), plaintiffs must first allege particularized facts creating a "cogent" inference that defendants acted with the intent to deceive, manipulate, or defraud shareholders; or with severe recklessness as to the risk that the statements would mislead shareholders. *Tellabs*, 551 U.S. at 31 n.3; *Ernst & Ernst v. Hochfelder*, 425 U.S.185, 193 n.

12 (1976) ("*Ernst*"); *Lormand*, 565 F.3d at 251. Second, plaintiffs must explain why the misstatements were false when made; it is insufficient to show, using hindsight, that the statements were incorrect. *Lustgraaf v. Behrens*, 619 F.3d 867, 874 (8th Cir. 2010).

The PSLRA sets a particularly high pleading standard for scienter; omissions and ambiguities weigh against inferring scienter and a complaint will survive only "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing non-culpable explanations or inferences one could draw from the facts alleged." *Tellabs*, 551 U.S. at 326. Courts analyzing personalized and corporate scienter must determine each individual's intent when they made the statement. *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008).

Instead of pleading specific facts that Red River knew or should have known its statements were false–that the company did not prioritize environmental compliance and work to avoid environmental events– Respondents employed hindsight to assert Red River's management ignored evidence of an avoidable crisis. Respondents construed the ambiguous reports of seismic activity as a canary in a coal mine, making any statement regarding environmental compliance a material misstatement. This distorted reasoning skims past the fact that reports prompted management's responsible decision to further investigate, in line with Red River's commitment to environmental compliance. In accepting this reasoning, the Fourteenth Circuit failed to

enforce any one cohesive definition of severe recklessness and failed to apply any pleading standard to the corresponding facts.

1. Respondents failed to plead sufficient facts giving rise to a cogent inference of scienter.

Severe recklessness constitutes scienter in Section10(b) claims. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999), *as amended* (Aug. 4, 1999). When "properly defined and adequately distinguished from mere negligence," the severe recklessness standard identifies a "slightly lesser species of intentional misconduct." *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408–09 (5th Cir. 2001). Severe recklessness is limited to highly unreasonable omissions or representations. *Id.* Simple or even inexcusable negligence will not suffice. *Id.* Instead severe recklessness involves an extreme departure from the standard of ordinary care, presenting a danger of misleading buyers or sellers that is "known to the defendant or so obvious that the defendant must have been aware of it." *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 866 (5th Cir. 2003). Respondents failed to meet this high bar.

The Fourteenth Circuit correctly noted that "an egregious refusal to see the obvious, or investigate the doubtful, may in some cases give rise to an inference . . . of recklessness." (R.20.) (*citing Novak* 216 F.3d at 308). However, the Fourteenth Circuit ignored the immediately subsequent language in *Novak*:

> allegations that defendants should have anticipated future events and made certain disclosures earlier than they did does not suffice to make out a claim of securities fraud. . . . As long as the public statements are consistent with reasonably available data, corporate officials need not present an overly gloomy or cautious picture of current performance and future prospects.

Novak, 216 F.3d at 309. Red River's decision to investigate the risk posed by low-level seismic activity did not amount to "turning a blind eye" to environmental risks. (R.20.) Plaintiff's theory of intent is conceivable, but not as cogent as the reality that Red River was caught off guard by the unforeseen mid-level seismic activity and did not act recklessly to defraud investors. *In re MRU Holdings Sec. Litig.*, 769 F. Supp. 2d 500, 517 (S.D.N.Y. 2011).

Red River's decision to investigate at its earliest convenience falls far short of the requisite near intentional conduct. The standard for near intentional conduct was met in *Matrixx*, where a pharmaceutical company failed to disclose adverse events and corresponding lawsuits because of their likely effect on the market. 563 U.S. at 49. There, the pharmaceutical company issued a press release reporting studies confirming its drug did not cause loss of smell when, in actuality, the studies were inconclusive. *Id.* The company also prohibited a doctor from using the drug's name in a presentation exposing the adverse effects. *Id.* The Court found these actions demonstrated extreme recklessness as to the possibility of misleading investors because they amounted to near intentional conduct. *Id.* at 50.

Hypothetically, if Red River conducted its July review, the results were inconclusive as to whether Red River's activities contributed to the likelihood of environmental event, Red River advertised that the results did not expose any material risks, and Red River silenced geologists from voicing their concerns; an extreme recklessness finding would be well-founded as it was in *Matrixx*.

