No. 19-132

IN THE SUPREME COURT OF THE UNITED STATES

RED RIVER;

JAMES WILSON,

Petitioners

v.

FORDHAM MUNICIPAL RETIREMENT FUND, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED,

Respondents

ON WRIT OF CERTIORARI TO THE

UNITED STATES COURT OF APPEALS FOR THE FOURTEENTH CIRCUIT

BRIEF FOR THE PETITIONERS

Team P4

Counsel of Record for Petitioners

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QUESTIONS PRESENTED

1. Whether claims challenging certain statements describing a company's environmental commitments, practices, and risks are inactionable under 15 U.S.C. § 78j(b) as a matter of law, and whether those claims adequately plead scienter.
2. Whether a claim for control person liability under 15 U.S.C. § 78t(a) requires an allegation that the control person was a culpable participant in the primary violation.

STATEMENT OF THE CASE

On August 10, 2018, the Teacher's Retirement System of Fordham and the Fordham Municipal Retirement Fund (collectively, "Respondents") filed a putative class action on behalf of all purchasers of common stock of Red River Exploration Company ("Red River") between March 2, 2018 and August 2, 2018 (the "Class Period") against Red River and James Wilson ("Wilson") (collectively, "Petitioners") in the United States District Court for the District of Fordham. R. at 8. The complaint alleged that Red River violated § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") when it made materially misleading statements regarding its environmental safety practices and commitments in its March 1 and June 1, 2018 Form 10-K and Form 10-Q, respectively, and in public statements made by Wilson on May 15, 2018. R. at 9.

Respondents pleaded that Red River "us[ed] excessive blasting in [its] fracking process, disregard[ed] environmental risks, and adopt[ed] inadequate procedures to prevent an environmental disaster," *id.*, ignored "issues with wastewater storage capacity," and "received three reports of seismic activity but failed to take any precautions to mitigate the potentially serious environmental consequences," R. at 15. Respondents claimed that Red River's failure to disclose reports of increased seismic activity constituted an actionable omission. R. at 18. Respondents also asserted a control person liability claim against Wilson pursuant to § 20(a). R. at 9.

The District Court granted Petitioners' motion to dismiss for failure to state a claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.

R. at 10. The District Court found that Respondents failed to sufficiently plead materially misleading statements and requisite scienter and that Respondents failed to plead culpable participation required for a § 20(a) claim. *Id.*

Respondents appealed to the United States Court of Appeals for the Fourteenth Circuit, which reversed. R. at 10, 26. In doing so, the Fourteenth Circuit found that Respondents adequately pleaded materially misleading statements and scienter, R. at 22, and that culpable participation is not a pleading requirement for control person liability, R. at 26. This Court granted certiorari on February 1, 2019. R. at 37.

STATEMENT OF FACTS

In 2000, Red River, under Wilson's leadership since he founded the company in 1962, pioneered the use of hydraulic fracking. *See* R. at 2, 4. Red River has an "impressive infrastructure of administrative and operating personnel," including Pamela Thompson ("Thompson"), chief operating and environmental officer, and Sandra Grimes ("Grimes"), senior vice president and general counsel. R. at 3. Thompson and Grimes have significant experience in the oil industry and are "well schooled in regulatory compliance and public company disclosure requirements." *Id.*

In late 2017, Red River received three reports of low-level seismic activity in an area of its fracking operations, the Eagle Ford Shale. R. at 5. The environmental compliance team was unconcerned about the seismic activity and believed it was not likely caused by fracking. *Id.* Evidenced by an email exchange in December, Thompson and Grimes believed that neither disclosure

nor suspension of fracking was warranted at that time. *Id.* Contemporaneously, Wilson decided against Red River's engineers' suggestion to expand Red River's wastewater storage system after the engineers espoused their belief that, while it occasionally came close to capacity, the system was structurally sound. *Id.*

In an effort to provide a "balanced and realistic picture" of Red River's operations, Red River revised its disclosure policies. *See* R. at 5-6. Grimes and Thompson no longer would pre-approve Wilson's public statements, and disclosure documents would focus on Red River's environmental compliance and safe practices. *See* R. at 5-7. The new disclosure policy involved clearly and repeatedly stating Red River's commitment and dedication of resources to environmental compliance and "its views on the adequacy of steps taken to protect the environment." R. at 6. On March 1, 2018, in its Form 10-K, Red River stated, "[its] commitment to the environment is unwavering and constant," that "[t]here is no higher priority than ensuring that [Red River's] drilling activity continues to be conducted in a manner consistent with preventing or remediating any damage resulting from an environmental occurrence," that it "continue[s] to conduct frequent environmental practices reviews to assure [its] commitment to environmental best practices and devotes [its] most talented personnel and a substantial budget to ensure the protection of the environment," that its "commitment to the environment is demonstrated through [its] investment in and adoption of the latest technology in order to minimize water or soil contamination [and that] this commitment differentiates

[Red River] from [its] competitors," and that "[f]racking involves no serious environmental issues not associated with conventional drilling." R. at 36.

