IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

THOMAS L. TAYLOR, III, in his capacity as Court-appointed temporary receiver for Breitling Energy Corp. et al., Plaintiff v. ROTHSTEIN KASS & COMPANY, PLLC and BRIAN MATLOCK, Defendants.	§ § § § § § § § § § § § §	NO. 3:19-cv-01594-D

DEFENDANTS' REPLY IN SUPPORT OF
DEFENDANTS' MOTION TO DISMISS RECEIVER'S ORIGINAL COMPLAINT

E. LEON CARTER
State Bar No. 03914300
lcarter@carterarnett.com
LINDA R. STAHL
State Bar No. 00798525
lstahl@carterarnett.com
COURTNEY BARKSDALE PEREZ
State Bar No. 24061135
cperez@carterarnett.com
CARTER ARNETT PLLC
8150 N. Central Expy., Suite 500
Dallas, Texas 75206-1860
(214) 550-8188 (main)
(214) 550-8185 (facsimile)

NICOLAS MORGAN (admitted pro hac vice)
Cal. State Bar No. 166441
nicolasmorgan@paulhastings.com
THOMAS ZACCARO (admitted pro hac vice)
Cal. State Bar No. 183241
thomaszaccaro@paulhastings.com
PAUL HASTINGS LLP
515 South Flower Street, Twenty-Fifth Floor
Los Angeles, CA 90071
(213) 683-6000 (main)
(213) 627-0705 (facsimile)

Attorneys for Defendants
ROTHSTEIN, KASS & COMPANY, PLLC and BRIAN MATLOCK

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

Cases

TABLE OF AUTHORITIES
(continued)

Page(s)

Statutes

TABLE OF AUTHORITIES
(continued)

Page(s)

Other Authorities

Defendants Rothstein Kass & Company, PLLC ("Rothstein Kass") and Brian Matlock ("Matlock") (together, the "Defendants"), through undersigned counsel, hereby reply to the Receiver's Response and Brief in Opposition to Defendants' Rothstein Kass & Company and Brian Matlock's Motion to Dismiss the Receiver's Original Complaint.

I. LEGAL ANALYSIS

A. The Receiver's Professional Negligence Claim Is Not Subject to Equitable Tolling

Defendants moved to dismiss the Receiver's professional negligence claim (Count I) because it was brought after the two-year statute of limitations for professional malpractice. Tex. Civ. Prac. & Rem. Code Ann. § 16.003(a); *see also Won Pak v. Harris*, 313 S.W.3d 454, 459 (Tex. App.—Dallas 2010, pet. denied). The Receiver does not dispute that the claim was untimely, but contends that the statute of limitations was tolled while the Breitling entities were under the control of Christopher Faulkner ("Faulkner"), the former President and Chief Executive Officer of two private companies, Breitling Oil & Gas Corporation ("BOG") and Breitling Royalties Corporation ("BRC"). (Receiver's Original Complaint (Dkt. No. 1) ("Complaint"), ¶ 13.) The Receiver contends that the receivership entities themselves are innocent of wrongdoing and cannot have intended to violate the law or deceive investors. *See Janvey v. DSCC*, 712 F.3d 185, 190-92 (5th Cir. 2013). However, as this Court has previously acknowledged, well-established Fifth Circuit and Texas law requires a principal's knowledge to be imputed to a company he controls (even for fraudulent purposes) when the principal *acts for the benefit of the company*. *Reneker v. Offill*, No. 3:08-CV1394-D, 2012 WL 2158733, at *10, 11 (N.D. Tex. June 14, 2012) (Fitzwater, C.J.) (*citing FDIC v. Ernst & Young*, 967 F.2d 166, 170-71 (5th Cir. 1992)). As the Fifth Circuit in *Ernst & Young* explained:

> In Texas, whether an employee's fraud is attributable to a corporation depends on whether the fraud was on behalf of the corporation or against it:

> Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims; their equities vis-a-vis a careless or reckless auditor are therefore strong. ***But the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud*** ... But the primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by outsiders to the corporation, and ***the stockholders should not be allowed to escape all responsibility for such a fraud, as they are trying to do in this case.***

Id. at 170-71 (alteration in original) (emphasis added) (*quoting Greenstein, Logan & Co. v. Burgess Mktg., Inc*., 744 S.W.2d 170, 190–91 (Tex. App.—Waco 1987)). According to the Receiver's Complaint, Faulkner's actions repeatedly benefitted the Breitling entities:

- Because BOG kept the difference between the total amount of money they raised from purchaser of oil and gas interests on each offering and the actual costs of drilling and completing any wells, this gross inflation of the AFEs by Faulkner ensured ***that Breitling would pocket millions of dollars in inflated profits*** from unwitting purchasers; (Complaint, ¶ 17 (emphasis added))

- During the BOG Phase, [before the merger] BOG and BRC raised approximately $81.5 million in gross proceeds from purchasers. During this period, Faulkner [only] misappropriated over $15 million from company coffers; (Complaint, ¶ 21)

- From December 9, 2013 through February 2016 (the "BECC Phase"), Breitling raised approximately $68.5 million in gross proceeds from purchasers of oil and gas interests. During this period, Faulkner [only] misappropriated at least $18.5 million from Breitling; (Complaint, ¶ 25)

The Receiver goes to great lengths to point out that he is pursuing claims for purchasers of oil and gas interests sold by the Breitling entities. (Complaint, ¶ 76; Receiver's Opposition to Motion to Dismiss (Dkt. No. 22) ("Opposition") at 7-8.) Apart from the Receiver's obvious lack of standing to bring such claims, the Receiver can sue only on behalf of the Receivership entities, which plainly benefitted from the fraud. "[T]he primary costs of a fraud ***on the corporation's behalf*** are borne not by the stockholders but by outsiders to the corporation . . . ." *Greenstein, Logan & Co*., 744 S.W.2d at 190–91 (emphasis added). Additionally, Faulkner, Parker Hallam

and Dustin Miller, the shareholders of BOG and BRC owned 90% of BECC, the public company. *See SEC v. Faulkner*, Case No. 3:16-cv-01735-D (N.D. Tex.)(Amended Complaint, ¶¶ 24, 32, and 37). These shareholders as owners of the entities benefitted from the Breitling fraud.

1. Ponzi Schemes Are Factually Distinct from Faulkner's Alleged Scheme

The Receiver cites to *Janvey v. DSCC*, 712 F.3d at 190-92 to support his argument that Breitling's fraud should not be attributed to the Receiver. In *Janvey*, which concerned Stanford's *Ponzi* scheme, the Court found that the Stanford corporations were the robotic tools of the scheme, and therefore, knowledge of the fraud could not be imputed to them while they were under Stanford's coercion. *Id.* at 193. *Janvey* is easily distinguished. First, as discussed above, Faulkner's actions benefitted the Breitling entities by raising more than $150 million in gross proceeds "for entities under his control." (Complaint, ¶¶ 2, 23.) Second, the defendants in *Janvey* were asserting an *in pari delicto* defense, *i.e.* that the plaintiff entity was at equal fault as a defense to fraudulent conveyance claims. *See Janvey*, 712 F.3d at 191. Rothstein Kass and Matlock have not asserted an *in pari delicto* defense in the pending Motion and do not rely upon Faulkner's knowledge to defeat the Receiver's fraudulent conveyance claims.[1] Third, the Stanford proceedings involved a *Ponzi* scheme wherein the initial investors were the parties who benefitted from the fraud. But the Breitling fraud is not a *Ponzi* scheme as the Receiver implicitly concedes. (Opposition at 7.) Here, the corporate entities—not purchasers of oil and gas interests—benefited from the fraud. *See e.g. Janvey v. Brown*, 767 F.3d 430, 442 n.67 (5th Cir. 2014) (earlier investors who received these payments will enjoy an advantage over later

[1] As discussed in the Motion to Dismiss, the fraudulent conveyance claims are barred by the statute of repose.

investors sucked into the Ponzi scheme who were not so lucky). Considered together, *Janvey* is inapplicable to the issues presented in the Motion.