This scenario would convey a cogent intent to defraud investors. Red River's actual actions fall far short of the standard requiring near intentional conduct.

Respondents asserted that Red River had access to information undermining the accuracy of statements discussing its exacting environmental standards and the risk of an environmental event. (R.21.) In alleging contrary information, plaintiffs "must specifically identify the reports or statements containing this information." *Novak*, 216 F.3d at 309. *See also San Leandro*, 75 F.3d at 812. ("Plaintiffs' unsupported general claim of the existence of confidential company sales reports . . . is insufficient to survive a motion to dismiss.") Respondents failed to meet this exacting standard, because without specifically identifying the reports and details contained therein (e.g. the level of certainty, measurement, etc.), the sporadic phone calls do not undermine the accuracy of Red River's commitment and risk statements.

Respondents' argument for scienter fails because they can only assert a failure to investigate before an act of God preempted the July review. "Allegations that a defendant would have learned the truth if it had performed sufficient due diligence have been repeatedly rejected as insufficient to allege knowledge or conscious recklessness" *McIntire v. China MediaExpress Holdings, Inc.*, 927 F.Supp.2d 105 (S.D.N.Y. 2013) (citing *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 112 (2d Cir. 2009)). A failure to investigate can only amount to something more than negligence if factual allegations establish knowledge of the alleged fraudulent acts. *Friffin v. McNiff*, 744 F.Supp. 1237, 1251 (S.D.N.Y 1990), *aff'd,* 996 F.2d 303 (2d Cir.1993). Respondents failed to

make this showing and instead only argued that if Red River had conducted its investigation immediately after receiving a few anecdotal phone calls, the company would have uncovered the magnitude of risk posed by seismic activity. *McIntire,* 927 F. Supp. 2d at 128.

2. A corporate official's objective of protecting their company's stock price is not relevant to scienter.

Remnants of the pre-PSLRA pleading requirements maintain that in order to allege motive, plaintiffs must demonstrate that defendants benefitted from the alleged fraud in a "concrete and personal way." *ECA,* 553 F.3d at 198. The desire to protect a corporation's stock "do[es] not constitute 'motive' for the purposes of this inquiry." *Id.* If motives common to all corporate officials were sufficient to prove scienter, the scienter requirement would essentially become moot, as it would be impossible to distinguish the motives of fraudsters from all other corporate officers. *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994). The Fourteenth Circuit ignored this principle when it concluded that awareness of market implications indicated motive. (R.21.) Respondents presented no evidence of personal motive or benefit, only that Red River's executives wanted to protect their company's share price from unfounded market volatility. For these reasons, Respondents failed to make any showing, let alone a cogent inference, of extreme recklessness.

II. THE FOURTEENTH CIRCUIT ERRED IN HOLDING THAT PLAINTIFFS ARE NOT REQUIRED TO PLEAD CULPABLE PARTICIPATION AS A PRIMA FACIE ELEMENT FOR A SECTION 20(A) CLAIM.

The culpable participation requirement is the equivalent to scienter in a Section 10(b) claim, which requires, at a minimum, recklessness. *See Ernst*,

425 U.S. at 209 n. 28. Section 20(a)'s text demonstrates that plaintiffs must plead culpable participation in order to abide by the plain meaning of the statute. Moreover, the PSLRA compels plaintiffs to plead particularized facts for all state of mind violations, including Section 20(a). Congress enacted Section 20(a) with the intent to impose control person liability based on the extent of the control person's involvement in the fraudulent conduct. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 884-85 (3d Cir. 1975). Courts can balance culpable participation with the good faith defense by requiring that plaintiffs plead culpable participation, while defendants can assert a good faith defense at trial.

A. Culpable Participation is the Equivalent to Section 10(b) Scienter.

Culpable participation exists where a controlling defendant had knowledge of the fraudulent activity or acted recklessly within the context of the 10(b) violation. *Lapin v. Goldman Sachs Grp., Inc.*, 506 F.Supp.2d 221, 246 (S.D.N.Y. 2006). The Second Circuit requires plaintiffs to plead culpable participation as an element for Section 20(a) liability; however, the district courts within this circuit are divided as to what culpable participation entails. *Compare Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F.Supp.2d 210, 231 (S.D.N.Y. 2008) *and In re Parmalat Sec. Litig.*, 474 F.Supp.2d 547, 554 (S.D.N.Y. 2007). Relying on *Ernst*, a majority of these district courts correctly determined that culpable participation requires particularized facts demonstrating recklessness or conscious misbehavior on the part of the controlling person. 425 U.S. at 209 n. 28.