In early May, Red River received additional reports of increased low-level seismic activity in the Eagle Ford Shale. R. at 7. Thompson, Grimes, and Wilson met and, "[a]fter considerable thought," decided that the reports did not warrant disclosure. *Id.* Instead, Red River planned to investigate the activity in its July environmental practices review. *Id.*

On May 15, Wilson publicly stated, "I think we have the tightest environmental practices in the West Texas oil patch," and "[c]andidly, 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." *Id.* Two weeks later, Red River received more reports of seismic activity, which Thompson and Grimes decided not to disclose. *Id.*

On June 1, 2018, in its 10-Q , Red River stated that its "operations could be subject to disruption by natural disasters beyond our control, including . . . severe storms, fires, earthquakes, civil unrest, and terrorist attacks," R. at 36, after which Respondents acquired Red River stock. R. at 8.

On June 10, mid-level seismic activity in the Eagle Ford Shale destroyed Red River's wastewater storage site's integrity, causing wastewater to leak into the West Texas groundwater and regional aquifers. *Id.* This event made international news, and the stock fell from $126 to $94.50 per share. *Id.*

On August 1, 2018, government investigators disclosed that Red River had been using excessive amounts of explosives as part of its fracking process

and that its wastewater storage tanks were filled beyond recommended capacity, however, "[t]he reports were inconclusive as to whether blasting had contributed to seismic activity." *Id.*

SUMMARY OF THE ARGUMENT

Respondents' claims are inactionable as a matter of law because their pleadings were inadequate and sound in state law. The Fourteenth Circuit erred in reversing the District Court's dismissal. Congress enacted heightened pleading standards for securities fraud claims. Respondents failed to plead facts that meet those heightened standards to establish that Red River made a material misrepresentation. Further, no reasonable investor would rely on Red River's statements in making an investment decision because the statements were expressions of general corporate optimism, which is inactionable puffery. Also, the facts pleaded by the Respondents suggest, at most, a breach of fiduciary duties, or corporate mismanagement, for which the remedy resides in Texas state law. Finally, accepting severe recklessness as the standard for scienter, Respondents failed to plead facts that suggest that Red River acted with the required state of mind to subject it to § 10(b) liability.

A claim for control person liability requires an allegation that the control person was a culpable participant. This requirement adheres to Congress's intent because if it wanted to shift the burden to the defendants for § 20(a) claims, it would have drafted accordingly. Culpable participation also improves judicial efficiency and facilitates productivity. For the reasons stated herein, this Court should reverse the Fourteenth Circuit's decision.

ARGUMENT

I. RESPONDENTS' CLAIMS ARE INACTIONABLE AS A MATTER OF LAW BECAUSE THEY FAIL TO PLEAD, WITH REQUISITE PARTICULARITY, MISREPRESENTATIONS OF MATERIAL FACTS AND SCIENTER.

Section 10(b) of the Exchange Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance . . . ." 15 U.S.C. § 78j(b) (2012). The Securities and Exchange Commission ("SEC") promulgated Rule 10b-5, which provides that it is unlawful to "make any untrue statement of a material fact or to omit 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." 17 CFR § 240.10b-5(b) (2018). This Court has implied that a private cause of action exists under § 10(b) and Rule 10b-5 (herein, "§ 10(b)"). *See Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 37 (2011). To establish § 10(b) liability, a plaintiff must prove "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Inv. Partners v. Sci.-Atlanta*, 552 U.S. 148, 157 (2008) (citing *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005)).

Section 10(b) claims are subject to heightened pleading requirements. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007). They must satisfy the pleading standards of Federal Rule of Civil Procedure 9(b) and comply with the Private Securities Litigation Reform Act ("PSLRA"). *Id.* A court

properly dismisses a complaint that fails to adequately satisfy these heightened pleading standards when, as a matter of law, the allegations in the complaint, "however true, could not raise a claim of entitlement to relief." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 558 (2007). Respondents failed to adequately plead that Red River made a material misrepresentation or omission and possessed the requisite scienter to subject it to liability under § 10(b). Thus, the District Court properly dismissed the claims upon Red River's Rule 12(b)(6) motion.

A. Red River's statements amounted to mere puffery.

Section 10(b) liability requires the plaintiff to prove that the defendant's statement was "misleading as to a material fact." *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988). A material fact is one that has "actual significance in the deliberations of the reasonable shareholder." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Due to the fact-intensive nature of materiality, a court properly dismisses claims as immaterial at the Rule 12(b)(6) stage if the statements "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their unimportance." *In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 570 (6th Cir. 2004).

Unlike material misrepresentations, "expressions of optimism" and "other puffery" do not constitute § 10(b) liability. *See Novak v. Kasak*s, 216 F.3d 300, 315 (2d Cir. 2000). Generalized "statements about reputation, integrity, and compliance with ethical norms are inactionable 'puffery.'" *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014). Because such statements are "too general to cause a reasonable investor to rely

upon them," *ECA, Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009), complaints that allege mere puffery are properly dismissed for failure to state a claim. *See Lopez v. CTPartners Exec. Search Inc.*, 173 F. Supp. 3d 12, 27-28 (S.D.N.Y. 2016). Alleging mere puffery, Respondents' complaint was properly dismissed. R. at 10.

