REMEDIES FOR DEFRAUDED PURCHASERS OF OIL AND GAS INTERESTS UNDER THE SECURITIES LAWS

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I. INTRODUCTION

It is often surprising to most people, including attorneys, when they learn that many oil and gas interests are securities. After all, the term "securities" typically conjures up visions of stocks and bonds issued by large corporations and traded on Wall Street. So, it seems counterintuitive to include oil and gas interests in the same category as stocks and bonds. But the reality of the matter is that many oil and gas interests do fall within the statutory definition of a security.

As noted by Oliver Wendell Holmes, "[t]he life of the law has not been logic: it has been experience."[1] In other words, the law does not always make a lot of sense unless viewed in the context of its historical development. There is no question about it: on its face, the grouping of oil and gas interests into the same category as stocks and bonds is somewhat illogical. However, when the United States Congress and many state legislatures enacted securities laws in the early twentieth century, fraud in oil and gas transactions was rampant. Consequently, these legislative bodies included the term "oil and gas interests," or some variation thereof, in the statutory definition of a security to give defrauded investors in oil and gas interests an additional legal remedy. Therein lies the explanation of how such dissimilar instruments were grouped together under the rubric of securities.

This article provides the practitioner with a working knowledge of when an oil and gas interest is considered a security under federal law, Texas law, or both.[2] Then it examines the private rights of actions available to defrauded investors under federal and Texas law. Particular

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1. OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1 (Dover Publ,'ns 1991) (1881).

2. Many people are unaware of the applicability of the federal and state securities laws to oil and gas interests or simply choose to ignore the laws. *See* George Lee Flint, Jr., *Annual Survey of Texas Law Article: Securities Regulation*, 57 SMU L. Rev. 1207, 1217-18 (2004). Flint noted the following:

> The Board had numerous enforcement actions against issuers who did not register their securities. . . . A considerable portion dealt with sale of oil and gas interests, where some operators either are unaware of the securities laws aspects of oil and gas interests, or felt that the penalty, usually refunding the investment of the complaining purchaser, was not a sufficient deterrent warranting registration.

Id.; John Burritt McArthur, *Coming of Age: Initiating the Oilfield Into Performance Disclosure*, 50 SMU L. Rev. 663, 736 (1997) ("Though securities requirements should apply to many oil and gas investments, they often are ignored."); Peter W. Goodwin, *What Sellers of Producing Oil & Gas Properties Should Know about Federal Laws*, HOUS. LAW., Sept.-Oct. 1990, at 46, 46 ("[S]ales of producing properties that are sales of securities may be more common than many lawyers suspect."); Julian M. Meer noted the following:

> It frequently comes as a shock to many people in the oil and gas business to be informed that as a general rule, in both the federal and state securities laws, oil and gas property interests are included within the broad definition of the term "security," and that a transfer of an oil and gas interest for value involves the sale of a security.

Julian M. Meer, *The Securities Laws and Oil and Gas Financing*, 20 TEX. B.J. 211, 212 (1957).

attention is given to the significant differences between the Texas Securities Act (TSA) and the federal securities laws. The article concludes by identifying which law typically provides the most relief to defrauded investors.

II. DEFINITION OF A SECURITY

Under both federal and Texas law, the definition of a security includes oil and gas interests. However, the term "security" under the TSA includes many oil and gas interests that the federal definition of the term security excludes. Consequently, the TSA oftentimes regulates transactions in oil and gas interests that the federal securities laws do not. The definitions of a security under federal law and Texas law are examined in turn below.

A. Oil and Gas Interests Covered by the Federal Securities Laws

Oil and gas interests may be classified as securities under either one of two analyses under the federal securities laws.[3] An oil and gas interest may be considered a security under the portion of the federal securities acts that expressly defines a security to include certain oil, gas, or other mineral interests. Alternatively, an oil and gas interest may be considered a security under the portion of the securities act that includes "investment contracts" as securities.

1. Fractional Undivided Interest in Oil and Gas Rights

The Securities Act of 1933 defines a security to include any "fractional undivided interest in oil, gas, or other mineral rights."[4] The Securities Exchange Act of 1934 defines a security to include any "participation in. . . any oil, gas, or other mineral royalty or lease."[5] Although these two definitions differ slightly in which oil and gas interests qualify as a security, courts have interpreted them in harmony to mean virtually the same thing.[6] Courts have done this by ignoring the 1934 Act's definition of a security and using the 1933 Act's definition of a security as the exclusive basis for deciding which oil and gas interests are securities.[7]

3. Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093, 1097-99 (5th Cir. 1973).
4. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).
5. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2006).
6. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n. 1 (1985) ("We have repeatedly ruled that the definitions of "security" in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical and will be treated as such in our decisions dealing with the scope of the term."); Adena Exploration, Inc. v. Sylvan, 860 F.2d 1242, 1244 n. 4 (5th Cir. 1988).
7. Goodwin, *supra* note 2, at 46 ("If the definitions of 'security' in the 1933 and 1934 Acts are to be treated the same, which specific reference to oil and gas interests is controlling? The 10th Circuit has held that the 1933 Act's reference to oil and gas interests is controlling.").

