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October 26, 2016

False Financial Statements Not Always Actionable

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A Houston federal court recently held that neither an oil and gas company nor two of its directors were liable for federal securities fraud—and were not liable to shareholders—even though the company issued annual financial statements that (1) purportedly mischaracterized certain assets as unimpaired and (2) wrongfully overstated earnings for eight consecutive quarters.

The court said that the investors failed to allege the assets' impairment was so obvious that the characterization was no longer within the confines of the business judgment of the company. And the court also said the earnings overstatements accounted for an aggregate drop in net earnings of only 1.2% over the applicable two-year period, which the court characterized as accounting mistakes. Without accompanying false statements or other aggravating circumstances, those accounting mistakes were not actionable as securities fraud.

The background to the lawsuit against the company, Harvest Natural Resources, begins in 2006, as set forth in *Phillips v. Harvest Natural Resources, Inc.*, No. H-13-801, 2016 WL 4523849 (S.D. Tex. Aug. 25, 2016). For nearly 14 years prior, Harvest had been operating state-owned oilfields in Venezuela. But in 2006, after the Venezuela government declared all operating agreements illegal, Harvest converted its interest into a 40% ownership interest in Petrodelta, a Venezuela nationalized oil company. The conversion meant Harvest's primary source of cash going forward would be dividends issued by Petrodelta.

Not long after the conversion, however, the Venezuela government interfered to Harvest's financial detriment. The government demanded Harvest reinvest its cash into operations, oppressively taxed Harvest, reduced Harvest's dividend from $93 million in 2008 to $12.2 million in 2010. A second dividend, announced in November 2010 for another $12.2 million, was never paid. Harvest repeatedly warned its investors about these developments. Harvest's annual disclosures told investors that its primary source of income was Petrodelta dividends, that the November 2010 dividend had not been paid, that future dividend payments were not guaranteed, and that Harvest's value was being eroded by problems with Petrodelta and the Venezuelan government. Despite this outlook, however, Harvest's annual financial disclosures listed Petrodelta's unpaid dividend and Petrodelta's value as unimpaired assets.

Harvest, wanting to get out of Venezuela, announced its intent to sell its interest in Petrodelta. The news sent Harvest's stock price up 23%. In June 2012, Harvest announced it had reached an agreement to sell its interest in Petrodelta to an Indonesia nationalized company, subject to approval by both Venezuela and Indonesia.

But in February 2013, Indonesia vetoed the sale. Harvest's stock price dropped more than 40%. And a month later, in March 2013, Harvest discovered two financial errors during an annual audit. The two errors—improperly accounting for commercial paper and improperly capitalizing exploration costs—required Harvest to restate its finances between 2010 and 2012. The restatement resulted in an aggregate decline in earnings between 2010 and 2012 of approximately $650,000 (on approximately $58 million in earnings total). The auditors also expressed doubts about Harvest's ability to stay in business. Harvest's stock price dropped another 32%.

John Phillips, an investor, sued.

The court succinctly summarized what Phillips had to allege and prove in order to prevail on his securities fraud allegations:

To state a claim for securities fraud the facts in the plaintiffs' complaint must raise a strong inference that a materially false statement was made by the defendants with fraudulent intent or

scienter, and that the false statement caused the plaintiffs' loss. A strong inference is more than a permissible inference—a reasonable person must find it cogent and compelling.

In reviewing Harvest's motion to dismiss, the court reiterated the legal standard it would follow. The court: (1) accepted all of Phillips' factual allegations as true; (2) reviewed those facts collectively, not in isolation; and (3) weighed whether the scienter Phillips alleged was at least as likely as an opposing inference of non-fraudulent intent. The court concluded Phillips had not met his burden.

Regarding Harvest's alleged mischaracterization of Petrodelta's value and the Petrodelta dividend, the court emphasized Harvest's repeated warnings about Petrodelta—that Harvest's value in Petrodelta was almost completely dependent on Venezuela, that earnings were more heavily taxed and were required to be reinvested instead of being used for dividend payments, and that the sale of Harvest's interest in Petrodelta was contingent on the approval of the governments of both Venezuela and Indonesia. Phillips' allegation that Petrodelta had a bleak outlook and its value should therefore be impaired was not supported by any particular accounting rule requiring that classification and was not supported by any facts showing Petrodelta's book value against its market value. Considering Harvest valued its interest in Petrodelta at between $290 million and $360 million, and considering Harvest found a purchaser of that interest willing to pay $725 million, the court concluded Harvest's valuation was within Harvest's business judgment and was not unreasonable.

Regarding Harvest's restatement of its finances, the court held that the fact of restatement meant the statements were incorrect when made, but that not all incorrect statements are actionable. The court emphasized the aggregate change reflected in the restatements over the course of time that the restatements were made—a mere 1.2% of total earnings. The 32% drop in stock price, the court held, was not due to the restatements but instead to the cancelled sale to Indonesia of Harvest's interest in Petrodelta. Phillips did not allege facts showing Harvest acted recklessly or with intent to deceive investors. According to the court, Harvest's publication of inaccurate accounting figures, issuing of restatements, or its failure to follow generally accepted accounting principles would not alone support a finding of recklessness: "Accounting mistakes without accompanying false statements or other aggravating circumstances are not enough to infer malice. Corporations should be encouraged to revise and restate."

Finally, regarding the allegations against the individual directors, the court held that because Harvest—the company—was not liable, then neither could be its directors.

Reliance on this case is justified, but practitioners should consider other opinions that arise within the Fifth Circuit, such as *Owens v. Jastrow*, 789 F.3d 529 (5th Cir. 2015) and *In re Arthrocare Corp. Sec. Litig.*, 726 F. Supp. 2d 696 (W.D. Tex. 2010). *Owens* is a published Fifth Circuit case with a lengthy discussion on scienter, *see Owens*, 789 F.3d at 535–46, and *In re Arthrocare* includes citations to cases holding that the fact of financials needing to be restated is a sufficient basis for falsity, *see In re Arthrocare*, 726 F. Supp. 2d at 709–11.

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