Puffery includes general statements about corporate commitments. *Lopez*, 173 F. Supp at 28. In *Lopez*, the defendant company touted its culture for honesty and integrity, *id.* at 17, boasted that its "voluntary turnover rate [was] the lowest in the industry," *id.* at 27, and pledged a "commitment to accountability and transparency in the marketplace," *id* at 26. The court held that the statements about its commitment to transparency and culture were puffery, but the statement about voluntary turnover, "which [was] a statement of fact," was not. *Id.* at 28. *See also Ong v. Chipotle Mexican Grill, Inc.*, 294 F. Supp. 3d 199, 219, 232 (S.D.N.Y. 2018) (holding that the defendant's stated commitment "to serving safe, high quality food to [its] customers," was puffery despite its failure to implement sufficient food safety controls); *In re MobileMedia Sec. Litig.*, 28 F. Supp. 2d 901, 938 (D.N.J. 1998) (holding that the defendant's statement that it "will continue to provide the best in customer service" was puffery).

For purposes of § 10(b) liability, the alleged misstatement "must be sufficiently specific for an investor to reasonably rely on that statement as a guarantee of some concrete fact or outcome." *City of Pontiac*, 752 F.3d at 185. In *City of Pontiac*, the defendant publicly stated that it "held its employees to

the highest ethical standards and complied with all applicable laws," although it "was engaged in [a] cross-border tax scheme." *Id.* at 182. The Second Circuit held that the statements constituted inactionable puffery on account of their generality. *See id.* at 183, 185; *see also ECA*, 553 F.3d at 206 (holding that the defendant's statement, "[it] set the standard for best practices in risk management techniques" was puffery because it was not a "guarantee that [the defendant] would never take a step that might adversely affect its reputation").

Vague, non-specific statements are inactionable puffery. *See Ford*, 381 F.3d at 570. In *Ford*, the defendant stated: (1) "quality comes first," (2) the defendant "has its best quality ever," (3) the defendant "has made quality a top priority," and (4) the defendant "is the worldwide leader in automotive safety," *id.*, while allegedly knowing its vehicles were unsafe. *See id.* at 568-69. The Sixth Circuit held that the statements, "even if they were misleading," amounted to either corporate puffery or nonmaterial hyperbole. *Id.* at 570.

Conversely, statements that misrepresent specific existing facts are not puffery. *Novak*, 216 F.3d at 315. In *Novak*, a significant part of the defendant's inventory was several years old and unlikely to be sold at full price. *Id.* at 304. The Second Circuit held that statements in which the defendants specifically claimed the "inventory situation was 'in good shape' or 'under control' while they allegedly knew that the contrary was true," were actionable. *Id.* at 315.

Also, in *In re Massey Energy Co. Securities Litigation*, 883 F. Supp. 2d 597, 603-04 (S.D.W. Va. 2012), the defendant coal mining company proclaimed that its "formula for success" was "safety first, production second." The

defendant affirmed its commitment by touting its nonfatal days lost ("NFDL") rate in its annual reports and announcing that it was an "industry leader in safety." *Id.* at 604-605. The court held that the statements were more than puffery because the plaintiff pleaded facts showing the defendant's reported NFDL rates were blatantly false and that the defendant significantly underperformed the industry in safety (based on statistics such as fatalities and injuries at the defendant's mines). *Id.* at 616-17; *see also Bricklayers & Masons Local Union No. 5 Ohio Pension Fund v. Transocean Ltd.*, 866 F. Supp. 2d 223, 243-44 (S.D.N.Y. 2012) (determining the defendant drilling company's statement that it "conducted 'extensive' training and safety programs" was not puffery because "in an industry as dangerous as deepwater drilling, . . . investors will be greatly concerned about an operator's safety and training efforts," and the defendant's statement was unlike a "[q]uintessential example of puffery" such as declaring the "company 'sets the standard for integrity.'" (quoting *ECA*, 553 F.3d at 206)).

In this case, Red River's statements amounted to mere puffery because they were expressions of general corporate optimism on which no reasonable investor would rely. First, Red River's statements that emphasized its "commitment to the environment," despite its excessive blasting, R. at 9, 36, were like the statements in *Lopez*, which emphasized the defendant's commitment to transparency and culture despite its hostile work environment, 173 F. Supp. 3d at 28, and in *Chipotle*, which emphasized that the defendant was "committed to serving safe, high quality food to [its] customers," despite its

failure to implement sufficient food safety controls to prevent food-borne illness breakouts, 294 F. Supp. 3d at 219. Forward-looking statements describing Red River's continued commitment to the environment were puffery in the same way as the statement by the defendant in *MobileMedia* that it "will continue to provide the best in customer service" was puffery. *See* 28 F. Supp. 2d at 938.

Second, Red River's alleged misstatements were not specific enough for an investor to reasonably rely on "as a guarantee of some concrete fact or outcome." *See City of Pontiac* 752 F.3d at 185. Like the defendant in *City of Pontiac*, which stated that it "held its employees to the highest ethical standards and complied with all applicable laws," *id.* at 182, and like the defendant in *ECA*, which stated that it "set the standard for best practices in risk management techniques," 553 F.3d at 206, Red River stated that its "high[est] priority" was to ensure that it continued to drill in a way that prevented or remediated damage from an environmental occurrence, *see* R. at 36. Like in *ECA*, where a reasonable investor would not rely on the defendant's statements as "a guarantee that it would never take a step that might adversely affect its reputation," 553 F.3d at 206, a reasonable investor would not rely on Red River's statements as a guarantee that it would never take a step that might adversely affect the environment.

Third, Wilson's statements were hyperbole upon which no reasonable investor would rely. Like the defendant's statements in *Ford*, such as it had the "best quality ever," and that it was the "worldwide leader in automotive safety," 381 F.3d at 570, Wilson's statements touting that a major environmental event

had about a "zero percent chance" of happening, R. at 36, were hyperbole. Reasonable investors would expect such promotion from a CEO.

