United States Courts
Southern District of Texas
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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE ENRON CORPORATION SECURITIES LITIGATION	Consolidated Civil Action No. H-01-3624
This Document Relates To: MARK NEWBY, et al., individually and on behalf of all others similarly situated, Plaintiffs, v. ENRON CORPORATION, et al., Defendants.	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., individually and on behalf of all others similarly situated, Plaintiffs, v. KENNETH L. LAY, et al., Defendants.	

MEMORANDUM OF LAW OF MERRILL LYNCH & CO., INC.
IN SUPPORT OF ITS MOTION FOR RECONSIDERATION
OR CERTIFICATION PURSUANT TO 28 U.S.C. § 1292(b)

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MEMORANDUM OF LAW OF MERRILL LYNCH & CO., INC. IN SUPPORT OF ITS MOTION FOR RECONSIDERATION OR CERTIFICATION PURSUANT TO 28 U.S.C. § 1292(b)

Defendant Merrill Lynch & Co., Inc. ("Merrill Lynch") respectfully submits this memorandum of law in support of its motion for reconsideration of the Court's Memorandum and Order re Secondary Actors' Motions to Dismiss, dated December 19, 2002 and entered

December 20, 2002 (the "Order"), or, alternatively, for certification of the Order for interlocutory appeal pursuant to 28 U.S.C. § 1292(b).[1]

PRELIMINARY STATEMENT

We recognize the difficult task that this Court faces in presiding over this complex and noteworthy case. The Order denying Merrill Lynch's motion to dismiss, however, appears to be based on media allegations and extrajudicial "evidence" that the Court cites throughout its opinion, rather than on the allegations of the Consolidated Complaint about Merrill Lynch. Without any allegations in the Complaint to this effect, and without any other permissible basis for considering such matters, the Order was based on, among other factors: "recent disclosures of extraordinary corporate misconduct" (Order at 64); "a plethora of revelations, investigations, evidence, indictments, guilty pleas, and confessions of widespread corporate corruption and fraud by companies, auditors, brokerage houses, and banks" (*id.* at 259); "facts unearthed in current investigations by the SEC and by prosecutors like Eliot Spitzer, the attorney general of New York" (*id.* at 262); and even an opinion by one newspaper columnist that American financial institutions pose a greater risk to the nation's economy than do terrorists (*id.* at 64 n.33). None of this was a proper basis for denying Merrill Lynch's motion to dismiss.

Indeed, with respect to Merrill Lynch in particular (as to whom there has never been an adjudication of any Enron-related issues), the Court acknowledged that "[t]he complaint fails to assert any specific facts to give rise to actual knowledge of or reckless disregard of fraud."

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[1] For convenience, Merrill Lynch is filing a single motion addressing the separate issues of reconsideration and certification. We understand that a number of other defendants are considering filing certification motions as well, and the Court may wish to defer ruling on the certification aspect of this motion until all such motions are fully submitted to the Court.

Order at 294. Nevertheless, the Order denied Merrill Lynch's motion to dismiss, noting that allegations concerning two transactions involving Merrill Lynch "have been in the news recently," *id.* at 184 n.87, and holding that "the facts asserted about these two transactions *in the news* would raise a strong inference of scienter." *Id.* at 294 (emphasis added). Allegations made in news reports but not in a complaint are not properly considered on a motion to dismiss. *See, e.g., Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1017 (5th Cir. 1996); *Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 993 F.2d 269, 272-73 (1st Cir. 1993). Even assuming *arguendo* that the Order's conclusions would follow if those allegations had been pled (they would not), the proper procedure would have been to *grant* Merrill Lynch's motion to dismiss and, if the Court saw fit, to permit plaintiffs to amend or supplement their complaint in an attempt to satisfy the pleading standard of the Private Securities Litigation Reform Act of 1995 ("PSLRA") and Fed. R. Civ. P. 9(b). Instead, based on unidentified media reports, the Order prejudged the sufficiency of allegations that have not yet been made and that Merrill Lynch has not had the opportunity to address in a motion to dismiss.

Merrill Lynch respectfully submits that the Order contains at least the following two manifest errors of law:[2]

- First, the Order improperly denied Merrill Lynch's motion based on allegations in the media that had not been alleged in the Complaint.

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[2] In basing this motion for reconsideration on the manifest errors set forth in the text, Merrill Lynch does not concede that these are the only errors in the Order, and reserves its rights to raise additional points as appropriate in later proceedings.

- Second, the Order erroneously obliterated the distinction, mandated by *Central Bank*,[3] between conduct that is actionable as a primary violation of Section 10(b) and conduct that is merely non-actionable aiding and abetting.

Merrill Lynch's motion to dismiss should have been decided based on the allegations of the Complaint and the law established by *Central Bank*. Instead, the Order considered unpled allegations and permitted a claim to proceed against a party that itself engaged in no deceptive or manipulative conduct. Accordingly, this Court should grant Merrill Lynch's motion for reconsideration and, on reconsideration, grant Merrill Lynch's motion to dismiss the Consolidated Complaint.