In *Ernst*, the Court concluded that Section 10(b) claims must include allegations of scienter in order to survive a motion to dismiss. 425 U.S. at 194. First Securities's customers sued its accounting firm after the customers discovered that First Securities engaged in fraudulent activity. *Id.* at 188-89. The Court held that courts cannot impose Section 10(b) liability for negligence alone. *Id.* at 201. In making its determination, the Court discussed several provisions of the '34 Act that contain a "state-of-mind condition requiring something more than negligence." *Id.* at 209 n. 28. The Court included Section 20(a) in this list, noting that Section 20(a) imposes liability on controlling persons, unless the controlling person "acted in good faith and . . . did not induce the act . . . constituting a violation." *Id.* (quoting 15 U.S.C. § 78t). The Court relied on Section 20(a)'s language to indicate that such claims require proof of a defendant's state of mind beyond mere negligence.

The Second Circuit's district courts rely on *Ernst* to conclude that plaintiffs must plead at least recklessness in order to meet the culpable participation requirement. *See In re Livent, Inc. Noteholders Sec. Litig.*, 506 F.Supp.2d 371, 413-18 (S.D.N.Y. 2001); *Lapin*, F.Supp.2d at 246. Section 20(a)'s "good faith and . . . did not induce the act" language demonstrates that such violations require a particular state of mind. *Ernst* and Section 20(a) indicate that the state of mind requirement manifests itself into what is today known as culpable participation. The Court alluded that culpable participation requires proof beyond mere negligence, suggesting that plaintiffs, at a

minimum, must plead recklessness. Thus, Respondents must plead recklessness in order to survive a motion to dismiss.

In *Lapin*, the court held that pleading culpable participation was akin to pleading scienter under a 10(b) claim, which compels plaintiff to allege particularized facts detailing plaintiff's "conscious misbehavior or recklessness." 506 F.Supp.2d at 246. Plaintiffs alleged that Goldman Sachs's CEO was liable under Section 20(a) as a control person. *Id.* at 244. The court relied on *Ernst* in holding that culpable participation requires a particular state of mind amounting to recklessness. *Id.* at 246. Further, Section 20(a)'s state of mind requirement parallels Section 10(b)'s scienter requirement, triggering the PSLRA's heightened pleading requirements. *Id.* at 247. Thus, plaintiffs alleging Section 20(a) violations must plead facts with particularity demonstrating that defendants acted, at a minimum, recklessly.

In order to circumvent the PSLRA trigger, some courts within the Second Circuit argue that Section 20(a)'s text does not include a scienter element. *See In re Initial Public Offering Sec. Litig.*, 241 F.Supp.2d at 396-97 ("*In re IPO*"). In *In re IPO*, plaintiffs claimed that individual defendants were liable as control persons under Section 20(a). *Id.* at 392. Judge Scheindlin believed that the Court in *Ernst* interpreted Section 20(a)'s good faith requirement as an affirmative defense without a scienter element.[1] *Id.* at 396. Thus, the court concluded that controlling liability does not require proof of scienter. *Id.*

[1] Prior to this decision, Judge Scheindlin held that culpable participation was required in order to plead a Section 20(a) claim. *See In re Independent Energy Holdings PLC Securities Litigation*, 154 F.Supp.2d 741, 770 (S.D.N.Y. 2001).