Finally, unlike in *Novak*, where the defendant misrepresented its true inventory situation, 216 F.3d at 315, in *Massey*, where the defendant blatantly lied about its NFDL rate and its rank within the industry for safety, or in *Transocean*, where the defendant's statement that it "conducted 'extensive' training and safety programs," was false, 866 F. Supp. 2d 223, 243-44, Red River boasted about its environmental commitment in a general sense. Much like a "[q]uintessential example of puffery" such as declaring the "company sets the standard for integrity," *id.* at 243, Petitioner's statements, summed up by Wilson's thematic proclamation that Red River has "the tightest environmental practices in the West Texas oil patch" are quintessential puffery and therefore inactionable under § 10(b).

B. Respondents failed to plead sufficient facts to infer § 10(b) liability.

Congress, in its enactment of the PSLRA, established that courts must subject § 10(b) claims to heightened pleading standards. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006). Section 10(b) claims must satisfy the pleading standards of Federal Rule of Civil Procedure 9(b) and the demanding pleading standards of the PSLRA. *ATSI*, 493 F.3d at 99. Claims that are "conclusory or unsupported by factual assertions are insufficient" to survive a motion to dismiss. *Id.*

Rule 9(b) requires that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." Fed. R.

Civ. P. 9(b). Under the PSLRA, "the complainant shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b) (2012). Therefore, in order to adequately plead a § 10(b) violation, plaintiffs "must do more than say that the statements . . . were false and misleading; they must demonstrate with specificity why and how that is so." *Rombach v. Chang*, 355 F.3d 164, 174 (2d Cir. 2004).

1. *Respondents failed to adequately plead that the statements constituted material misrepresentations at the time made.*

Plaintiffs must plead particular facts that adequately establish a statement was a material misrepresentation at the time it was made, *see Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1329 (2015) (stating that investors would expect a statement "fairly aligns with the information in the [maker's] possession at the time"). "[F]raud by hindsight" is therefore inactionable. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 (2007); *MobileMedia*, 28 F. Supp. 2d at 925 ("Liability cannot be imposed on the basis of subsequent events."). In order to be actionable, the "statement in question must have been false when made." *Mulligan v. Impax Labs., Inc.*, 36 F. Supp. 3d 942, 959 (N.D. Cal. 2014).

In *In re Banco Bradesco, S.A. Securities Litigation*, 277 F. Supp. 3d 600, 612 (S.D.N.Y. 2017), a group of persons (the "Bribe Group"), on behalf of the defendant-company, allegedly engaged in a bribery scheme from 2004 to 2015. The plaintiffs claimed that the company's disclosures misrepresented the efficacy of its internal control over financial reporting due to the ongoing bribery scheme. *Id.* at 647. The court dismissed the plaintiffs' claims for

statements made prior to March 24, 2014, *see id.* at 646, because the plaintiffs failed to plead that the defendants (including executives) were "aware" that the company was involved in an unlawful bribery scheme prior to that date, *id.* at 632. The pleadings in *Bradesco* merely "contain[ed] some blanket allegations that payments were made by the company" to members of the bribe group. *Id.*

Complaints that contain blanket allegations and conclusory statements must fail as a matter of law. *ATSI*, 493 F.3d at 99; s*ee also Menaldi v. Och-Ziff Capital Mgmt. Grp.*, 164 F. Supp. 3d 568, 578 (S.D.N.Y. 2016) (requiring a "plausible claim that the underlying conduct occurred" when the action rested on the premise that the defendants failed to disclose their conduct); *In re Axis Capital Holdings Ltd. Sec. Litig.*, 456 F. Supp. 2d 576, 585 (S.D.N.Y. 2006) (granting a 12(b)(6) motion when plaintiffs' claims depended on the "predicate allegation that [the defendants] participated in an anticompetitive scheme . . . [but] offer[ed] nothing more than conclusory allegations that an anticompetitive scheme existed"); *In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 632 (S.D.N.Y. 2005) (deciding that the plaintiffs failed to state a claim for fraud because they "allege[d] no facts supporting the generalized assertion that [the defendants] diverted corporate opportunities").

In order to survive a motion to dismiss, the plaintiff must have pleaded the "who, what, when, where, and how" of the circumstances that establish the alleged misrepresentation. *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990). While the court in *Bradesco* dismissed the claims containing "blanket allegations," 277 F. Supp. 3d at 632, it did not dismiss the plaintiffs' claims

pertaining to the defendants' statements made after March 24, 2014 because the plaintiffs sufficiently alleged that the defendants knew about the bribery scheme. *Id.* at 635, 670-71. The plaintiffs' allegations included specific dates of meetings between the defendants and members of the Bribe Group, the content that was discussed at those meetings, and the content of proposals and requests regarding the amount and outcomes of the bribes. *See id.* at 635.

In this case, the Record is devoid of any factual allegations pleaded by Respondents that would give rise to an inference that Red River's statements constituted a misrepresentation at the time made. The entirety of facts in the Record that Respondents pleaded include: Red River "us[ed] excessive blasting in [its] fracking process, disregard[ed] environmental risks, and adopt[ed] inadequate procedures to prevent an environmental disaster," R. at 9, ignored "issues with wastewater storage capacity," and "received three reports of seismic activity but failed to take any precautions to mitigate the potentially serious environmental consequences," R. at 15. As in the cases cited above, Respondents' allegations fail to provide the "who, what, when, where, and how," required to establish a misrepresentation. *See DiLeo*, 901 F.2d at 627. Therefore, the District Court properly dismissed Respondents' complaint.

