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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.
AND MERRILL LYNCH, PIERCE, FENNER & SMITH INC.
IN SUPPORT OF THEIR MOTION TO DISMISS AMENDED COMPLAINT

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
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MEMORANDUM OF LAW OF MERRILL LYNCH & CO., INC.
AND MERRILL LYNCH, PIERCE, FENNER & SMITH INC.
IN SUPPORT OF THEIR MOTION TO DISMISS AMENDED COMPLAINT

Defendants Merrill Lynch & Co., Inc. ("ML & Co.") and Merrill Lynch, Pierce, Fenner & Smith Inc. ("MLPF&S" and, together with ML & Co., "Merrill Lynch") respectfully submit this memorandum of law in support of their motion, pursuant to Fed. R. Civ. P. 12(b)(6), to dismiss with prejudice plaintiffs' First Amended Consolidated Complaint for Violation of the Securities

Laws (the "Amended Complaint") as against Merrill Lynch. As explained below, plaintiffs' allegations against Merrill Lynch allege, at most, that Merrill Lynch aided and abetted securities fraud committed by Enron Corp. ("Enron"), and plaintiffs' claims are therefore barred by the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Moreover, plaintiffs have not and are unable to plead loss causation, a required element of a securities fraud claim.[1]

PRELIMINARY STATEMENT

The Amended Complaint represents plaintiffs' second attempt to plead a claim against Merrill Lynch for violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5.[2] Plaintiffs' first effort resulted in a finding by this Court that, with respect to Merrill Lynch, "[t]he complaint fails to assert any specific facts to give rise to actual knowledge of or reckless disregard of

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[1] By virtue of this motion to dismiss, discovery in this action is stayed under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(3)(B).

[2] Plaintiffs' original complaint named only ML & Co., and not MLPF&S, as a defendant. Plaintiffs now name two Merrill Lynch entities, but they lump both entities together and do not distinguish the conduct of one from the conduct of the other. For purposes of this motion to dismiss, Merrill Lynch accepts the truth of plaintiffs' allegations and assumes that all such conduct can be attributed to Merrill Lynch collectively. Merrill Lynch further recognizes that the Court has denied as premature motions for summary judgment by other defendants who contended that they were not proper parties to this litigation. *See* Order, dated May 21 and entered May 22, 2003 (Docket #1392)). Merrill Lynch reserves its rights to seek dismissal, at the appropriate time, of ML & Co. and/or MLPF&S on the ground that they are not the appropriate parties to this action. As other bank defendants have argued, however, the claim against the newly named entity, MLPF&S, is barred by the statute of limitations, because it was filed more than one year after discovery of the facts constituting the alleged violation, and does not relate back to the filing of the claim against ML & Co. because, at a minimum, plaintiffs cannot show any "mistake" about the identity of the appropriate party.

fraud." Memorandum and Order re Secondary Actors' Motions to Dismiss, dated December 19 and entered December 20, 2002 ("December 19 Order"), at 294.

Plaintiffs have now added allegations concerning Merrill Lynch's involvement as a counterparty in two transactions with Enron. Applying the test articulated by the Court in the December 19 Order, Merrill Lynch respectfully submits that the conduct alleged by plaintiffs in the Amended Complaint is, if anything, merely aiding and abetting securities fraud, and not a primary violation of Section 10(b) and Rule 10b-5. With respect to the newly added transactions, Merrill Lynch is not alleged to have knowingly or recklessly made any material misstatements or omissions, and it is not alleged to have engaged in conduct that itself was manipulative or deceptive. Rather, even as now amended and supplemented by plaintiffs, the most that Merrill Lynch is alleged to have done is to participate in transactions with Enron – which Merrill Lynch is not alleged to have designed, structured, created or proposed – that were later misrepresented *by Enron* in its financial statements. Thus, the only *fraudulent* statements or conduct on which plaintiffs allege reliance were made or undertaken by Enron. Merrill Lynch itself did not say or do anything fraudulent but, under plaintiffs' allegations, assisted Enron in Enron's fraudulent conduct. This is precisely the type of conduct that is actionable by the SEC as aiding and abetting, but not by private plaintiffs as a primary violation of Section 10(b). Indeed, just three months ago, the SEC filed a complaint against Merrill Lynch and four of its former employees based on allegations concerning two transactions that are virtually identical to the allegations concerning Merrill Lynch added by plaintiffs in their Amended Complaint. The SEC complaint charged only that Merrill Lynch aided and abetted securities fraud violations, not that Merrill Lynch committed a primary violation of the securities laws.