In the alternative, the Order should be certified for interlocutory appeal pursuant to 28 U.S.C. § 1292(b) because (i) it involves a "controlling question of law," (ii) as to which there is "substantial ground for difference of opinion," and (iii) an immediate appeal from the Order "may materially advance the ultimate termination" of this litigation. In the Order, this Court has already acknowledged that the motions to dismiss raised "a number of novel and/or controversial issues that the law has thus far not addressed or about which the courts are in substantial disagreement." Order at 5; *see also id.* ("frequently divergent case law"). Specifically, the controlling question of law here is the standard for imposing primary liability under Section 10(b) and Rule 10b-5 on secondary actors following the Supreme Court's decision in *Central Bank*. The Court rightly observed that there is "substantial disagreement" regarding the applicable law, and there is substantial ground for that disagreement given the complex interaction of the statutory and regulatory language and the "divergent case law" articulated by a

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[3] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

number of different courts. Moreover, in the circumstances here, immediate appellate review of this issue may materially advance the ultimate termination of this case. Clearly, dismissal of plaintiffs' claims against Merrill Lynch and all or some of the other "secondary actors" will simplify and shorten both the discovery process and trial, and thereby "materially advance the ultimate termination of the litigation." Discovery in this case will be extremely extensive and complex. *See, e.g.*, Order at 294 (this case involves "an extraordinarily complex scheme that even experts are struggling to decipher"). Trial will be equally complicated, as claims against some 75 defendants – many of whom are sued on complex financial transactions that are unique to that defendant – will be presented to a jury of laypersons. Thus, any significant simplification of the issues – such as would occur by eliminating claims against "secondary actors" who are sued solely for participating in legitimate transactions that Enron allegedly misrepresented in its financial statements – will materially advance the termination of this litigation. For these reasons, certification to the Fifth Circuit is appropriate.

ARGUMENT

I.

THE COURT SHOULD RECONSIDER ITS ORDER AND DISMISS THE CLAIMS AGAINST MERRILL LYNCH

A motion to reconsider, when made within ten days after the entry of an order, is treated like a motion to alter or amend a judgment pursuant to Fed. R. Civ. P. 59(e). *See Krim v. Pcorder.com, Inc.*, No. A-00-CA-776-SS, 2002 WL 31873385, at *2 (W.D. Tex. Dec. 16, 2002); *see also Resolution Trust Corp. v. Gaudet*, Nos. Civ. A. 92-2661, Civ. A. 95-1929, 1996 WL 125591, at *2 (E.D. La. March 19, 1996). "A motion under Rule 59(e) may be granted to correct manifest errors of law or fact upon which the judgment is based, to allow the moving party to present newly discovered evidence, to prevent manifest injustice, or to recognize an intervening

change in controlling law." *Great Pines Water Co. v. Liqui-Box Corp.*, 962 F. Supp. 990, 991 (S.D. Tex. 1997).

Here, reconsideration is warranted because of manifest errors of law contained in the Order.

A. The Order Erroneously Based the Denial of Merrill Lynch's Motion on Media Allegations that Were Not Alleged in the Complaint

The permissible scope of matters to be considered on a motion to dismiss is well-established and quite limited. "Normally, in deciding a motion to dismiss for failure to state a claim, courts must limit their inquiry to the facts stated in the complaint and the documents either attached to or incorporated in the complaint." *Lovelace*, 78 F.3d at 1017; *see also Spivey v. Robertson*, 197 F.3d 772, 774 (5th Cir. 1999) ("This court will not look beyond the face of the pleadings to determine whether relief should be granted based on the alleged facts."); *Martin v. Morgan Drive Away, Inc.*, 665 F.2d 598, 602 n.1 (5th Cir. 1982) ("the court could not look beyond the face of the pleadings"); *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 881 (S.D. Tex. 2001) ("usually a court limits its review under a Rule 12(b)(6) motion to the facts stated in the complaint . . ., or it converts the motion to one for summary judgment under Rule 56, with notice to the parties and an opportunity to be heard"); *Porter v. Shearson Lehman Bros. Inc.*, 802 F. Supp. 41, 52 (S.D. Tex. 1992) ("it is reversible error for the district court to consider outside matter without converting the motion to dismiss into a motion for summary judgment"); 5A Charles Alan Wright & Arthur R. Miller, *Federal Practice & Procedure* § 1366 & n.20 (2d ed. 1990) (citing cases).

The limited exception to this established rule is that "courts may also consider matters of which they may take judicial notice." *Lovelace,* 78 F.3d at 1017-18. The Fifth Circuit in *Lovelace* adopted the Second Circuit's holding in *Kramer v. Time Warner Inc.,* 937 F.2d 767,

774 (2d Cir. 1991), that courts may take judicial notice of relevant public disclosures required to be filed and actually filed with the SEC "only for the purpose of determining what statements the documents contain, not to prove the truth of the documents' contents." *Id.* at 1018.[4] In addition, this Court has held that it may "also take judicial notice of stock prices and documents of public record," such as prior court orders. *BMC Software*, 183 F. Supp. 2d at 882. To our knowledge, no court has ever denied a motion to dismiss on the ground that it can assume the truth of unpled allegations in the media.