2. Faulkner's Knowledge Is Imputed to the Breitling Entities Regardless of the Allegations Against Rothstein Kass

The Receiver further contends that the imputation doctrine was designed solely to benefit and protect innocent third parties. The Receiver is incorrect that the doctrine is so limited. Indeed, it has been recognized as a valid defense on numerous occasions when claims have been made against alleged wrongdoers, including accountants. *See Ernst & Young*, 967 F.2d 166 (action against accounting firm alleging negligence and breach of contract); *Greenstein, Logan & Co.*, 744 S.W.2d 190–91 (claims brought against accounting firm for failure to perform audits in accordance with generally accepted auditing standards); *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982) (claims brought against auditors for breach of contract, professional malpractice and fraud).

3. Adverse Domination Doctrine Is Inapplicable

The Receiver contends that the "adverse domination" doctrine tolled the statute of limitations against the Defendants, but has not pleaded facts sufficient to support this doctrine. The adverse domination doctrine is recognized in Texas as an equitable tolling doctrine that suspends the running of limitations while a corporation continues under the domination of the wrongdoers *when the wrongdoers are adversaries in the action at issue*. *FDIC v. Dawson*, 4 F.3d 1303, 1309-10 (5th Cir.1993); *FDIC v. Henderson*, 61 F.3d 421, 426 (5th Cir. 1995). The Fifth Circuit has further limited the application of the adverse domination doctrine to claims against corporate officers and directors. *See FDIC v. Shrader & York*, 991 F.2d 216, 227 (5th Cir. 1993) ("The FDIC has not produced any cases from Texas or this Court that extend the adverse domination doctrine beyond corporate officers and directors. Moreover, the FDIC does

not allege that Shrader and York committed intentional torts, or conspired with Adams to defraud City or Lamar.") Here the Defendants were never officers or directors of the Breitling entities. Nor has the Receiver pleaded facts sufficient to establish that Defendants committed an intentional tort or conspired with Faulkner to defraud anyone.

B. The Receiver Has Not Alleged Reliance, a Component of Causation

The Receiver has failed to identify any factual allegations in the Complaint that anyone—Faulkner, BOG, BRC, BECC, or even the Receiver himself—relied upon the financial statements audited by Rothstein Kass. Under Texas law, negligence requires proof of causation. *Lucas v. Texas Indus., Inc*., 696 S.W.2d 372, 376 (Tex. 1984). In *Ernst & Young*, 967 F.2d at 170, the Fifth Circuit determined that reliance was a critical component in causation: "a claim that reliance is not a component of causation strains credulity." If nobody relied upon the audit, then the audit could not have been a "substantial factor in bringing about the injury." *Id.; see also Craig v. Metro Bank of Dallas*, 601 S.W.2d 734, 736 (Tex. Civ. App.—Dallas 1980).

The Receiver cites to *Thabault v. Chait*, 541 F. 3d 512, 524 (3d Cir. 2008) for the proposition that filing a Form 10-K with the Securities and Exchange Commission can support a jury verdict on reliance. In *Thabault*, however, Vermont's Insurance Commissioner actually *relied on* PwC's loss reserve calculations. *Id.* at 525.[2] To be sure, the Receiver contends that Defendants' negligence damaged the Breitling entities, but the Complaint does not contain a single *factual* allegation of reliance. Realistically, the Receiver cannot make such a factual allegation. The crux of the Receiver's theory is that Faulkner defrauded purchasers of oil and gas interests for whom the Breitling entities' financial statements would have had no bearing