Consequently, an oil and gas interest may be a security under either act if it is a fractional undivided interest in oil, gas, or other mineral rights.[8]

But not all fractional undivided interests in oil, gas, or other mineral rights are securities.[9] Fractional undivided interests in oil, gas, or other mineral rights are only considered securities if they were created by the seller splitting an interest into several fractional undivided interests. And even then, the fractional undivided interests are securities only for the purpose of the first transaction after they were created. A fractional undivided interest is not considered a security when the purchaser of the fractional undivided interest subsequently sells his entire ownership in the fractional undivided interest.[10] Courts reached this conclusion by reading the definition of a security under the federal securities laws in conjunction with the definition of an issuer under the federal securities laws.[11] In the context of selling interests in oil, gas, or other mineral rights, the definition of an issuer under federal law has been explicitly limited to owners of fractional undivided interests in oil, gas, or other mineral rights who create fractional interests to be sold.[12]

In *SEC v. Joiner*, the U.S. Supreme Court explained why Congress limited its inclusion of oil and gas interests in the definition of a security to just fractional undivided interests:

> Oil and gas rights posed a difficult problem to the legislative draftsman. Such rights were notorious subjects of speculation and fraud, but leases and assignments were also indispensable instruments of legitimate oil exploration and production. To include leases and assignments by name might easily burden the oil industry by controls that were designed only for the traffic in securities. This was avoided by including specifically only that form of splitting up of mineral interests which had been most utilized for speculative purposes.[13]

As discussed below, the Texas legislature was less concerned with overburdening the oil industry than protecting investors. Consequently,

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8. *Adena Exploration*, 860 F.2d at 1252-53; *Nor-Tex Agencies*, 482 F.2d at 1097-98.

9. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352 (1943); Woodward v. Wright, 266 F.2d 108, 112 (10th Cir. 1959); *Adena Exploration*, 860 F.2d at 1246 ("What *Joiner* left to implication Judge Murrah made explicit in his influential opinion in *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959), a landmark securities case which remains frequently cited today.").

10. *Adena Exploration*, 860 F.2d at 1245 n.5 ("Where the owner of a fractional undivided working interest surrenders his entire interest whole, there is no sale of a 'fractional undivided interest' under the Act."); Lynn v. Caraway, 252 F. Supp. 858, 861-862 (W.D. La. 1966), *aff'd per curiam*, 379 F.2d 943 (5th Cir. 1967), *cert. denied*, 393 U.S. 951 (1968).

11. *Woodward*, 266 F.2d at 112; *Lynn*, 252 F.Supp. at 861.

12. Securities Act of 1933 § 2(a)(4), 15 U.S.C. § 77b(a)(4) (2006) ("[T]he term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offerings.")

13. *C.M. Joiner Leasing*, 320 U.S. at 352.

the definition of security under Texas law includes a large number of oil and gas interests that the federal definition excludes.

2. An Oil and Gas Interest that is an Investment Contract

Pursuant to the United States Supreme Court's analyses in *Landreth*[14] and then in *Reves*,[15] courts should first determine whether the oil and gas interest is a fractional undivided interest in oil, gas, or other mineral rights. If the oil and gas interest at issue does not fall with this phrase, then the court may determine whether it is considered an "investment contract" and therefore a security under the federal securities laws.[16]

The Securities Act of 1933 and the Securities Exchange Act of 1934 each define a security to include an "investment contract." The United States Supreme Court has defined an "investment contract" to mean a contract, transaction or scheme that "involves [1] an investment of money in [2] a common enterprise [3] with profits to come solely from the efforts of others."[17] This three-pronged analysis is a general catchall that qualifies many investments in business arrangements as securities. Oftentimes an oil and gas interest will qualify as an investment contract, and hence a security under federal securities law, where the purchaser of the oil and gas interest will "look entirely to the efforts of other persons to make their investment a profitable venture."[18]

B. Oil and Gas Interests Covered by the Texas Securities Act

The methodology under Texas law to determine if an oil and gas interest is a security is somewhat similar to that under federal law. An oil and gas interest may fall within the phrase in the TSA definition of a security that specifically identifies certain oil and gas interests as securities. Alternatively, the oil and gas interest may be covered as a security under the portion of the TSA that includes "investment contracts" as securities. The distinction, however, is that the TSA definition of a security explicitly includes many oil and gas interests that are excluded from the federal definition of a security.[19]

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14. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).
15. Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).
16. *E.g.*, *Adena Exploration*, Inc. v. Sylvan, 860 F.2d 1242, 1247 (5th Cir. 1988).
17. Long v. Shultz Cattle Co., 881 F.2d 129, 132 (5th Cir.1989) (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)).
18. San Francisco-Oklahoma Petroleum Exploration Corp. v. Carston Oil Co., 765 F.2d 962, 966 (10th Cir. 1985) (quoting Woodward v. Wright, 266 F.2d 108, 112 (10th Cir. 1959)).
19. The court in *Darwin*, stated the following:

> In defining the term "security" the Federal Act refers to "fractional undivided interest in oil, gas, or other mineral rights." The Texas Act, Sec. 2(a) does not so limit the

1. Whole, Fractional, Segregated or Undivided Interests in Oil and Gas Rights

The TSA reads in relevant part that a security includes any "certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title."[20] This definition is notably more far-reaching than the federal definition of a security.[21] After all, the federal definition of a security only includes fractional undivided interests in oil, gas, or other mineral rights.

As explained above, the definition of a security under federal law is read in conjunction with the definition of an issuer to exclude many oil and gas interests from the scope of the federal securities laws.[22] However, because the TSA does not have such a restrictive definition of an issuer, the definition of a security under Texas law has not been similarly constricted. Under the TSA, an issuer is defined broadly to include "every company or person who proposes to issue, has issued, or shall hereafter issue any security."[23] In contrast, federal securities law limits the definition of an issuer, in the context of oil and gas interests, to owners of fractional undivided interests in oil, gas, or other mineral rights who create fractional interests to be sold.[24] Due to the different definitions of an issuer under federal and state law, most fractional undivided interests are considered securities under the TSA, regardless of whether the seller created it by splitting an interest into several fractional undivided interests.

In fact, when read in conjunction with another provision of the TSA, it is apparent that the Texas legislature intended the definition of a security to include a wide variety of oil and gas interests besides fractional undivided interests. The TSA provides that "interests in and under oil, gas or mining leases, fees or titles, or contracts relating thereto . . . whether whole, fractional, segregated or undivided in any single oil, gas or mineral lease, fee or title, or contract relating thereto" may be exempt from registration under the TSA under certain circumstances.[25] By implication, the TSA definition of a security includes "interests in and under oil, gas or mining leases, fees or titles, or contracts relating

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definition, but includes "* * * any instrument representing any interest in or under an oil, gas or mining lease, fee or title * * *."

Darwin v. Jess Hickey Oil Corp., 153 F. Supp. 667, 672 (N.D. Tex. 1957).

20. TEX. REV. CIV. STAT. ANN. art. 581-4, §A (Vernon 2003).

21. *See generally* Meer, *supra* note 2, at 238.

22. *Woodward*, 266 F.2d at 112; Lynn v. Caraway, 252 F. Supp. 858, 861 (W.D. La.1966), *aff'd per curiam*, 379 F.2d 943 (5th Cir.1967), *cert. denied*, 393 U.S. 951 (1968).

23. TEX. REV. CIV. STAT. ANN. art. 581-4, § G (Vernon 2003).

24. Securities Act of 1933 § 2(a)(4), 15 U.S.C. § 77b(a)(4) (2006).

25. TEX. REV. CIV. STAT. ANN. art. 581- 5, §Q (Vernon 2003).

thereto . . . whether whole, fractional, segregated or undivided in any single oil, gas or mineral lease, fee or title, or contract relating thereto."[26]

In *Kadane v. Clark*, the Texas Supreme Court explained why the legislature included oil and gas interests in the definition of a security under state law and intimated that the TSA should cover a broad array of oil and gas interests.

> The history relating to the sale of securities in this State is well known. The development of the oil industry emphasized the necessity of regulating sales of securities issued on oil leases and other instruments relating to the oil business. An enormous number of worthless securities were sold to the public, and nothing was realized on many of these investments by the buyers. There was no restraint upon such sales nor upon those who made them. The public was notoriously imposed upon, and ofttimes people were defrauded out of their life's savings. There was a public demand for protection against such sales. The legislature sought to cope with the situation by enacting the Securities Act.[27]

Although the variety of oil and gas interests included within the TSA definition of a security is broad, there are limitations. For instance, the original lease created by a landowner who grants an oil and gas lease to the first lessee is not a security under the TSA.[28] (But any subsequent trading of the oil and gas lease after its creation is regulated as a security under the TSA.[29]) And, a license to simply test the ground for the existence of oil or gas is not considered a security under the TSA either.[30]

2.An Oil and Gas Interest that is an Investment Contract

Of course an oil and gas interest may qualify as a security under the TSA under the portion of the definition of a security that includes an "investment contract" as a security. Texas courts follow federal court interpretations in applying the investment contract analysis, so analysis of

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26. As explained in more detail below, even though a security may be exempt from registration under the TSA, it is still subject to the antifraud provision of the TSA. *See infra* Part II.C.

27. Kadane v. Clark, 143 S.W.2d 197, 199 (Tex. 1940). Although the Texas legislature has amended the TSA several times since *Kadane*, the TSA definition of a security as it relates to oil and gas interests has remained the same since then.