In denying Merrill Lynch's motion to dismiss, the Order went far beyond the allegations and documents appropriately considered on a motion to dismiss. The Order made reference to allegations concerning two transactions involving Merrill Lynch that "the Consolidated Complaint does not mention" but "that have been in the news recently." Order at 184 n.87. The Order held that the facts asserted "in the news" about these transactions would raise a strong inference of scienter and, on that basis, the Order denied Merrill Lynch's motion to dismiss, requiring only that plaintiffs "supplement" their claims to include one or both of the transactions. *Id.* at 294. Absent consideration of the allegations "in the news," the Court held, "[t]he complaint fails to assert any specific facts to give rise to actual knowledge of or reckless disregard of fraud." *Id.*

It was clear error to deny Merrill Lynch's motion to dismiss based on facts not pled in the Complaint nor contained in documents either attached to or incorporated in the Complaint.

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[4] In *Lovelace*, the Fifth Circuit observed that the Second Circuit had "stress[ed] that our holding relates to public disclosure documents required by law to be filed, and actually filed, with the SEC, *and not to other forms of disclosure* such as press releases or announcements at shareholder meetings." 78 F.3d at 1018 n.1 (quoting *Kramer*, 937 F.2d at 774) (emphasis added).

Although plaintiffs alluded to one of the transactions in their memorandum in opposition to Merrill Lynch's motion to dismiss, "it is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss." *BMC Software*, 183 F. Supp. 2d at 915; *see also Portannese v. Donna Karan Int'l, Inc.*, No. 97-CV-2011, 1998 WL 637547, at *20 (E.D.N.Y. Aug. 14, 1998) ("In their brief in opposition to the motion to dismiss the § 10(b) and Rule 10b-5 claim, the Subclass plaintiffs argue that DKI also benefited from the fraudulent scheme because by inflating its third quarter operating results, the company was able to obtain financing under better terms and conditions than it otherwise would have been able to secure. *Once again, this assertion cannot provide a basis for denying defendants' motion to dismiss because the [complaint] contains no such allegation.*") (emphasis added). The other transaction involving Merrill Lynch that was referred to in the Order was mentioned nowhere in plaintiffs' court papers, much less in the Complaint.

Moreover, the Court could not take judicial notice of the media reports because the facts surrounding the two transactions are subject to dispute. *See Hardy v. Johns-Manville Sales Corp.*, 681 F.2d 334, 347 (5th Cir. 1982) ("[J]udicial notice applies to self-evident truths that no reasonable person could question, truisms that approach platitudes or banalities."); *Hennessy v. Penril Datacomm Networks, Inc.*, 69 F.3d 1344, 1354 (7th Cir. 1995) ("In order for a fact to be judicially noticed, indisputability is a prerequisite."); *Cofield v. Alabama Pub. Serv. Comm'n*, 936 F.2d 512, 517 (11th Cir. 1991) ("That a statement of fact appears in a daily newspaper does not of itself establish that the stated fact is 'capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.'") (quoting Fed. R. Evid. 201(b)(2)). In addition, the Court failed to give Merrill Lynch notice that it had decided to consider materials outside the pleadings. *See* Fed. R. Evid. 201(e) ("A party is entitled upon timely request to an

opportunity to be heard as to the propriety of taking judicial notice and the tenor of the matter noticed."); *Cooperativa de Ahorro*, 993 F.2d at 273 (citing cases); 21 Charles Alan Wright & Kenneth W. Graham, Jr., *Federal Practice & Procedure: Evid.* § 5107 (1990) ("[T]he judge must notify the parties that he is taking judicial notice of an adjudicative fact . . . [because] the Constitution requires that a party be informed when the court is noticing facts."). This lack of notice was unfair to Merrill Lynch because Merrill Lynch has not had the opportunity to be heard on a motion to dismiss claims based on a set of definite and well-pleaded facts as to the two transactions.

Similar circumstances were presented in *Cooperativa de Ahorro*. There, in considering a motion to dismiss, the district court relied upon materials outside the pleadings, including "national press reports" and "articles in the national press" that had been "submitted by neither party." 993 F.2d at 272. "In relying on these extraneous materials, the district court gave the parties neither notice nor opportunity to be heard, nor did it convert the proceeding to one for summary judgment." *Id.* at 273. Under these circumstances, the First Circuit reversed the lower court, holding that "the district court's use of scattered press reports to take judicial notice of an adjudicative fact was beyond the proper scope of judicial notice." *Id.*; *see also Ericson v. City of Meriden*, 113 F. Supp. 2d 276, 283 (D. Conn. 2000) (refusing to consider newspaper article and report of findings issued by State of Connecticut's Commission on Human Rights and Opportunities in connection with Rule 12(b)(6) motion to dismiss because materials outside the pleadings cannot be considered).

