

[Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— S.D.N.Y.: Accounting errors leading to a restatement by themselves not evidence of fraudulent intent, \(Jan. 12, 2022\)](#)

Securities Regulation Daily Wrap Up

[Click to open document in a browser](#)

By Jeffrey H. Brochin, J.D.

Complaint did not sufficiently plead motive and opportunity to defraud where it did not allege a concrete and personal benefit by executives to conceal a material accounting weakness.

A federal district court in New York has granted the motion to dismiss filed by the former CEO and CFOs of Gulfport Energy Corporation (Gulfport or Company) in a putative class action lawsuit brought by a shareholder who alleged that the officers defrauded investors by concealing a material weakness in the Company's accounting methodology regarding oil and gas properties. The court found that absent a showing that the officers benefitted in some concrete and personal way, the shareholder could not establish the requisite scienter to satisfy the high PSLRA threshold (*Woodley v. Wood*, January 11, 2022, Ramos, DJ).

Permissible accounting methodologies. The shareholder filed suit under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5, alleging that Gulfport and the former officers violated federal securities laws by making materially false and misleading statements concerning the manner in which they accounted for their oil and gas properties in Eastern Ohio and Central Oklahoma. The oil and gas industry faces unique accounting problems due to the non-regenerative nature of the resource, large capital requirements, and abnormally high risks. To respond to these challenges, the SEC allows two accounting methodologies: (1) the “successful efforts” approach, and, (2) the “full cost” approach, which differ in terms of how costs associated with properties are accounted for.

Gulfport used the full-cost accounting approach, as set forth in SEC Rule 4-10(c) of Regulation S-X. Ex. 1, 2018 10-K, F-9. That approach distinguishes between “proved properties” – oil and gas assets with proved reserves that can be estimated with reasonable certainty – and “unproved properties” – oil and gas assets with no proved reserves. The full-cost approach then capitalizes all costs associated with both proved and unproved properties, but later amortizes and depletes, or recognizes as an expense, the costs associated with proved properties, abandoned properties, and properties that have undergone “complete evaluation.”

Accounting errors and restatements. Gulfport issued a press release with their Q3 2019 financial statements on October 31, 2019, reporting a net loss of \$48.8 million for the three months ending September 30, 2019 and net income of \$248.4 million for the nine months ending September 30, 2019. The financial statement noted a \$35.6 million impairment of Gulfport's oil and gas properties, as well as depreciation, depletion and, after amortization, a carrying value for its oil and gas properties and equipment of approximately \$5.584 billion.

When Gulfport issued a press release with their Q4 2019 and FY 2019 financial results on February 27, 2020, they also included a restatement of the Q3 2019 financial results after management discovered “an error related to the transfer of certain unevaluated leasehold costs to the amortization base.” The same day, Gulfport further explained the accounting error, stating that ‘management determined it did not effectively design and maintain controls over the completeness and accuracy of the accounting of transfers of unevaluated capitalized costs into the amortization base for the three- and nine-month periods ending on September 30, 2019 and the 12-month period ending on December 31, 2019.’ The shareholder filed suit alleging securities fraud arising from false and misleading statements and material omissions related to the 2019 filings. The Gulfport officers filed the instant motion to dismiss.

The element of scienter. To state a claim under Section 10(b) and Rule 10b–5, a plaintiff must plead that: (1) the defendant made a material misrepresentation or omission, (2) with scienter, *i.e.*, a wrongful state of mind, (3) in connection with the purchase or sale of a security, and (4) that the plaintiff relied on the misrepresentation or omission, thereby (5) causing economic loss. In addition, the Private Securities Litigation Reform Act of 1995 (PSLRA) requires that particular allegations giving rise to a strong inference of scienter be pleaded. Plaintiffs can establish the requisite strong inference of fraudulent intent either (a) by demonstrating that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

Motive and opportunity to commit fraud. To show motive and opportunity to commit fraud, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud that is more than a generalized motive that any public for-profit company might have. To show strong circumstantial evidence of conscious misbehavior or recklessness, a plaintiff must allege conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.

The officers argued that the Complaint did not plead a motive and opportunity to defraud because it did not plead a concrete and personal benefit, rather, the shareholder merely pleaded that the officers felt pressure from shareholders to improve Gulfport’s stock and therefore had motive to conceal Gulfport’s material weakness. The court noted that such a motive has been routinely rejected by courts in the Second Circuit as sufficient to establish a motive to defraud.

Pressure not a concrete motive. In the instant case, the Complaint broadly alleged that the officers faced pressure from shareholders to improve Gulfport’s financial results and thereby protect their positions in the company from the threat of a proxy contest. The court observed that most corporate officers face these threats as part of their role, and the court was not persuaded that the shareholder press releases excerpted in the Complaint created a unique motive significant enough to satisfy the high PSLRA threshold for scienter. The court therefore concluded that the Complaint did not establish motive and opportunity to commit fraud.

Based on the foregoing, the court granted the officers’ motion to dismiss.

The case is [No.: 1:20-cv-02357-ER.](#)

Attorneys: Attorneys: Frederic Scott Fox, Sr. (Kaplan Fox & Kilsheimer LLP) for Joseph A. Rotunno. David D. Sterling (Baker Botts L.L.P.) for David M. Wood and Keri Crowell.

Companies: Gulfport Energy Corporation.

LitigationEnforcement: AccountingAuditing CorporateFinance CorporateGovernance DirectorsOfficers
FraudManipulation NewYorkNews