28. Allen v. Sorenson, 388 S.W.2d 757, 759 (Tex. Civ. App.—Beaumont 1965); *see also* William T. Fleming, Jr. & William E. Joor III, *Oil and Gas Interests as Securities Under the Federal and Texas Securities Acts*, 5:1 BULL. SEC. CORP., BANKING & BUS. LAW 1, 3 (1966); Meer, *supra* note 2, at 238; Andrew Johnson, *The Texas Securities Act as it Applies to Interests in Oil and Gas*, TEX. L. REV. 346, 346 (1944).

29. Meer, *supra* note 2, at 238.

30. Auers v. Phillips Petroleum Co., 25 F. Supp. 458, 459 (N.D. Tex. 1938).

what is an investment contract under Texas law is generally the same as under federal law.[31]

III. CHOOSING BETWEEN CLAIMS UNDER THE FEDERAL SECURITIES LAWS AND THE TEXAS SECURITIES ACT

The purchaser of an oil and gas interest may have a remedy under the securities laws if he (1) purchases an oil and gas interest that should have been registered under the securities laws but was not, or (2) is the victim of a misrepresentation or omission. The federal and Texas claims available to address the first type of injury are actually quite similar, so they are discussed only briefly in this article. On the other hand, if the investor is a victim of either a misrepresentation or an omission, a claim under the TSA is generally far superior to those under the federal laws. Nonetheless, each of these federal securities claims bear examination because in certain instances the TSA is preempted by the federal securities laws.

A. Sale of an Unregistered Security

The mantra for securities lawyers is that there are only three types of securities: (1) registered, (2) exempt, or (3) or illegal. To elaborate, after identifying an instrument as a security, it must be registered pursuant to the securities laws—unless it is exempt from registration. If a security is not exempt from registration, the purchaser of such a security can seek rescission of the sales transaction under either state or federal law.[32]

Under both federal and state law, the statutory claim to seek rescission of an unregistered security is relatively straightforward. In general, the aggrieved investor simply has to prove that the investment was a security, was not registered, and was not exempt from registration.[33] Proof of scienter and reliance is unnecessary.[34] Because the elements for proving a rescission claim under federal and Texas law are so similar, neither has a significant advantage over the other. The most significant differences are that, as explained above, many more oil and gas interests fall within the TSA definition of a security than under the federal definition of a

31. Sparks v. Baxter, 854 F.2d 110, 113-14 (5th Cir. 1988) ("In Searsy v. Commercial Trading Corp., 560 S.W.2d 637 (Tex.1977), Texas adopted the elements of an investment contract which the Supreme Court had announced for such a contract under the federal securities legislation."); *see also* TEX. REV. CIV. STAT. ANN. art. 581-10-1, §A (Vernon 2005) (The Texas Securities Act "may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states' law and administration . . . .").

32. Securities Act of 1933 § 12(a)(1), 15 U.S.C. §77*l*(2) (2006); TEX. REV. CIV. STAT. ANN. art. 581-33, § A(1) (Vernon 2005).

33. Swenson v. Engelstad, 626 F.2d 421, 424 (5th Cir. 1980).

34. *Id.* ("The Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities. Recovery may be had under § 12(1) 'regardless of whether (the purchaser) can show any degree of fault, negligent or intentional, on the seller's part.'")

security and the statute of limitations for the Texas claim is longer than under the federal claim.[35]

B. Federal Securities Claims to Recover for Misrepresentations and Omissions

Statutory claims for fraud under the federal securities laws are much more popular than those under state securities laws. The popularity of the federal securities claims is probably due in part to wide spread coverage that those claims are given in law review articles and treaties. When confronted with securities fraud, the claims most often asserted are those under Section 10(b) of the Securities Exchange Act of 1934 and Sections 11 and 12(a)(2) of the Securities Act of 1933.

1. Rule 10b-5 Claim

Since 1946, courts have recognized a private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder (the "Rule 10b-5 claim").[36] The Rule 10b-5 claim is regarded as the general antifraud claim under the federal securities laws.[37] Unlike claims under Section 11 or Section 12(a)(2) of the Securities Act of 1933, the Rule 10b-5 claim addresses all claims of fraud in the sale or purchase of securities. As explained below, claims under Section 11 and Section 12(a)(2) are only available if the fraud took place in the context of a public offering. The Rule 10b-5 claim may be asserted to recover for fraud that regardless of whether it takes place in the context of a public offering, private placement, or secondary transaction.[38]

Although the Rule 10b-5 claim is generally applicable to redress fraud in the sale or purchase of a security, it does have significant shortcomings. For instance, the Rule 10b-5 claim requires proof of scienter and reliance,[39] making it significantly more difficult to prove. And since 1975,

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35. The statute of limitations for a claim under Section 12(a)(1) of the Securities Act of 1933, 15 U.S.C. 77*l*(a)(1) is "one year after the violation upon which it is based" and in no event "more than three years after the security was bona fide offered to the public." 15 U.S.C. § 77m (2006). The statute of limitations for a claim under the TSA is generally no "more than three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence; or . . . more than five years after the sale . . . ." TEX. REV. CIV. STAT. ANN. art. 581-33, § H(2) (Vernon 2005).