Explaining its consideration of news reports in addition to the allegations in plaintiffs' Complaint, the Order stated that "Lead Plaintiff was required without any discovery to file its consolidated complaint on an expedited schedule." Order at 294. This justification is

unavailing. First, nothing required Lead Plaintiff to name Merrill Lynch as a defendant in the Consolidated Complaint filed on April 8, 2002. The schedule established by the Court provided an opportunity for plaintiffs to join new parties as defendants later in the case, *see* Scheduling Order, dated February 28, 2002 (Docket #326), at 5, and Lead Plaintiff has recently indicated its intention to do just that, assuming that its further diligence supports the bringing of claims against such additional defendants. *See* The Regents of the University of California's Motion to Modify Pretrial Scheduling Order, dated December 12, 2002 (Docket #1189), at 2 ("Lead Plaintiff has investigated potential claims against parties presently unnamed in this action. To preserve litigant and judicial resources, The Regents seeks to determine whether to bring those claims only after further investigation and the initiation of formal discovery."). Lead Plaintiff could have been just as careful before filing claims against Merrill Lynch, yet it opted to charge forward with allegations that, this Court has effectively held, fail to state a viable Section 10(b) claim against Merrill Lynch.

Second, the absence of discovery is no justification for relaxing the pleading standards or considering factual allegations outside the pleadings. The PSLRA and its discovery stay "clearly contemplates that 'discovery should be permitted in securities class actions *only after the court has sustained the legal sufficiency of the complaint.*'" *SG Cowen Sec. Corp. v. United States District Court*, 189 F.3d 909, 912-13 (9th Cir. 1999) (quoting S. Rep. No. 104-98, at 14 (1995)) (emphasis added by court). "Directly put, the who, what, when, and where must be laid out *before* access to the discovery process is granted." *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997). Thus, in almost every securities fraud case, the plaintiff is required to attempt to plead its claims without the benefit of discovery. This case is no different.

The express language of the PSLRA provides that the Court "*shall* . . . dismiss the complaint" if the pleading requirements are not met. 15 U.S.C. § 78u-4(b)(3)(A) (emphasis added); *see also* Order at 15 ("If the facts are not pled with the requisite particularity, *the action is to be dismissed.*") (emphasis added); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 350 (5th Cir. 2002) ("If a complaint fails to meet the pleading requirements of the PSLRA or Rule 9(b), *the complaint must be dismissed.*") (emphasis added); *SG Cowen*, 189 F.3d at 913 (the PSLRA "*requires* the trial court to dismiss the complaint if it fails to satisfy the Act's heightened pleading standards") (emphasis added); *Kunzweiler v. Zero.Net, Inc.*, No. Civ. A. 3:00-CV-2553-P, 2002 WL 1461732, at *3 (N.D. Tex. July 3, 2002) ("The PSLRA *mandates* that the court shall dismiss a complaint on motion of any defendant if the complaint does not meet this pleading requirement.") (emphasis added).[5]

That there have been media allegations concerning Merrill Lynch subsequent to the filing of plaintiffs' Consolidated Complaint could have been considered by this Court as a ground for permitting plaintiffs to attempt to replead their claim against Merrill Lynch. It was clearly improper, however, to prejudge the sufficiency of allegations based on media reports and other extrajudicial documents that Merrill Lynch did not even have the opportunity to address in its motion to dismiss. Thus, the Court should have granted Merrill Lynch's motion to dismiss and then exercised its discretion as to whether or not to grant leave to replead. *See, e.g.*, *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 432-33 (S.D.N.Y. 2001) (where allegation was "not in the complaint" but was asserted in plaintiffs' brief in opposition to motion to dismiss,

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[5] The improper procedure employed by the Order is more than a technical, academic issue. A dismissal – even one with leave to replead – can have important substantive consequences, such as on the issue of the statute of limitations and whether an amended complaint relates back to the date of the filing of the original complaint.

court granted motion to dismiss and granted plaintiffs leave to replead). There are no exigent circumstances here that could possibly justify suspending the Federal Rules of Civil Procedure or the requirements of the PSLRA. The fact that substantial money damages are sought by plaintiffs does not mean that "the interests of justice" required denial of Merrill Lynch's motion, rather than granting the motion with leave to replead. Order at 294.

The error in prejudging the sufficiency of allegations that have not been pled is exacerbated in this case, because the heightened pleading standard of Fed. R. Civ. P. 9(b) "applies to fraudulent acts as well as fraudulent statements." *In re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2000 WL 1727377, at *5 n.2 (N.D. Cal. Sept. 29, 2000); *see also id.* ("allegations of fraudulent acts must meet the same standard as allegations of fraudulent statements"). Thus, plaintiffs would not only have had to plead details of the transactions alleged to constitute fraudulent acts by Merrill Lynch, but also to "explain why the [acts] were fraudulent." *BMC Software*, 183 F. Supp. 2d at 865 n.14 (quoting *Williams*, 112 F.3d at 177); *see also* 15 U.S.C. § 78u-4(b)(1) ("the complaint shall specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading").[6] As discussed in greater detail below, plaintiffs could not – and the Order did not – explain *why* Merrill Lynch's participation in the two transactions reported in the media constituted *fraudulent* conduct.