In re IPO is incorrect for several reasons. First, Judge Scheindlin relied on the "Personal Liability" section of *First Jersey*, which analyzed defendant's liability under both Section 10(b) and Section 20(a). *In re IPO*, 101 F.3d at 1471. This served as the basis to determine that even the Second Circuit "render[ed] the culpable participation requirement meaningless," because *First Jersey* did not evaluate the culpable participation requirement. 151 F.Supp.2d at 395. However, this analysis is flawed because *First Jersey* held that defendant acted with scienter under Section 10(b), therefore the same defendant must also have the requisite intent for Section 20(a). *Id.* Second, *In re IPO* analogized Section 20(a) to Section 11 of the '33 Act. 241 F.Supp.2d at 396. Where Section 11's text creates a burden shifting mechanism, Section 20(a) contains no such language. This demonstrates purposeful congressional silence and indicates the court's misunderstanding of the statute. Finally, *In re IPO* fails to adequately address the legislative history surrounding Section 20(a), which many courts have interpreted as not extending liability "without regard to the defendant's state of mind." *Rochez Bros.*, 527 F.2d at 889-90. *In re IPO* represents the most sophisticated criticism of the culpable participation requirement, yet it suffers from fatal flaws ground in misconceptions of Section 20(a)'s legislative history, plain meaning, and workability.

B. Culpable Participation is an Element of a Section 20(a) Claim.

Circuits that refuse to include culpable participation as a prima facie element of control person liability ignore Section 20(a)'s plain language, statutory history, and the general workability of the elements. Plaintiffs must

plead culpable participation in order to abide by congressional intent and statutory plain language. Additionally, Section 20(a) implements a burden-shifting mechanism relating to the culpable participation requirement and the good faith affirmative defense.

1. Section 20(a)'s plain language and the PSLRA require plaintiffs to plead culpable participation.

Liability under Section 20(a) ultimately turns on defendant's state of mind, which, in light of the PSLRA, requires plaintiffs to plead culpable participation. *Miskhin v. Ageloff*, No. 97 Civ. 2690,1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998). Section 20(a) states that any person who controls a person liable for violating securities laws, will be held jointly and severally liable to the same extent as the controlled person unless the controlling person "acted in good faith and did not directly or indirectly induce the acts . . . constituting a violation[.]" 15 U.S.C. § 78t(a). When read alone, the Court has interpreted the "good faith and did not . . . induce the act" language as requiring plaintiffs to prove a defendant's state of mind in order to prevail on the Section 20(a) claim. *See Ernst*, 425 U.S. at 209 n. 28. Courts use this as the basis for requiring culpable participation in a Section 20(a) cause of action. The PSLRA requires plaintiffs alleging state of mind violations to "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)(A). When read together the PSLRA reinforces the determination that plaintiffs must allege culpable participation as a prima facie element of Section 20(a) liability.

In light of the PSLRA, *Mishkin* held that, at the pleading stage, plaintiffs must allege particularized facts demonstrating the control person's culpable participation. No. 97 Civ. 2690,1998 WL at *25. In *Mishkin*, defendants allegedly engaged in a fraudulent purchase scheme that led to a stock-clearing firm's bankruptcy. *Id.* at *1. The court determined that since Section 20(a) provides defendants with a good faith affirmative defense, plaintiff's case ultimately hinged on defendant's state of mind. *Id.* at *23 (referring to the acting "in good faith" requirement listed in 15 U.S.C. § 78t(a)). Moreover, the state of mind element triggered the PSLRA, requiring plaintiffs to abide by the heightened pleading standard. *Id.* at *23. Thus, the court held that plaintiffs must plead culpable participation with sufficient particularity in order to survive a motion dismiss. *Id.* at *24.

Mishkin demonstrates that Section 20(a) and the PSLRA reinforces culpable participation as a requirement for Section 20(a) claims. The Fourteenth Circuit relied on a Ninth Circuit decision in concluding that "the culpable participation requirement is inconsistent with the language of Section 20(a)." (R.24) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1572 (9th Cir. 1990)). However, the court's reliance on *Hollinger* is misplaced for two reasons. First, the Ninth Circuit decided *Hollinger* prior to the passage of the PSLRA. Second, subsequent Ninth Circuit decisions support *Mishkin*'s rationale, acknowledging that Section 20(a) requires scienter, which would subject plaintiffs to the PSLRA's heightened pleading requirements. *See Arthur Children's Trust v. Keim*, 994 F.2d 1390, 1398 (9th Cir. 1993) (holding a control

person can prove the absence of scienter to refute a Section 20(a) claim). Thus, this Court should reverse the Fourteenth Circuit's decision because a plain reading of Section 20(a) and the PSLRA requires plaintiffs to plead culpable participation with sufficient particularity at the very filing of the complaint.