36. 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2005); Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

37. Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970) (addressing filing suit under Section 12(2) of Securities Act of 1933).

38. Section "10(b) of the 1934 Act and Securities and Exchange Commission (SEC) Rule 10b-5 reach both initial and secondary distributions." Gustafson v. Alloyd Co., 513 U.S. 561, 592 (1995).

39. Dura Pharm., Inc. v. Broudo, 125 S.Ct. 1627, 1631 (2005); Unger v. Amedisys Inc. 401 F.3d 316, 322 n.2 (5th Cir. 2005).

the U.S. Supreme Court has taken every opportunity it has had to make the Rule 10b-5 claim less attractive for aggrieved investors to assert.[40] As a result, it is a far less useful claim than it used to be.

Fortunately for investors in Texas, the general antifraud claim under the TSA has not been watered down like the Rule 10b-5 claim and is often a very attractive alternative. But because claims under the TSA may be preempted by claims under the federal securities acts,[41] an aggrieved investor may have to fall back on the Rule 10b-5 claim under certain limited circumstances.

2. Section 11 and Section 12(a)(2) claims

Claims under Section 11 and Section 12(a)(2) of the Securities Act of 1933[42] are much easier to prove than a Rule 10b-5 claim because neither of these two claims requires proof of scienter.[43] In addition, proof of reliance is never required to prove a Section 12(a)(2) claim and is only occasionally required to prove a Section 11 claim.[44] But claims under Section 11 and Section 12(a)(2) have their own drawbacks.

A Section 11 claim only provides a remedy if the misrepresentation or omission was made in a registration statement.[45] Therefore, Section 11 only protects investors "who purchased their stock during the relevant public offerings" and "aftermarket purchasers as long as the stock is 'traceable' back to the relevant public offering."[46] Section 11 does not provide a remedy to investors that purchased securities issued through a private offering.

Section 12(a)(2) only provides a remedy if the misrepresentation or omission was made in, or orally about, a prospectus.[47] The Fifth Circuit

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40. *See* James D. Redwood, *Toward a More Enlightened Securities Jurisprudence in the Supreme Court? Don't Bank on it Anytime Soon*, 32 HOUS. L. REV. 3, 66 n.339 (1995).

41. *See infra* notes 76 -78 and accompanying text.

42. Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006); Securities Act of 1933 § 12(a)(2), 15 U.S.C. 77*l*(a)(2) (2006).

43. Krim v. pcOrder.com, Inc., 402 F.3d 489, 495 (5th Cir. 2005) ("Section 11's liability provisions are expansive—creating 'virtually absolute' liability for corporate issuers for even innocent material misstatements . . . ."); *In re* Enron Corp., 235 F. Supp. 2d 549, 567 n.6 (S.D. Tex. 2002), *dismissed by, in part,* 2003 U.S. Dist. LEXIS 1668 (S.D. Tex. Jan. 28, 2003) (Section 12(a)(2) "is basically a strict liability statute (unless one of the express exceptions applies) with no scienter requirement.").

44. *In re* Enron Corp., No. MDL1446, 2003 WL 23305555, at *6 (S.D. Tex. Dec. 11, 2003) (footnote omitted) ("[U]nder § 11 the plaintiff generally does not have to establish scienter, causation (materiality) or reliance." 15 U.S.C. § 77k(a) provides "a statutory exception to the usual rule that reliance is not required for a § 11 claim . . . .").

45. Rosenzweig v. Azurix Corp., 332 F.3d 854, 873 (5th Cir. 2003) ("[Section] 11 only applies to public registered offerings.").

46. *Krim*, 402 F.3d at 492.

47. Shanahan v. Vallat, No. 03 Civ. 3496 (MBM), 2004 U.S. Dist. LEXIS 25523, at *19 (S.D.N.Y. Dec. 14, 2004) ("The phrase 'oral communication' is restricted to oral communications that relate to a prospectus . . . ."); Liberty Ridge LLC v. RealTech Sys. Corp., 173 F. Supp. 2d 129, 135 (S.D.N.Y. 2001) ("In this District, courts have consistently interpreted

has held that Section 12(a)(2) only applies in the context of a public offering.[48] Consequently, the protections of Section 12(a)(2) do not extend to defrauded investors who purchased a security through a private offering, a secondary market offering, or in the aftermarket.[49]

Section 11 and Section 12(a)(2) each contain a statutory defense granting defendants the right to raise the affirmative defense of loss causation. For years, Section 11 provided that loss causation may be raised as an affirmative defense.[50] In 1995, Congress amended the Securities Act of 1933 to provide that a defendant may assert the affirmative defense of loss causation to a claim under Section 12(a)(2).[51] The "loss causation affirmative defense allows a defendant to avoid liability if the depreciation in the value of the security did not result from any nondisclosure or false statement made in the prospectus or registration statement."[52]

As explained below, the aggrieved investor would probably prefer to bring a claim under the general antifraud provisions of the TSA instead of under either Section 11 and Section 12(a)(2) unless it is preempted.[53] That way the aggrieved investor would be able to avoid dealing with all of the above described obstacles that others asserting a claim under either Section 11 and Section 12(a)(2) must address.