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[6] Even those courts that have utilized somewhat relaxed pleading standards for market manipulation claims "where the exact mechanism of the scheme is likely to be unknown to the plaintiffs" have required the plaintiffs to plead "the nature . . . of the fraudulent conduct and the roles of the defendants." *In re Blech Sec. Litig.*, 961 F. Supp. 569, 580 (S.D.N.Y. 1997) (*Blech II*); *see also* Order at 37. Thus, simply pleading the existence of transactions without allegations of *fraudulent* conduct by Merrill Lynch would be insufficient. *See In re Sterling Foster & Co., Inc., Sec. Litig.*, 222 F. Supp. 2d 216, 281 (E.D.N.Y. 2002) (dismissing claims against clearing broker alleged to have cleared trades with knowledge that prospectus omitted mention of secret agreements because complaint "does not explain how this knowledge or conduct is fraudulent").

While the Order stated that it would "address[] party-specific, concrete factual allegations against each Defendant . . . to see if Lead Plaintiff has asserted with specificity some material misrepresentation or omission, use of a deceptive device or contrivance or participation in a scheme or course of business to defraud investors," Order at 276, the Order never actually conducted such an analysis with respect to Merrill Lynch. Instead, in discussing the two transactions reported in the media, the Order merely held that "the facts asserted about these two transactions in the news would raise a strong inference of scienter." *Id.* at 294. As the Order itself noted, "scienter [is] a separate issue and not relevant to" the question of whether a defendant is a primary violator or merely an aider and abettor. Order at 60 (citing *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998)). "[W]hether [a defendant] was a primary violator rather than an aider and abettor turns on the nature of his acts, not on his state of mind when he performed them." *U.S. Envtl.*, 155 F.3d at 111. Here, in addition to relying on allegations that had never been pled, the Order never analyzed the nature of Merrill Lynch's unpled acts to explain why they constitute an alleged primary violation of Section 10(b) by Merrill Lynch.

Accordingly, if for no other reason, the Court should grant reconsideration and grant Merrill Lynch's motion to dismiss because the Order is based on manifest error in that it considered newspaper reports outside the pleadings and allegations that were not made in the Complaint.

B. The Order Has Obliterated the Distinction Between Primary Liability and Aiding and Abetting in Contravention of *Central Bank*

The Court rightfully focuses its attention on the meaning of *Central Bank* and whether the conduct alleged in this case constitutes a primary violation of Section 10(b) and Rule 10b-5, or merely aiding and abetting a violation, which is no longer actionable. Despite the Court's effort to be faithful to the Supreme Court's decision in *Central Bank*, the effect of the Order as to

Merrill Lynch is to obliterate any distinction between primary liability and aiding and abetting. For that reason, the Order constitutes manifest error and the Court should reconsider, and grant, Merrill Lynch's motion to dismiss.

Certain aspects and consequences of *Central Bank* are not in doubt. *Central Bank* makes clear (and Merrill Lynch does not dispute) that "[a]ny person," including a secondary actor, "who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191.

Central Bank dictates, however, that only conduct that is expressly prohibited by the text of Section 10(b) can suffice to violate Section 10(b) or Rule 10b-5. 511 U.S. at 177. "[T]he statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . . We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." *Id.* at 177-78; *see also Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

In the key cases on which the Court relied, primary liability has been found only where the defendant itself is alleged to have engaged in a "manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972), the defendant bank employees undertook a duty to the shareholders, and therefore acted deceptively by inducing the shareholders to sell their stock without disclosing that the bank was acting as a market maker and stood to gain financially. *Cf. Chiarella*, 445 U.S. at 230

(explaining that, in *Affiliated Ute*, "no duty of disclosure would exist if the bank merely had acted as a transfer agent"). In *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9 (1971), the seller of bonds "was duped into believing that it, the seller, would receive the proceeds," but instead the defendants misappropriated the proceeds. Similarly, in *SEC v. Zandford*, 535 U.S. 813 (2002), a broker with management discretion over a securities account allegedly engaged in deceptive conduct by engaging in unauthorized sales for his own benefit without disclosure to his customer. In *SEC v. U.S. Envtl.*, the defendant "effect[ed] the very buy and sell orders that artificially manipulated USE's stock price upward." 155 F.3d at 112. In *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997), the defendant itself made misleading statements to analysts with the intent that the analysts communicate those statements to the market. In *Blech II*, the court held that "[t]he act of clearing sham trades alone, even with scienter, is not enough" to constitute primary liability; the complaint stated a claim only insofar as it alleged that the defendant not only cleared the trades, but also "directed" or "contrived" certain allegedly fraudulent trades. 961 F. Supp. at 584.