2. *Respondents failed to adequately plead that the statements were demonstrably false or omitted required information.*

Section 10(b) liability requires either an *untrue statement* or an omission required to correct a potential misinterpretation in the circumstances surrounding the statement. *See Matrixx*, 563 U.S. at 37; *Chipotle*, 294 F. Supp. 3d at 232 (holding that misstatements were not "demonstrably false" because

the plaintiffs did "not allege that [the defendant] failed to undertake [the] endeavors" it proclaimed in its statements, "but merely that [the defendant] failed to do so 'adequately,' or that [the defendant] 'failed to live up to its own food safety standards' or that [the defendant]'s food-safety auditing system was 'inherently deficient'").

In this case, Respondents failed to plead particular facts to establish that Red River's statements were untrue. Demonstrated by the extensive experience and qualifications held by its leadership team, Red River has an "impressive infrastructure of administrative and operating personnel," to ensure environmental and regulatory compliance, R. at 3, that it proclaimed in its disclosures, R. at 36. The fact that Wilson, a CEO with 56 years of experience, decided not to expand the wastewater storage facility after Red River's engineers told him that it was structurally sound, R. at 5, does not mean that Red River failed to adhere to the highest standards of environmental protection.

Like in *Chipotle*, where the plaintiffs pleaded facts that may have showed the defendant "failed to live up to its own food safety standards," but did not plead facts that showed the defendant failed to undertake the endeavors it proclaimed in its statements, 294 F. Supp. 3d at 232, Respondents pleaded facts that Wilson decided not to expand the wastewater facility and that Red River used excessive blasting. Respondents did not plead facts that showed Red River did not undertake endeavors it proclaimed in its statements, nor did it plead any facts that showed the level of blasting harmed the environment.

Respondents also contend that Red River's decision not to disclose seismic activity is an actionable omission. R. at 18. This Court acknowledged that some "information concerning corporate developments could well be of 'dubious significance,'" *Basic*, 485 U.S. at 232 (quoting *TSC Indus.*, 426 U.S. at 448), and that "insistence on its disclosure may accomplish more harm than good." 426 U.S. at 448. This Court was careful not to set too low a standard of materiality because a minimal standard might bring an overabundance of information within its reach, leading management "simply to bury the shareholders in an avalanche of trivial information." *Basic*, 485 U.S. at 231. In order to comprise an actionable omission, "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." *TSC Indus.*, 426 U.S. at 449.

The more circumstances indicate that the true state of affairs conflict with a statement, the more likely disclosure is required. *See Matrixx*, 563 U.S. at 47. In *Matrixx*, the defendant company produced a cold remedy, Zicam. *Id.* at 31. In 1999 a doctor reported a possible link between Zicam and anosmia (smelling loss) in his patients. *Id.* at 32. In September 2002, the defendant informed a researcher of complaints of anosmia from other customers. *Id.* The researcher alerted the defendant to prior studies that linked anosmia to the key ingredient in Zicam, and in September 2003, presented descriptions of eleven of defendant's customers' anosmia. *Id.* at 32-33. During the class period, several customers sued the defendant, alleging that Zicam caused their

anosmia. *Id.* Despite this, the defendant declared that its revenues were going to rise significantly. *Id.* at 33-34. This Court held the defendant was required to disclose reports of anosmia to correct the misrepresentation that Zicam was safe, *id.* at 47, because the defendant "received information that plausibly indicated a reliable causal link between Zicam and anosmia," *id.* at 45.

However, a disclosure is not required "merely because a reasonable investor would very much like to know that fact." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993). In *Time Warner*, the plaintiffs alleged that the defendants' statements hyping strategic alliances "gave rise to a duty to disclose problems in the alliance negotiations as those problems developed." *Id.* The Second Circuit held that such duty existed only when statements were sufficiently definite. *Id.*; *see also Cutsforth v. Renschler*, 235 F. Supp. 2d 1216, 1225-32 (M.D. Fla. 2002) (holding that general revenue warnings sufficed despite the plaintiffs' contention that the defendants knew the company was "experiencing serious operational problems integrating the computer systems of the acquired companies").

In this case, Respondents contend that Red River's decision not to disclose seismic activity is an actionable omission. R. at 18. In its 10-Q, Red River listed earthquakes as a risk. R. at 36. Like in *Cutsforth*, where the company was not required to disclose its serious operational problems associated with its acquisitions because its general warnings were sufficient, 235 F. Supp. 2d at 1231-32, Red River was not required to disclose reports of seismic activities because its general earthquake risk warning was sufficient.

Further, Red River's environmental compliance team did not believe that the seismic activity was caused by fracking, R. at 5, and the government investigatory "reports were inconclusive as to whether blasting had contributed to seismic activity," R. at 8. Unlike in *Matrixx*, where there was a "reliable causal link between Zicam and anosmia," 563 U.S. at 45, no evidence suggests a link between Red River's blasting and earthquakes that would warrant disclosure. As in *Time Warner*, Red River's generalized warnings "lack[ed] the sort of definite positive projections that might require later correction." 9 F.3d at 267. If this Court finds that Red River was required to disclose the unlinked seismic activity, then this Court expands the concept of materiality to any "fact which a reasonable shareholder might consider important" in contravention to its precedent in *TSC Industries*. *See* 426 U.S. at 448-49. This unfortunate holding would cause corporations to "bury shareholders in an avalanche of trivial information" in their disclosures, "a result that is hardly conducive to informed decisionmaking." *See id.* at 449.