C. The Texas Securities Act's General Antifraud Claim

Fortunately for defrauded investors in Texas, they usually have the option of asserting a claim under the TSA that is far superior to any of those that could be brought under the federal securities laws. The general antifraud claim under the TSA is just as easy, in fact easier, to prove than

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Gustafson to hold that the term 'oral communication' in Section 12(a)(2) is a 'communication that relates to a public written communication, such as a prospectus.'")

48. Lewis v. Fresne, 252 F.3d 352, 357 (5th Cir. 2001) ("In *Gustafson*, the Supreme Court analyzed the legislative history of the 1933 Act to determine that Congress meant for § 12 to apply only to public offerings."); *In re* Enron Corp., 310 F. Supp. 2d 819, 861 (S.D. Tex. 2004) ("[A] § 12(a)(2) claim may be asserted only by purchasers of stock in a public offering pursuant to a prospectus containing material misrepresentations or omissions."); *In re* Azurix Corp., 198 F. Supp. 2d 862, 893 (S.D. Tex. 2002).

49. *Lewis*, 252 F.3d at 357 ("Section 12 of the 1933 Act does not apply to private transactions."); *In re* Enron Corp., 310 F. Supp. 2d at 860 ("Section 12 applies only to public offerings and not to private transactions."); Shanahan v. Vallat, No. 03 Civ. 3496 (MBM), 2004 U.S. Dist. LEXIS 25523, at *20 (S.D.N.Y. Dec. 14, 2004) ("Several courts have held that *Gustafson* excludes 'purchasers in private or secondary market offerings' from bringing claims under section 12(2)."); First Union Disc. Brokerage Servs., Inc. v. Milos, 997 F.2d 835, 843-44 (11th Cir. 1993) ("[S]ection 12(2) of the 1933 Act does not apply to aftermarket transactions.")

50. Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2006); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1421-22 (9th Cir. 1994).

51. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105(3), 109 Stat. 737, 757 (codified as amended at 15 U.S.C. § 77*l*(b) (2000)).

52. Azzolini v. Corts Trust II for Provident Fin. Trust I, No. 1:03-CV-1003, 2005 WL 3448053, at *5 (E.D. Tenn. Dec. 14, 2005) (mem.).

53. *See infra* notes 76-78 and accompanying text.

a claim under either Section 11 or Section 12(a)(2). But unlike a claim under Section 11 or Section 12(a)(2), the TSA claim is not constrained to redressing fraudulent registration statements or misrepresentations or omissions made in, or orally about, a prospectus. Instead, the general antifraud claim under the TSA applies to all sales and purchases of securities,[54] just as the Rule 10b-5 claim does. But the TSA claim is much easier to prove and generally provides a better remedy than a Rule 10b-5 claim.

As noted by the Texas Supreme Court, the TSA "considered as a whole, is something less than a model of lucidity in legislative drafting."[55] That much is apparent when reviewing the civil liability provision of the TSA which reads in part:

> A person who offers or sells a security (whether or not the security or transaction is exempt under [the Texas Securities Act]) by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, is liable to the person buying the security from him . . . .[56]

But the complexity of this provision belies the ease of proving a TSA claim. For starters, the claim does not require proof of either scienter or reliance,[57] both of which are elements of a Rule 10b-5 claim. In fact, the TSA imposes strict liability upon violators.[58]

As if these attributes were not attractive enough, many defenses that can be raised against claims under the federal securities laws cannot be raised against a TSA claim. This is significant because common law defenses such as ratification, waiver, estoppel, and failure to mitigate are often formidable obstacles to establishing a Rule 10b-5 claim.[59]

The only defenses to a TSA claim are those provided for in the statute itself and the defense of joint adventurers.[60] In *Duperier v. Texas State*

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54. Tex. Capital Sec., Inc. v. Sandefer, 58 S.W.3d 760, 776 (Tex. App.—Houston [1st Dist.] 2001) ("[W]e conclude article 581-33(A)(2) applies to private, secondary securities transactions.").

55. Flowers v. Dempsey-Tegeler & Co., 472 S.W.2d 112 (Tex. 1971).

56. TEX. REV. CIV. STAT. ANN. art. 581-33, § A(2) (Vernon 2005).

57. Herrmann Holdings Ltd. v. Lucent Techs. Inc., 302 F.3d 552, 563 (5th Cir. 2002) ("[A]n article 581-33 claim does not require scienter."); Granader v. McBee, 23 F.3d 120, 123 (5th Cir. 1994) (observing that a TSA claim does not require proof of reliance).