2. Legislative history demonstrates Congress's intent to include culpable participation as a prima facie element.

Congress enacted Section 20(a) of the '34 Act with the intent of providing a fiduciary standard of liability on control persons. S.Rep. 47, 73d Cong., 1st Sess. 5 (1933); H.R.Rep. 85, 73d Cong., 1st Sess. 5 (1933); H.R.Rep. 152, 73d Cong., 1st Sess. 27 (1933). The House explicitly rejected the Senate's proposed "insurer liability" because it opposed subjecting corporate controllers to strict liability for another person's fraudulent acts. S.Rep. 47, 73d Cong., 1st Sess. 5 (1933); H.R.Rep. 85, 73d Cong., 1st Sess. 5 (1933); H.R.Rep. 152, 73d Cong., 1st Sess. 27 (1933). Circuits differ as to whether plaintiffs must assert culpable participation. Several circuits reflected Congress's intent by requiring plaintiffs to plead facts that depict defendants as culpable participants who failed to act in good faith. *Compare Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc) *and Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000). This Court should reverse the Fourteenth Circuit's decision and include "culpable participation" as a prima facie element for control person liability.

In *Rochez Bros.*, the court relied on legislative history in determining that Section 20(a) liability requires elements beyond simple control. 527 F.2d at 884-85. Because Congress adopted the House's fiduciary standard, the court rejected Rochez's arguments for agency type liability. *Rochez Bros.*, 527 F.2d at

885. Agency liability would hold the corporation responsible for any action that an employee perpetuated in their individual capacity, which runs contrary to Section 20(a)'s purpose. *Id.* Thus, the court held that plaintiffs must plead culpable participation to support Section 20(a)'s fiduciary-like liability. *Id.*

In order to abide by Congressional intent and avoid a system of strict liability, Section 20(a) exempts defendants that "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation" from liability. 15 U.S.C. § 78t(a). The Fourteenth Circuit claimed that this passage simply provides defendants with an affirmative defense. (R.25). In doing so, the Fourteenth Circuit disregarded legislative history, relying instead on a flawed reading of the statute and misunderstanding of the burden-shifting effect.

3. Section 20(a)'s culpable participation requirement is a workable element.

The Fourteenth Circuit incorrectly held that pleading culpable participation and asserting a good faith affirmative defense creates "illogical result[s]." (R.25). *First Jersey*, decided prior to the PSLRA, demonstrates the harmony between the culpable participation requirement and good faith defense arrangement. 101 F.3d at 1473. Moreover, other circuits that follow the Fourteenth Circuit's workability argument fail to distinguish between the pleading requirement and the affirmative defense. *See Metge*, 762 F.2d at 631.

In *First Jersey*, the court held that in order to demonstrate a Section 20(a) violation, plaintiffs must demonstrate that the controlled person committed a primary violation, the controlling person had control over the

controlled person, and that the controlling person was somehow culpable for the fraud committed by the controlled individual. 101 F.3d at 1472. These elements are sufficient to establish control person liability under Section 20(a), but not determinative. *Id.* After plaintiffs establish these elements, the burden shifts to defendants who can show that they acted in good faith and did not induce the acts constituting a violation. *Id.* at 1473. Defendants pleading the good faith defense must demonstrate that they "maintained and enforced a reasonable and proper system of supervision and internal control[s]." *Id.* at 1473 (quoting *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, at 716 (2d Cir. 1980). The court concluded that defendant's role in the unlawful acts, in addition to his sham training and monitoring programs, demonstrated that he could not carry his burden of good faith. *First Jersey*, 101 F.3d at 1474.

Both Respondents and Fourteenth Circuit allege that the culpable participation requirement and the good faith affirmative defense are repetitive and unworkable with the construction of Section 20(a). (R.25). *First Jersey* demonstrates that the culpable participation requirement and the good faith affirmative defense comprise a harmonious Section 20(a) claim. Under *First Jersey*, plaintiffs form a prima facie controller liability case by alleging culpable participation at the pleading stage, at which point defendants can disprove the element via a good faith affirmative defense at trial. *In re Livent, Inc.*, 151 F.Supp.2d at 416 (citing *First Jersey*, 101 F.3d at 1473). Moreover, district courts adopted *First Jersey*'s burden shifting standard, with examples of disputes that resulted in plaintiffs successfully pleading culpable participation

followed by a successfully asserted a good faith affirmative defense. *See In re Alstrom SA*, 406 F.Supp.2d 433, 447 (S.D.N.Y. 2005). *First Jersey* and these district courts refute the presumption that the culpable participation-pleading requirement cannot work in with the good faith defense.