C. Respondents merely alleged corporate mismanagement.

The scope of liability under § 10(b) does not include corporate mismanagement. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977). In *Pepper v. Litton*, 308 U.S. 295, 306 (1939), this Court pronounced the principle that directors and controlling shareholders are fiduciaries. However, redress for breach of fiduciary duties is within the purview of state law, not federal securities law. *Santa Fe*, 430 U.S. at 479. Texas law provides that corporate directors and officers owe the corporation duties of obedience, care, and

loyalty. *See Ritchie v. Rupe*, 443 S.W.3d 856, 868 (Tex. 2014); *Sneed v. Webre*, 465 S.W.3d 169, 172 (Tex. 2015). Thus, claims for breach of fiduciary duties sound in Texas state law, not federal securities law.

When the claims' underlying narrative is corporate mismanagement, the allegations are inactionable under § 10(b). *In re Lululemon Sec. Litig.*, 14 F. Supp. 3d 553, 562 (S.D.N.Y. 2014). In *Lululemon*, the plaintiffs alleged that the defendant-clothing manufacturer misled investors by touting the quality of its products despite evidence that suggested otherwise. Some of the statements included "[the defendant]'s quality level was the 'highest in the industry'" *id.* at 575-76 and "'[q]uality' was the [defendant]'s 'key differentiating factor' from its peers." *Id.* at 576. The plaintiffs alleged that the defendant would have realized the quality problems if someone had tried the products before the defendant shipped them. *Id.* at 562. The court declared that the plaintiffs' "narrative require[d] the [c]ourt to stretch allegations of, at most, corporate mismanagement into actionable federal securities fraud." *Id.* at 562.

In this case, Respondents' narrative similarly requires the Court to stretch a claim for a breach of duty of care into actionable federal securities fraud. Like the decision whether to have someone try its products before shipping them in *Lululemon*, *id.*, decisions regarding the adequacy of "procedures to prevent an environmental disaster," R. at 9, are business decisions. Since the remedy for negligent business decisions sounds in Texas state law, the district court properly dismissed Respondents' § 10(b) claims.

D. Respondents failed to allege that Red River acted with the requisite scienter to establish an actionable § 10(b) claim.

A plaintiff must prove that the defendant acted with scienter in order to establish § 10(b) liability. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Scienter consists of "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. In *Hochfelder*, this Court noted that in "certain areas of the law[,] recklessness is considered to be a form of intentional conduct for purposes of imposing liability," but it did not address whether recklessness "is sufficient for civil liability under § 10(b)." *Id.* Yet, the majority of circuits "generally agree that recklessness suffices as a form of scienter" for § 10(b) liability. Jeanne P. Bolger, *Recklessness and the Rule 10b-5 Scienter Standard after Hochfelder*, 49 FORDHAM L. REV. 817, 818-19 (1980).

Nevertheless, most courts view recklessness as very close to an "actual intent to defraud." Ann M. Olazabal & Patricia S. Abril, *Recklessness as a State of Mind in 10(b) Cases: the Civil-Criminal Dialectic*, 18 NYU J. LEG. & PUB. POL. 305, 306 (2015); *see, e.g.*, *Novak*, 216 F.3d at 312 (declaring that recklessness requires a state of mind that approximates actual intent, not a heightened level of negligence). The level of recklessness must rise to an "extreme departure from the standards of ordinary care, and that present a danger of misleading [investors] which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001). This "extreme departure" represents "[a]n egregious refusal to see the obvious, or to investigate the doubtful." *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996).

Both Rule 9(b) and the PSLRA apply when pleading scienter. *Dabit*, 547 U.S. at 81. The PSLRA states that plaintiffs alleging scienter must "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) (2012) (emphasis added). Acknowledging that scienter may include severe recklessness, *see Matrixx*, 563 U.S. at 48 (assuming, "without deciding, that the standard applied by the Court of Appeals [was] sufficient to establish scienter"), Respondents failed to plead any facts that give rise to a strong inference that Red River acted with the requite scienter for § 10(b) liability.

In *Tellabs*, this Court "prescribe[d] a workable construction of the 'strong inference' standard." 551 U.S. at 322. In order to determine whether a complaint alleges a strong inference of scienter, courts must "consider the complaint in its entirety . . . [and] take into account plausible opposing inferences." *Id.* at 322-23. However, a strong inference of scienter "must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations." *Id.* at 324.

Recklessness requires awareness of the possibility for misinterpretation. *S.E.C. v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1095 (9th Cir. 2010). The defendant in *Platforms*, with only preliminary plans, no built prototype, and no money to develop a prototype, authorized a press release declaring the product's unveiling. *Id.* at 1082. The Ninth Circuit held that the defendant was reckless because the defendant was aware of the risk that the press release might be misinterpreted. *Id.* at 1095; *see also Ind. Pub. Ret. Sys. v. SAIC, Inc.*,

818 F.3d 85, 89-90 (2d Cir. 2016) (finding recklessness where the defendant's internal audit revealed a kick-back scheme, yet despite this knowledge, the defendant emphasized its commitment to high standards of "ethical performance and integrity").