By contrast, where the defendant's conduct itself does not involve "some element of deception," courts have found no primary liability. *See Santa Fe Indus.*, 430 U.S. at 475 (allegations of fiduciary breach without material misrepresentation, failure to disclose, or manipulative conduct did not state a claim for violation of Section 10(b) or Rule 10b-5); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 207 (3d Cir. 2001) (lawful short selling did not constitute market manipulation because it did not involve "injecting false inaccurate information into the marketplace or creating a false impression of supply and demand for the stock"), *cert. denied*, 122 S. Ct. 2588 (2002); *Splash Tech. Holdings*, 2000 WL 1727377, at *19-20 (defendants not primarily liable where they did not make a misleading statement and where

plaintiffs failed to allege adequately that defendants engaged in manipulative or deceptive insider trading); *Pegasus Holdings v. Veterinary Ctrs. of Am., Inc.*, 38 F. Supp. 2d 1158, 1163 (C.D. Cal. 1998) (dismissing complaint against "three non-speaking defendants, who have not been charged with any specific predicate acts of fraudulent behavior"); *Scone Invs., L.P. v. American Third Mkt. Corp.*, No. 97 Civ. 3802 (SAS), 1998 WL 205338, at *8-9 (S.D.N.Y. April 28, 1998) (bank was not liable even though it financed other defendants' initial purchase of shares and later directed that shares be sold and released shares from inventory, which facilitated other defendants' fraud on plaintiffs; distinguishing *Blech II* because bank participated only indirectly in sale of securities).

In the Order, the Court at times correctly recognized that primary liability can lie only where the defendant engaged in an act (whether in the form of a misrepresentation or other device, scheme, artifice, act, or practice that operates as a fraud) that itself deceives investors. The Court stated, for instance, that a complaint alleging "scheme" liability against a group of defendants is sufficient only "as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." Order at 58-59 (quoting *Cooper*, 137 F.3d at 624); *see also* Order at 272-73 ("any Defendant that *itself*, with the requisite scienter, *actively employed* a significant material device, contrivance, scheme, or artifice to defraud or *actively engaged* in a significant, material act, practice, or course of business that operated as a fraud or deceit upon any person in connection with the purchase or sale of any security may be primarily liable") (emphasis added).[7]

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[7] At other times, the Order erroneously stated that primary liability may be found when a defendant has merely "participated" in a scheme to defraud, whether or not the conduct allegedly engaged in by the defendant was itself manipulative or deceptive. Order at 30; *see*

[Footnote continued on next page]

Similarly, in accepting the SEC's test for primary liability, the Court recognized that "a person who prepares a truthful and complete portion of a document," "[e]ven assuming such a person knew of misrepresentations elsewhere in the document," "would not be liable as a primary violator." Order at 52 (quoting SEC *amicus* brief).[8] That, of course, is because the deception is the product not of the person's own draftsmanship, but of the draftsmanship or statements of others. Analogously, a person who does not himself engage in a manipulative or deceptive act would not be liable as a primary violator, even if he knows that his lawful act was part of a scheme to defraud employed by another person.

Here, Merrill Lynch is not alleged to have engaged in any manipulative or deceptive conduct at all. Rather, the most that is alleged is that Merrill Lynch engaged in lawful transactions with Enron that were later misrepresented *by Enron* in its financial statements. There is no specific allegation that Merrill Lynch's role in the unpled transactions was anything more than as a passive, routine commercial counterparty, and it is not alleged to have created,

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[Footnote continued from previous page]
also id. at 276. Indeed, the Order stated that once a party engages in any prohibited conduct with scienter, "*any alleged subsequent activity* by that party," including even silence, "necessarily becomes suspect as further *complicity in*, expansion of, and perpetuation of the alleged Ponzi scheme." *Id.* at 277 (emphasis added). That is clearly an erroneous statement of the law following *Central Bank*, and insofar as that is the standard the Order applied, it constitutes manifest error. *See Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*."). Because the Order did not expressly analyze Merrill Lynch's alleged conduct under *any* standard of primary liability (*see supra* at 13), it is unclear whether the Order applied the wrong standard or whether it misapplied the proper standard. Either way, reconsideration is warranted.

[8] Merrill Lynch does not necessarily concur with the standard adopted by the Court – *i.e.*, that a person "makes" a misrepresentation when he or she "creates" a misrepresentation, even if the misrepresentation is not attributed to the person at the time of public dissemination – but whether that test or the "bright line" test is applied is irrelevant here. Under either standard, Merrill Lynch is not alleged to have committed a manipulative or deceptive act in connection with the two transactions.

structured, or directed the alleged misstatements or the transactions themselves. There can be no primary liability in such circumstances.

Clearly, Merrill Lynch's role in the two transactions does not constitute "manipulative" conduct because, as the Court acknowledged, "manipulation" is "virtually a term of art when used in connection with securities markets and refers to practices such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Order at 11 n.8 (internal quotation marks omitted; quoting *Santa Fe Indus.*, 430 U.S. at 476); *see also Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) (manipulative devices are "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself"). Neither of the transactions alleged in the media directly affected activity in the market for Enron securities, and therefore could not constitute manipulative conduct.