[2] In contrast, in *Muhl v. Ambassador Group, Inc.*, No. 28414/85 (N.Y.Sup.Ct. Sept.3, 1996), *aff'd mem. sub. nom., Muhl v. Coopers & Lybrand*, 239 A.D.2d 184, 660 N.Y.S.2d 969 (1997), which concerned the same audit, the accounting firm prevailed because the New York State Superintendent of Insurance did not rely upon the auditors' loss reserve calculations.

because these purchasers acquired interests in discrete oil and gas properties—not any stake in the Breitling entities. Audited financial statements were entirely irrelevant to the fraudulent scheme alleged by the Receiver. Because the Receiver has failed to allege any factual support for a critical element of its professional negligence claim, Count I must be dismissed.

C. The Receiver Failed to Rebut That a Statute of Repose Should Not Contain a Discovery Exception

Causes of action arising under the Texas Uniform Fraudulent Transfer Act ("TUFTA") may be extinguished under Section 24.010, which is appropriately titled, "Extinguishment of Cause of Action." The Receiver has conceded that TUFTA is a statue of repose, as opposed to a statute of limitations. (Opposition at 11.) The Receiver points to TUFTA § 24.010(a)(1) which provides that a claim "is extinguished unless" it is brought "within one year after the transfer or obligation was or *could reasonably have been discovered by the claimant . . . .*" *Id.* (emphasis added). The Receiver contends that the plain language of the statute allows for a discovery exception. As stated in the Defendants' Motion to Dismiss, this discovery exception should be given no legal effect because a discovery exception is antithetical to a statute of repose. As the Texas Supreme Court noted in *Galbraith Eng'g Consultants, Inc. v. Pochucha*, 290 S.W.3d 863, 864 (Tex. 2009):

> [s]tatutes of repose typically provide a definitive date beyond which an action cannot be filed. Unlike traditional limitations provisions, which begin running upon accrual of a cause of action, a statute of repose runs from a specified date without regard to accrual of any cause of action.

Id. (citation omitted). Given this precedent from the Texas Supreme Court regarding statutes of repose, the most appropriate reading of TUFTA § 24.010(a)(1) is that a discovery exception would be entirely inconsistent with the nature of a statute of repose. *See In re Am. Hous. Found.*, 543 B.R. 245, 260 (Bankr. N.D. Tex. 2015) (the essential function of all statutes of repose is to abrogate the discovery rule). The Receiver in his opposition simply states that the statute allows

for a discovery exception under TUFTA § 24.005(a)(1). But saying so does not rebut the Defendants' contention that such a discovery exception is inconsistent with statutes of repose. *Nathan v. Whittington*, 408 S.W.3d 870, 873 (Tex. 2013).

Alternatively, even if the discovery rule could apply, the Receiver failed to file suit within one year of the date that the claim "could reasonably have been discovered." The Receiver filed this suit on July 1, 2019. At least two events occurred at more than one year before that date that evidence when the Receiver "could reasonably have been discovered" his claim against Rothstein Kass. First, in November 2017, the former shareholders of Bering Exploration, Inc. filed suit against Rothstein Kass in Texas state court alleging violations of the Texas Securities Law, statutory fraud and common law fraud relating to the Breitling audit. *See SEC v. Faulkner*, No. 3:16-CV-1735-D, 2018 WL 5279321, at *2 (N.D. Tex. Oct. 24, 2018). Second, in his Motion for Leave to Conduct Ancillary Litigation against Rothstein Kass, the Receiver:

> reviewed extensive investigative testimony taken by the Securities and Exchange Commission and associated documentary evidence, conducted interviews of relevant persons and conducted a deposition of the Rothstein Kass principal in charge of auditing engagements for Receivership Entities.

(Dkt. No. 409 at 2). Many of those materials were attached to the SEC's motion to appoint the receiver that was filed on August 10, 2017. Therefore, the Receiver could have reasonably discovered his alleged claims against Rothstein Kass in either August or November 2017, which was more than one year before this suit was filed.