58. Sterling Trust Co. v. Adderley, 119 S.W.3d 312 (Tex. App.—Fort Worth 2003) *rev'd on other grounds*, 168 S.W.3d 835 (Tex. 2005) ("Under the strict liability provisions of sections 33(A)(2) and (B), a plaintiff may recover against a seller without proof that the seller knew or should have known of the untruth or omission on which the plaintiff's claim is based.").

59. Stephenson v. Paine Webber Jackson & Curtis, Inc. 839 F.2d 1095, 1098-99 (5th Cir. 1988) (holding that estoppel, waiver, and ratification may be raised to defeat a Rule 10b-5 claim); Mercer v. Jaffe, Snider, Raitt & Heuer, P.C., 730 F. Supp. 74, 77 (W.D. Mich. 1990) (recognizing failure to mitigate as an affirmative defense to a Rule 10b-5 claim).

60. Anderson v. Vinson Exploration, Inc., 832 S.W.2d 657, 663 (Tex. App.—El Paso 1992) (

Bank,[61] the court expressly held that a defendant could not raise ratification, comparative fault, loss causation, or mitigation as affirmative defenses to a TSA claim.[62] Although the court did not expressly hold that a defendant could not raise any common law defenses, the court implied as much in its opinion. For instance, the court held that comparative fault could not be raised as a defense "[b]ecause the statute provides no other defenses, and a comparative fault defense would abrogate the effect of the statute."[63] In sum, it appears that the *Duperier* court would not recognize any defense other than the two "absolute defenses"[64] available under the TSA.

The TSA expressly provides that "a person is not liable if he sustains the burden of proof that either (a) the buyer knew of the untruth or omission or (b) he (the offeror or seller) did not know, and in the exercise of reasonable care could not have known, of the untruth or omission."[65] These two statutory defenses mirror those that all of the above described federal claims are subject to anyway,[66] so they do not make the TSA claim any less advantageous.

Damages under the TSA are quite generous. As noted by one court, the federal statute upon which the TSA damage provision was modeled, "permits windfall recoveries."[67] The aggrieved investor pursuing a claim under the TSA is entitled to rescission if the investor still holds the securities.[68] But if the aggrieved investor already sold the securities in

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"A joint venture is a defense to any cause of action arising under the Texas Securities Act.").

61. 28 S.W.3d 740 (Tex. App.—Corpus Christi 2000).

62. *Id*. at 753-754.

63. *Id*. at 753.

64. *Id*.

65. TEX. REV. CIV. STAT. ANN. art. 581-33, § A(2) (Vernon 2005).

66. A defendant may avoid liability under Section 11 if "it is proved that . . . [the buyer] knew of such untruth or omission." 15 U.S.C. § 77k(a) (2006). "Section 12(2) of the 1933 Act explicitly provides that liability shall not lie for the failure to disclose a material fact in a prospectus where 'the purchaser . . . know[s] of such untruth or omission.'" Jensen v. Kimble, 1 F.3d 1073, 1079 n.10 (10th Cir. 1993) (citing 15 U.S.C. § 77*l*(2)). An offeror may avoid liability under Section 11 and Section 12(2) if he can "demonstrate that he did not know, and could not reasonably have been expected to know, of the untruth or omission." SEC v. Sw. Coal & Energy Co., 624 F.2d 1312, 1318-19 (5th Cir. 1980). If the plaintiff knew of the untruth or omission, the plaintiff cannot prove that he reasonably relied upon the untruth or omission, a required element in a Rule 10b-5 claim. If the defendant did not know of the untruth or omission, the element of scienter required under a Rule 10b-5 claim cannot be proved.

67. Bastian v. Petren Res. Corp., 892 F.2d 680, 685 (7th Cir. 1990) (construing Section 12(2) of the Securities Act of 1933). In 1995, Congress amended Section 12(2) and renumbered it 12(a)(2). Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (codified as amended at 15 U.S.C. § 77*l* (2000)). "[A]rticle 581-33, the civil liability section of the Texas Securities Act, was modeled after § 12(2) of the Federal Securities Act. In fact, cases interpreting the Texas Securities Act rely upon decisions construing § 12(2) because the language is virtually identical." Reed v. Prudential Sec. Inc., 875 F.Supp. 1285, 1292 (S.D. Tex. 1995) (citations omitted).