Contrastingly, in *South Cherry Street, LLC v. Hennessee Group*, 573 F.3d 98, 100-03 (2d Cir. 2009), the defendant recommended that the plaintiff invest in a hedge fund that secretly operated as a Ponzi scheme. The plaintiff alleged that the defendant acted recklessly because if the defendant performed the due diligence that it promised, it would have learned about the scheme. *Id.* at 112. The Second Circuit affirmed the district court's finding that such allegations did not amount to recklessness. *Id.* at 114; *see also In re Lululemon Sec. Litig.*, 14 F. Supp. 3d 553, 581, 584 (S.D.N.Y. 2014) (holding that the plaintiff's allegations of what the defendant *could have* done did not adequately plead scienter through recklessness because the complaint did not allege that the defendant did not believe its own statements, did not conduct the quality tests it stated, had contrary information, or believed that other quality tests were necessary, and therefore the plaintiff's complaint alleged corporate mismanagement rather than recklessness under § 10(b)).

Respondents failed to plead facts giving rise to a strong inference that Red River acted with severe recklessness. Respondents alleged that Red River disregarded issues with wastewater storage capacity, ignored reports of seismic activity, and used excessive blasting in its fracking operations, R. at 14-15, demonstrating a lack of commitment to environmental risk that contradicted

its public statements, R. at 15. However, Respondents failed to allege that Red River did not believe in the veracity of its statements.

First, Red River did not possess information that contradicted its general statements about a commitment to the environment. Wilson's discussion of wastewater storage with the engineering team was part of everyday operations. The engineers "believed the system to be structurally sound." R. at 5. Their recommendation to add additional capacity does not negate statements about general environmental practices and a commitment to environmental protection. If Red River explicitly touted that its wastewater storage practices were foolproof or able to handle an extreme increase in capacity, the engineers' comments might point to a conscious disregard of pertinent information.

However, Red River did not even reference wastewater storage in its statements. Similarly, the reports of low-level seismic activity, the first of which were received prior to Statements 1-5, fail to constitute any concrete facts that contradict Red River's statements. Red River's environmental compliance team was unconcerned with the first reports and believed they bore no connection to fracking. R. at 5. Thus, Statements 1-5 do not contradict the reports of seismic activity, which in Red River's view did not relate to it operations.

Unlike in *Platforms*, where the defendant advertised a product that did not exist, 617 F.3d at 1082, or *SAIC*, where the defendant spoke in complete disregard of its own internal fraud, 818 F.3d at 89-90, Red River emphasized its commitment to the environment without reason to believe otherwise. This is far from the "extreme departure from the standard of ordinary care" required

for the level of recklessness that satisfies § 10(b) scienter. *See Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 430 (5th Cir. 2002).

Second, Respondents failed to allege that Red River did not believe its statements. Red River received two other reports of low-level seismic activity when it made Statements 5-8. Respondents provided no factual allegations that Red River held a secret belief in the importance of the reports but publicly asserted otherwise. After the early May reports, Wilson, Thompson, and Grimes met to discuss the implications. R. at 7. After "considerable thought," they decided such reports did not warrant disclosure, and they decided to investigate the findings in Red River's upcoming environmental practices review. *Id.* After the late May reports, Thompson and Grimes again decided to postpone a decision on disclosure for after the upcoming environmental practices review. *Id.* Like in *Hennessee*, 573 F.3d at 112, and *Lululemon*, 14 F. Supp. 3d at 581, 584, Respondents failed to allege that Red River actually believed its environmental practices were inadequate. Instead, the crux of Respondents' allegations claims inefficient methods or improper standards for evaluating environmental risks. Like in *Lululemon*, *id.*, these claims sound in corporate mismanagement, not § 10(b). Because "recklessness" for scienter requires extreme and egregious conduct, *Abrams*, 292 F.3d at 430, Respondents failed to plead facts to infer the requisite degree of recklessness.

II. CULPABLE PARTICIPATION MUST BE PLEADED TO ESTABLISH A *PRIMA FACIE* CASE FOR CONTROL PERSON LIABILITY.

Section 20(a) of the Exchange Act provides that a person who controls another person who commits securities fraud is jointly and severally liable

"unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation." 15 U.S.C. § 78t(a) (2012). While the words "culpable participation" do not appear in the text of the statute, the statutory language clearly indicates that bad faith and inducement are requisite elements of a § 20(a) claim. This Court should hold that culpable participation must be pleaded as an element of a § 20(a) claim because (1) that was Congress's intent when it enacted § 20, (2) the requirement enhances judicial efficiency, and (3) the requirement facilitates productivity. The resulting standard would require a plaintiff to show (1) a primary violation, (2) control, and (3) "that the controlling person was in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person[]," in order "to establish a *prima facie* case" under § 20(a). *S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996).

A. Congress intended § 20(a) to include culpable participation.

Section 20(a) is an elemental statute that simply articulates the conditions for liability. Congress's capability of drafting clear statutes that shift the burden of proof or pleading to a defendant and Congress's disposition toward securities fraud claims indicate that Congress intended that a plaintiff must plead culpable participation for control person liability.