In *Metge*, the court held that culpable participation is not a prima facie element for Section 20(a) liability because courts could not harmonize pleading culpable participation and asserting a good faith defense. 762 F.2d at 631. The court interpreted Section 20(a) as requiring plaintiffs to demonstrate that control persons "participated in the operations" and "possessed actual control over the transaction in question." *Metge*, 762 F.2d at 630 (quoting *Stern v. American Bankshares Corp.*, 429 F.Supp. 818, 824 (E.D. Wis.1977)). Acknowledging that courts should construe Section 20(a) liberally, the court still rejected defendants' arguments in favor of culpable participation as a prima facie element. *Metge*, 762 F.2d at 630-31. The court determined that good faith and lack of culpable participation are affirmative defenses, not prima facie elements, and to hold otherwise would be to unnecessarily burden and confuse the parties. *Id.* 631. Thus, the court affirmed the district court's formulation of the Section 20(a) requirements. *Id.*

The Eighth and Fourteenth Circuits' claim that the good faith affirmative defense precludes a formulation of Section 20(a) that includes culpable participation. *See Metge*, 762 F.2d at 631; (R.25.) However, *First Jersey* resolves this misconception. 101 F.3d at 1473. Under the burden-shifting test, plaintiffs must plead facts to show that defendants were culpably involved in

the alleged violation, upon which defendants can demonstrate that they were acting in good faith during the trial. *In re Livent, Inc.*, 151 F.Supp.2d at 416 (citing *First Jersey*, 101 F.3d at 1473). Thus, the good faith affirmative defense does preclude the culpable participation-pleading requirement.

Culpable participation is necessary to plead control person liability under Section 20(a). Congress enacted the statute for the purpose of endowing control persons with a duty of care. Both the Second and Third Circuit have adopted workable standards that create a burden-shifting test for plaintiffs pleading Section 20(a) liability. These circuits properly interpreted Section 20(a)'s text to conclude that Section 20(a)'s culpable participation requirement is the equivalent to a scienter requirement. In doing so, the PSLRA requires that plaintiffs must plead particularized facts in order to demonstrate that a plaintiff acted, at a minimum, recklessly. Thus, plaintiffs must include culpable participation as a pleading requirement for Section 20(a) claims.

CONCLUSION

We respectfully ask this Court to (1) rule as a matter of law that Section 10(b) materiality and scienter were not present, and (2) dismiss Respondents' Section 20(a) claims for failure to plead culpable participation.

Respectfully submitted,

/s/ Team # P2
Counsel for the Petitioners

Appendix- Alleged Actionable Statements

Stmt. No.	Alleged Statement Maker and Source	Alleged Statement
Stmt. 1	March 1, 2018 10-K	"Our commitment to the environment is unwavering and constant."
Stmt. 2	March 1, 2018 10-K	"There is no higher priority than ensuring that our drilling activity continues to be conducted in a manner consistent with preventing or remediating any damage resulting from an environmental occurrence."
Stmt. 3	March 1, 2018 10-K	"We continue to conduct frequent environmental practices reviews to assure our commitment to environmental best practices and devote our most talented personnel and a substantial budget to ensure protection of the environment."
Stmt. 4	March 1, 2018 10-K	"Our commitment to the environment is demonstrated through our investment in and adoption of the latest technology in order to minimize water or soil contamination. This commitment differentiates us from our competitors."
Stmt. 5	March 1, 2018 10-K	"Fracking involves no serious environmental issues not associated with conventional drilling."
Stmt. 6	Wilson, May 15, 2018 Investor Conference	"I think we have the tightest environmental practices in the West Texas oil patch."
Stmt. 7	Wilson, May 15, 2018 Investor Conference	"Candidly, I honestly believe a major environmental event has about a zero percent chance of occurring on our property. We just pay too much attention for that to happen."
Stmt. 8	June 1, 2018 10-Q	"Our operations could be subject to disruption by natural disasters beyond our control, including . . . severe storms, fires, earthquakes, civil unrest, and terrorist attacks."