Nor was Merrill Lynch's conduct in any way "deceptive." There is no allegation, nor could there be, that the transactions themselves – as opposed to Enron's disclosures – deceived any investor. For this reason, the Order's conclusory and generalized statement that "various participant Defendants . . . utiliz[ed] *fraudulent transactions*" (Order at 32 n.15 (emphasis added)) is incorrect and unsupported, at least insofar as Merrill Lynch is involved. Had Enron properly accounted for the transactions (assuming that it did not), there would have been no fraud at all. Unlike the example used by the Court and the SEC (where a person "creates" a misrepresentation that is issued by another), Merrill Lynch is not alleged to have created, drafted, reviewed, advised on, authorized, or approved the accounting treatment or disclosure of the transactions in Enron's financial statements. Merrill Lynch is not alleged to have "directed" or

"contrived" the transactions, or in any way to have caused Enron to enter into or misrepresent the transactions. *Cf. Blech II*, 961 F. Supp. at 584. Even assuming that plaintiffs could or would allege that the transactions had no economic purpose other than to fraudulently inflate Enron's financial results, mere participation in the transactions as a counterparty to Enron – without any affirmative act of deceit by Merrill Lynch – is not a violation of Section 10(b) and Rule 10b-5.

Moreover, Merrill Lynch's participation in the two transactions cannot be the basis for plaintiffs' claims because plaintiffs cannot allege that they relied upon Merrill Lynch's conduct. *Central Bank* re-emphasized that a private Section 10(b) claim requires an allegation that the plaintiffs "relied upon the [defendant's] statements or actions." 511 U.S. at 180; *see also* Order at 40. Even assuming that "[r]eliance under prongs (a) and (c) [of Rule 10b-5] can also be established by the fraud-on-the-market doctrine" (Order at 273), that doctrine is based on the hypothesis that the price of a company's stock is based on "the available material information" concerning the company. *Basic Inc. v. Levinson*, 485 U.S. 224, 241 (1988) (citation omitted). Here, there is no contention that the market ever knew of Merrill Lynch's conduct in the transactions. In fact, there is no allegation that the market knew of the transactions at all. Rather, the only information made public was the financial statement impact of the transactions, which was allegedly misrepresented by Enron. Thus, the available public information, theoretically incorporated into the price of Enron securities, was *Enron's misrepresentation*, not any conduct by Merrill Lynch. Therefore, the fraud-on-the-market theory does not suffice to establish plaintiffs' reliance on any conduct by Merrill Lynch. *See, e.g.*, *Basic*, 485 U.S. at 248 ("Any showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff . . . will be sufficient to rebut the presumption of reliance."); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 414 (5th Cir. 2001) ("a fraud-on-the-market theory

may not be the basis for recovery in respect to an alleged misrepresentation which does *not* affect the market price of the security in question").

By permitting a private right of action against a secondary actor that, at most, is accused of engaging in transactions that were themselves lawful and which played no role in the only deceptive conduct alleged (*i.e.*, drafting the allegedly misleading disclosures), the ultimate effect of the Order is to obliterate any distinction between actionable conduct and non-actionable aiding and abetting. For this reason, the Order directly conflicts with the Supreme Court's decision in *Central Bank*, as well as with Congress' decision, in amending the securities laws in 1995, to give the SEC, *but not private plaintiffs*, the right to bring an action against someone who "knowingly provides substantial assistance to another person" in violation of the federal securities laws. 15 U.S.C. § 78t(e); *see* Order at 40 n.23.

Accordingly, because there are no allegations in the Complaint or in the media that would support a finding of a primary violation of Section 10(b) or Rule 10b-5 by Merrill Lynch, the Court should grant Merrill Lynch's motion for reconsideration and, on reconsideration, grant Merrill Lynch's motion to dismiss.

II.

ALTERNATIVELY, THE COURT SHOULD CERTIFY THE ORDER FOR INTERLOCUTORY APPEAL TO THE FIFTH CIRCUIT

Certification of an order for appeal pursuant to 28 U.S.C. § 1292(b) is appropriate where (1) the order involves a controlling issue of law; (2) as to which there is substantial ground for difference of opinion; and (3) an immediate appeal may materially advance the ultimate termination of the litigation. *See* 28 U.S.C. § 1292(b); *Ichinose v. Homer Nat'l Bank*, 946 F.2d 1169, 1177 (5th Cir. 1991).

A question of law is controlling if reversal would terminate the litigation, *see Jesco Constr. Corp. v. Nationsbank Corp.*, No. CIV. A. 98-1657, 2000 WL 1251960, at *3 (E.D. La. Sept. 1, 2000), or if interlocutory reversal might save time for the district court, and time and expense for the litigants. *See West Tennessee Chapter of Associated Builders & Contractors, Inc. v. City of Memphis*, 138 F. Supp. 2d 1015, 1019 (W.D. Tenn. 2000). Further, a question of law is considered controlling if its resolution has precedential value, or if its resolution is central to a finding of liability. *See id.* at 1018-19.