D. The Receiver's Claims for Aiding and Abetting Are in Substance Claims for Professional Malpractice

The Complaint also alleges that the Defendants aided, abetted, or participated in Faulkner's breach of fiduciary duty (Count II) or his fraudulent scheme (Count III). Both of these counts must be dismissed because they violate the Texas rule prohibiting the fracturing of

claims. The Receiver contends that the anti-fracturing rule does not limit a professional negligence suit. (Opposition at 15-16.) *See Beck v. Law Offices of Edwin J. Terry, Jr., P.C.*, 284 S.W.3d 416, 427 (Tex. App.—Austin 2009)) (*citing Deutsch v. Hoover, Bax & Slovacek, LLP*, 97 S.W.3d 179, 190 (Tex. App.—Hous. [14th Dist.] 2002)). The Receiver asserts that clients may sue professionals for malpractice as well as for separate claims including assisting another with their breach of a fiduciary duty. *See In re TOCFHBI, Inc.*, 413 B.R. 523, 534 (Bankr. N.D. Tex. 2009). However, the claimant must do more than "merely reassert the same claim for legal malpractice under an alternative label." *Duerr v. Brown*, 262 S.W.3d 63, 70 (Tex. App.—Houston [14th Dist.] 2008, no pet.). "The plaintiff must present a claim that goes beyond what traditionally has been characterized as legal malpractice." *Id.*

In this case, *all* of the Receiver's claims focus on the quality or adequacy of Rothstein Kass's audit as demonstrated by the eight discrete areas in which the Receiver alleges that the Defendants failed "to exercise the degree of care, skill and competence that reasonably competent members of their profession would exercise under similar circumstances in conducting their audit of the Audit Entities, which audit was not conducted in accordance with Generally Accepted Auditing Standards." (Complaint, ¶ 1.) The Receiver repeatedly alleges that the Defendants (i) continued to conduct the audit, (ii) failed to adjust the scope of the audit to account for potentially fraudulent activity, (iii) failed to apply heightened scrutiny in the audit, (iv) ultimately issued an unqualified audit of the Audit Entities' financial statements, and, accordingly (v) violated "their duty to exercise the ordinary care, skill, or diligence that a certified public accountant of ordinary skill and knowledge commonly possesses." (*Id.*, ¶¶ 43, 46, 55, 56, 61, 65, 70, 75.) The anti-fracturing rules apply when, as here, the gravamen of a client's complaint focuses on the quality or adequacy of the professional's representation.

Murphy v. Gruber, 241 S.W.3d 689, 692–93 (Tex. App.—Dallas 2007, pet. denied). "If the gist of a client's complaint is that the attorney did not exercise that degree of care, skill, or diligence as attorneys of ordinary skill and knowledge commonly possess, then that complaint should be pursued as a negligence claim, rather than some other claim." *Deutsch*, 97 S.W.3d at 189. Notably, in his response, the Receiver does not identify a single factual allegation that the Defendants committed something *other* than professional malpractice.

The Receiver cites Judge Godbey's opinion in *Janvey v. Proskauer Rose LLP*, No. 3:13-CV-0477-N, 2015 WL 11121540, at *5 (N.D. Tex. June 23, 2015), for the proposition that claims for aiding and abetting or participating in a breach of fiduciary duty may proceed against a law firm. The Receiver misreads the rationale offered by Judge Godbey. In *Janvey*, the court allowed the aiding and abetting claims to go forward because the claims focused on the lawyers' conduct vis-â-vis other parties—the Stanford officers and directors—as opposed to the lawyers' actions toward the plaintiff-clients themselves. *Id.* But in this case, the Receiver pursues claims solely on behalf of the Breitling entities and solely based on Rothstein Kass's conduct vis-â-vis the Breitling entities.[3]