1. *Congress would have used burden-shifting language if it intended to shift the burden to the defendant in § 20(a).*

Section 20(a) enumerates the material elements of control person liability. Plaintiffs bear the burden of pleading allegations "respecting all the material elements necessary to sustain recovery under some viable legal

theory." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 562 (2007) (citing *Car Carriers, Inc. v. Ford Motor Co.*, 745 F.2d 1101, 1106 (7th Cir. 1984)). Unlike other statutes drafted by Congress, § 20(a) contains no language that shifts the burden to defendants to establish an affirmative good faith defense.

For instance, § 11 of the 1933 Securities Act provides for private causes of action for misrepresentations or omissions in registration statements. 15 U.S.C. § 77k(a) (2012). Included within § 11 is language that expressly shifts the burden to the defendant. *See* § 77(k)(b) ("Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . ."). Congress's use of express burden-shifting language in the 1933 Securities Act demonstrates that it meant "unless the controlling person acted in good faith and did not directly or indirectly induce" to constitute an element of control person liability. Because it is an element for which the plaintiff bears the burden of pleading, this Court should require plaintiffs to plead culpable participation.

2. *Requiring culpable participation adheres to congressional intent regarding § 20(a) and securities law.*

Section 20(a) was designed to expand the scope of liability to controlling persons beyond the reach of an agency relationship. *Laperriere v. Vesta Ins. Grp.*, 526 F.3d 715, 722 (11th Cir. 2008). However, Congress intended "to impose liability only on those directors who fall within its definition of control and who are in some *meaningful sense culpable participants* in the fraud perpetrated by controlled persons." *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (emphasis added). Further, in 1995 Congress, motivated to

prohibit dubious lawsuits, *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000), passed the PSLRA with twin goals, "to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007). Considered together, Congress's intent for § 20(a) and the PSLRA indicate that it desires a scope of liability beyond agency theory but limited to meritorious claims.

Control person liability was not intended to be an "insurer's standard," evidenced by Congress's rejection of a Senate version of the bill containing such language. *Laperriere*, 526 F.3d at 724; *see* S. Rep. No. 73-47, at 5-6 (1933). With its enactment of the PSLRA, Congress desired to create procedural barriers to non-meritorious lawsuits, H.R. Conf. Rep. No. 104-369, at 41 (1995), to protect investors from bearing the costs of frivolous litigation. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977-78 (9th Cir. 1999).

Congress enacted the PSLRA to create stricter pleading requirements in securities actions. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006). Thus, "requiring culpable participation on the part of the allegedly controlling defendants is consistent with the purpose of the Exchange Act and the PSLRA." *In re Fed. Nat'l Mortg. Ass'n Sec., Derivative, & "ERISA" Litig.*, 503 F. Supp. 2d 25, 44 (D.D.C. 2007). Due to the absence of burden-shifting language and Congress's clear desire to create more stringent pleading requirements, this Court should require plaintiffs to plead culpable participation on a § 20(a) claim.

B. Requiring culpable participation enhances judicial efficiency.

Effective and efficient use of resources resounds within the core values of the federal judiciary. *See* JUDICIAL CONFERENCE OF THE UNITED STATES, STRATEGIC PLAN FOR THE FEDERAL JUDICIARY 2 (2015). However, "[l]itigation . . . exacts heavy costs in terms of efficiency and expenditure of valuable time and resources." *Ashcroft v. Iqbal*, 556 U.S. 662, 685 (2009).

Contrary to the contention that a culpable participation standard unnecessarily burdens plaintiffs, *see e.g.*, *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985), the absence of a culpable participation requirement unnecessarily burdens named defendants that must appear despite an absence of pleaded facts to infer the defendant acted in bad faith or induced the primary violation. The presence of more litigants necessarily results in higher litigation costs. Requiring that plaintiffs plead culpable participation for control person liability preserves judicial resources, a result that conforms to the core values of the federal judiciary.

C. Requiring culpable participation facilitates productivity.

Eliminating the culpable participation requirement would unacceptably expose innocent supervisory personnel to joint and several liability for their subordinates' securities violations. *See In re Alstom SA*, 406 F. Supp. 2d 433, 490–91 (S.D.N.Y. 2005). Without the culpable participation requirement, outside directors, who are typically not involved in the ordinary operations of the company, are subjected to liability based purely on their positions. *See id.* This is an untenable proposition. *See Lanza v. Drexel & Co.*, 479 F.2d 1277, 1307 (2d Cir. 1973) ("'If people of stature and creative potential are still wanted

for corporate directorships, we must take care how agonizingly subtle their choices are to be.'" (quoting *Lanza v. Drexel & Co.*, 1970 WL 197, at *21 n.18 (S.D.N.Y. Oct. 9, 1970))).

In addition to the possible detrimental impact on productive human capital, eliminating the culpable participation requirement would detrimentally impact investment capital. In the face of lax pleading standards for § 20(a) liability, companies must spend more on insurance for their directors and officers, thereby reducing the amount available to invest. *See* S. Rep. No. 104-98, at 22 (1995). Because culpable participation facilitates productivity, enhances judicial efficiency, and aligns with congressional intent, this Court should hold that it must be pleaded in a claim for control person liability.

CONCLUSION

For the reasons stated herein, Petitioner respectfully requests this Court reverse the decision of the United States Court of Appeals for the Fourteenth Circuit.

Respectfully submitted,

/s/ Team P4

Counsel of Record for Petitioners