Substantial ground for difference of opinion is found, *inter alia*, where there is a question regarding the scope of a recent Supreme Court opinion, *see Continental Life Ins. v. Laneco Constr. Sys., Inc.*, Civ. A. No. 94-3338, 1995 WL 468169, at *2 (E.D. La. Aug. 7, 1995), where there is no clearly controlling authority with respect to the question at issue, *see Mayo v. Hartford Life Ins. Co.*, No. Civ. A. H-01-2139, 2002 WL 1949237, at *3 (S.D. Tex. Aug. 9, 2002), or where the courts – whether in the same or different circuits – that have considered the issue have reached divergent conclusions. *See Castano v. American Tobacco Co.*, 162 F.R.D. 112, 116 (E.D. La.), *modified*, 889 F. Supp. 904 (E.D. La. 1995); *see also Petty v. Murphy Exploration & Prod. Co.*, Civ. A. Nos. 94-3203, 95-3812, 1996 WL 400861, at *1 (E.D. La. July 16, 1996) (granting certification in view of the split of opinion among competing lines of cases); *Johnson v. Washington Metro. Area Transit Auth.*, 790 F. Supp. 1174, 1180 (D.D.C. 1991) (granting certification in light of "possible intra-circuit split" and "confused" case law). Finally, substantial grounds for a difference of opinion also exist where the issue is difficult and of first impression. *See West Tennessee Chapter*, 138 F. Supp. 2d at 1019; *see also McClelland Eng'rs, Inc. v. Munusamy*, 784 F.2d 1313, 1316 & n.1 (5th Cir. 1986) (approving certification of novel

question involving the exercise of the district court's discretion), *overruled on other grounds by In re Air Crash Disaster*, 821 F.2d 1147 (5th Cir. 1987).

Lastly, certification of an interlocutory appeal advances the ultimate termination of the litigation if reversal potentially would terminate the litigation. *See Vicari Contractors, Inc. v. United States*, No. Civ. A. 92-2033, 1993 WL 293283, at *5 (E.D. La. July 23, 1993). In addition, if an immediate appeal "would best serve the interests of both the Court and the litigants in judicial economy and efficiency," courts hold that an interlocutory appeal advances the ultimate termination of the litigation, and that certification is proper. *FDIC v. Schreiner,* 892 F. Supp. 848, 859 (W.D. Tex. 1995); *see also Castano*, 162 F.R.D. at 117; *Mayo*, 2002 WL 1949237, at *3. Specifically, where, as here, a reversal on appeal would affect "the scope of discovery procedure, the length and complexity of ultimate trial, and the expenditure of time, money and effort," certification is warranted. *Atlantic City Elec. Co. v. General Elec. Co.*, 207 F. Supp. 613, 620 (S.D.N.Y.) (certifying statute of limitations question), *aff'd*, 312 F.2d 236 (2d Cir. 1962); *see also German v. Federal Home Loan Mortgage Corp.*, No. 93 Civ. 6941, 2000 WL 1006521, at *2 (S.D.N.Y. July 19, 2000) (granting certification where an appellate ruling "would greatly simplify the scope of discovery"). In this regard, "[i]nterlocutory appeal is most appropriate early in the proceedings," "where reversal would . . . relieve the parties of significant burdens." *West Tennessee Chapter*, 138 F. Supp. 2d at 1026.

Here, the three prerequisites for interlocutory appeal are clearly met. The test for primary liability under Section 10(b) following *Central Bank* and its application to assumed facts is a controlling question of law in that it will determine whether this case can proceed against Merrill Lynch and other of the secondary actors. This Court has already essentially determined that there is substantial ground for difference of opinion on this issue by observing that this case

"raises a number of novel and/or controversial issues that the law has thus far not addressed or about which the courts are in substantial disagreement." Order at 5. The Court also stated that "judicial construction of [the securities] statutes spans the full spectrum of possibilities" and includes "frequently divergent case law." *Id.*

Finally, certifying the Order for immediate interlocutory review may advance the ultimate termination of this litigation. Dismissal of plaintiffs' claims against Merrill Lynch and all or some of the other "secondary actors" will simplify and shorten discovery and trial. As the Court noted, this case involves "an extraordinarily complex scheme that even experts are struggling to decipher." Order at 294. To the extent that there is no need to explore the secondary actors' roles in these complex transactions, both discovery and trial will be easier, shorter, and less expensive for all concerned. Moreover, even if the Fifth Circuit affirms this Court's ruling on the scope of liability under Section 10(b) and Rule 10b-5, it will eliminate an element of uncertainty and thereby facilitate the possibility of settlement. Thus, immediate appeal will materially advance the termination of this litigation.

Accordingly, if the Court declines to reconsider the Order and grant Merrill Lynch's motion to dismiss, it should certify the Order for interlocutory appeal pursuant to 28 U.S.C. § 1292(b).

CONCLUSION

For these reasons, this Court should grant Merrill Lynch's motion to reconsider the Order and, on reconsideration, grant Merrill Lynch's motion to dismiss the Complaint. Alternatively, this Court should certify the Order for interlocutory appeal to the Fifth Circuit pursuant to 28 U.S.C. § 1292(b).

Dated: January 7, 2003

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the **Memorandum of Law of Merrill Lynch & Co., Inc. in Support of its Motion for Reconsideration or Certification Pursuant to 28 U.S.C. § 1292(b).** was served upon all known counsel of record by website, http: //www.esl3624.com, pursuant to the Court's Order dated August 7, 2002 (Docket No. 984), on this the **7th** day of **January, 2003**.

Please See Attached Service List

Taylor M. Hicks