68. In construing the TSA, the court in *Texas Capital Securities, Inc. v. Sandefer* held that "a plaintiff who still owns the securities in question is only entitled to rescission. Rescission is intended to restore plaintiffs to their original position. A finding of actual damages is not

dispute, he is entitled to damages equal to his out-of-pocket loss.[69] Consequently, if the securities in dispute declined in value after their sale, the aggrieved investor's recovery is unaffected. The aggrieved investor is entitled to the return of the purchase price,[70] plus pre-judgment interest, costs, attorney's fees, and possibly exemplary damages.[71] The seller who violated the TSA bears the risk that the securities may decline in value after the sale, not the aggrieved investor.[72]

Secondary liability is available and often sought under the TSA. The TSA allows a defrauded investor to pursue an aiding and abetting claim—a claim that the U.S. Supreme Court extinguished under the Rule 10b-5 claim in 1994. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,*[73] the Supreme Court held that a private plaintiff could not assert a private cause of action under Rule 10b-5 against aiders and abettors. Fortunately for Texas investors, the TSA explicitly allows defrauded investors to seek recovery from those who aid and abet a securities violation.[74]

For investors in oil and gas interests, perhaps the greatest advantage of the TSA claim over the Rule 10b-5 claim is that a greater variety of oil and gas interests are actionable under the TSA than under any of the federal securities claims. As explained above, the TSA defines the term security in a much more expansive fashion than the federal securities laws define the same term. Consequently, defrauded purchasers may be able

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required for equitable rescission." Texas Capital Sec., Inc. v. Sandefer, 58 S.W.3d 760, 776 (Tex. App.—Houston [1st Dist.] 2001).

69. "The remedies available to a purchaser in an action under [the TSA] depend on whether the purchaser still owns the securities at issue. The person buying the security 'may sue either at law or in equity for rescission or for damages if the buyer no longer owns the security.'" *Id.* at 776.

70. *E.g.*, *Texas Capital Sec., Inc.*, 58 S.W.3d at 767.

71. TEX. REV. CIV. STAT. ANN. art. 581-33, § D(3) (Vernon 2005) (prejudgement interest), § D(6) (Vernon 2005) (costs), § D(7) (Vernon 2005) (attorney's fees); Dempsey-Tegeler & Co. v. Flowers, 465 S.W.2d 208, 219 (Tex. Civ. App.—Beaumont 1971), *rev'd on other grounds*, 472 S.W.2d 112 (Tex. 1971) ("It is apparent that the Legislature, in Section 33 [of the Texas Securities Act], intended to provide a specific form of legal remedy so that the amount paid, interest and exemplary damages in some instances may be recovered by the purchaser, when the provisions of the Act are not complied with by the seller."); *Siebel v. Scott*, 725 F.2d 995, 1003 n.7 (5th Cir. 1984) ("[P]unitive damages . . . are available under the Texas Securities Act."); Colvin v. Dempsey-Tegeler & Co., 477 F.2d 1283, 1291 (5th Cir. 1973) (observing that exemplary damages are allowed under Section 33A(2) of the Texas Securities Act). *But see* Quest Med., Inc. v. Apprill, 90 F.3d 1080, 1091 (5th Cir. 1996) (holding that exemplary damages are not available under the TSA).

72. The federal statute upon which the TSA was modeled was "intended to provide a heightened deterrent against sellers who make misrepresentations by rendering tainted transactions voidable at the option of the defrauded purchases regardless of whether the loss is due to the fraud or to a general market decline." Casella v. Webb, 883 F.2d 805, 809 (9th Cir. 1989).

73. 511 U.S. 164 (1994).

74. TEX. REV. CIV. STAT. ANN. art. 581-33, § F(2) (Vernon 2005).

to assert a claim under the TSA when a claim under the federal securities laws is not available.

Despite the above described advantages to a claim under the TSA, there are limited instances when the claim will not be available. Perceiving a need for federal securities laws to preempt certain class actions brought under state law, Congress passed the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[75] SLUSA provides that the federal securities claims preempt state law claims in class actions involving "covered securities."[76] Covered securities are defined in such a way that they generally only include publicly traded securities.[77] Fortunately for oil and gas investors in Texas, the circumstances under which their access to the remedies under the TSA is barred are relatively limited.

IV. CONCLUSION

As explained above, there are substantial differences between the definition of a security under federal law and the definition of a security under Texas law. In sum, the definition of a security under Texas law includes many oil and gas interests that are excluded as securities under the federal securities laws. As a consequence, the purchaser of an oil and gas interest may have a claim under the TSA but not under the federal securities laws. Even if the oil and gas interest qualifies as a security under both the federal securities laws and the TSA, an aggrieved investor would probably prefer to file a TSA claim over a federal securities claim because of the relative ease in proving a corresponding claim under the TSA.

75. 15 U.S.C. §§ 77p, 78bb (2006); Pub. L. No. 105-353, 112 Stat. 3227, 3227-33 (1998); B. Scott Daugherty, *Comment: Uncharted Waters: Securities Class Actions in Texas After the Securities Litigation Uniform Standards Act of 1998*, 31 ST. MARY'S L.J. 143, 149 (1999).

76. 15 U.S.C. § 77p(b)-(c); 15 U.S.C. § 78bb(f)(1)-(2).

77. 15 U.S.C. § 77p(f)(3); 15 U.S.C. § 77r(b)(1)-(2); 15 U.S.C. § 78bb(f)(5)(E).