E. The Receiver Has Not Sufficiently Pleaded a Claim for Participation in a Fraudulent Scheme

In Count III, the Receiver alleged that Defendants participated in the fraud with Faulkner. (Complaint, ¶ 89.) In the response to the motion to dismiss the Receiver has conceded that his claim is not a direct claim for fraud, but rather a joint tortfeasor claim "with the primary fraud committed by Faulkner and the other Breitling directors and officers named in the Complaint

[3] To the extent that the Receiver attempts to make claims on behalf of purchasers of oil and gas interests those claims belong to the outside purchasers and not to the Receiver. It is a well-known legal principle that a receiver can bring only those claims belonging to the entities it represents and cannot bring claims on behalf of third parties such as investors. *Reneker*, 2012 WL 2158733, at *5.

who manipulated the Breitling entities and caused them to engage in a fraudulent scheme." (Opposition at 22).) However, the Receiver still must meet the heightened pleadings requirements of Rule 9(b) of the Federal Rules of Civil Procedure for this claim. *In re Enron Corp. Secs., Derivative & "ERISA" Litig.*, 540 F. Supp. 2d 759, 799 (S.D. Tex. 2007) ("Plaintiffs have not pleaded facts, with Rule 9(b) particularity, showing that RBC made any misstatement or omission of material fact. Instead they allege that RBC's purported participation with Enron in a number of transactions in a conspiracy to defraud that may impose derivative liability on RBC for Enron's underlying fraud . . . ."); *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir.1987). The Receiver has requested leave to amend in order to clarify the Defendants' alleged participation with the Breitling fraud. Any new fraud allegations must specify the time, place, speaker, and content of any alleged misrepresentations. *See Luce v. Edelstein*, 802 F.2d 49, 54 n.1 (2d Cir. 1986).

II. CONCLUSIONS

For the foregoing reasons, Count I should be dismissed because the Receiver has failed to allege reliance by the Breitling Entities and the statute of limitations for professional negligence claims has expired. Counts II and III should be dismissed because (i) they impermissibly violate Texas' anti-fracturing rules; (ii) the Receiver has failed to allege substantial assistance; and (iii) in Texas, an aiding and abetting theory of liability may not be premised on professional negligence because it is not dangerous, deviant, or antisocial. Count III should further be dismissed to the extent it alleges without the requisite specificity that Defendants participated in fraudulent conduct. Count IV should be dismissed because the Receiver's right to bring an action for fraudulent conveyance under Texas law has been extinguished and because the Receiver has failed to allege sufficient facts to establish fraudulent conveyances.

Date: October 4, 2019

Respectfully submitted

By: */s/ Nicolas Morgan*

E. LEON CARTER
State Bar No. 03914300
lcarter@carterarnett.com
LINDA R. STAHL
State Bar No. 00798525
lstahl@carterarnett.com
COURTNEY BARKSDALE PEREZ
State Bar No. 24061135
cperez@carterarnett.com
CARTER ARNETT PLLC
8150 N. Central Expy., Suite 500
Dallas, Texas 75206-1860
(214) 550-8188 (main)
(214) 550-8185 (facsimile)

NICOLAS MORGAN (*admitted pro hac vice*)
Cal. State Bar No. 166441
nicolasmorgan@paulhastings.com
THOMAS ZACCARO (*admitted pro hac vice*)
Cal. State Bar No. 183241
thomaszaccaro@paulhastings.com
PAUL HASTINGS LLP
515 South Flower Street
Twenty Fifth Floor
Los Angeles, CA 90071
(213) 683-6000 (main)
(213) 627-0705 (facsimile)

Attorneys for Defendants
ROTHSTEIN, KASS & COMPANY, PLLC and
BRIAN MATLOCK

CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of the foregoing document has been served to all counsel of record in accordance with the Federal Rules of Civil Procedure on October 4, 2019 via ECF notification.

/s/ Nicolas Morgan
Nicolas Morgan