This conclusion is also supported by a recent decision from the Central District of California in *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003). There, certain defendants were alleged to have participated in questionable transactions with Homestore designed to permit Homestore to recognize inflated revenue. The *Homestore* court dismissed the claims against those "business partner" defendants as failing to allege a primary violation of the securities laws, holding that no post-*Central Bank* case has ever found a primary violation by an outsider with no special relationship to the company or its shareholders, and that plaintiffs' damages were caused by Homestore's misleading statements, rather than the business partners' participation in any "scheme." Here, similarly, Merrill Lynch had no special relationship to Enron or its shareholders with respect to the allegedly questionable transactions, but simply acted as a business counterparty in those transactions. And, as in *Homestore*, any damages to Enron's shareholders were caused by Enron's alleged misstatements regarding its financial results, rather than by the transactions themselves or Merrill Lynch's conduct in connection with the transactions. Thus, as in *Homestore*, Merrill Lynch did not commit a primary violation of the securities laws.

For these reasons and others described below, plaintiffs' Amended Complaint against Merrill Lynch should be dismissed with prejudice.

STATEMENT OF FACTS

A. Procedural Background

The first lawsuits in this consolidated action were filed on October 22, 2001. The suits initially named Enron, certain of its officers and directors, and its auditor, Arthur Andersen. On April 8, 2002, following the appointment of a lead plaintiff and lead counsel, plaintiffs filed their Consolidated Complaint (the "Original Complaint"), naming Merrill Lynch and several other financial institutions (among others) as defendants for the first time. As they do in their

Amended Complaint, plaintiffs' Original Complaint asserted just one claim against Merrill Lynch, alleging a violation of Section 10(b) and Rule 10b-5.

The claim against Merrill Lynch was purportedly based on Merrill Lynch's "extensive and extremely close relationship with Enron" (Orig. Compl. ¶ 735) and its particular conduct in providing investment banking services to Enron (*id.* ¶¶ 738, 745), in issuing research reports concerning Enron (*id.* ¶ 746), and in serving as placement agent for and investing in "one of the primary vehicles of the Enron fraud – the LJM2 partnership." *Id.* ¶¶ 740-42.

On May 8, 2002, Merrill Lynch and most or all of the other defendants filed motions to dismiss. Merrill Lynch's motion was fully briefed and submitted on June 24, 2002.

B. <u>The December 19 Order</u>

On December 19, 2002, this Court issued a 307-page decision addressing the motions to dismiss filed by Merrill Lynch and the other "secondary actors." The Court addressed at length the requirements for pleading a Section 10(b) claim. Among other things, the Court discussed the difference between a primary violation of Section 10(b) and conduct that merely aids and abets a violation, which under *Central Bank* is not actionable by a private plaintiff. December 19 Order at 39-64. The Court analyzed the various tests that other courts have employed for determining whether conduct constitutes a primary violation, but rejected those tests in favor of a proposal by the SEC. Under the test adopted by the Court, a person is a primary violator if he or she "creates" a misrepresentation, whether or not that person was the "initiator" of the misrepresentation, and whether or not that person signs the misrepresentation or delivers it to the public. December 19 Order at 52. However, "a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere

in the document and thus had the requisite scienter, he or she would not have created those misrepresentations." *Id.* (quoting SEC *amicus* brief).

The Court also held that claims under Section 10(b) and Rule 10b-5 "are not merely limited to the making of an untrue statement of material fact or omission to state a material fact." December 19 Order at 29. Thus, "under Rule 10b-5(a) and (c), where a group of defendants allegedly participated in the scheme to defraud the public and enrich themselves in connection with the purchase or sale of securities, 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." *Id.* at 272-73.

After discussing the applicable law and the common allegations against the defendants, the Court indicated that it would "address[] party-specific, concrete factual allegations against each Defendant whose motion to dismiss is under review 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 in connection with the purchase or sale of securities that would raise a strong inference of scienter." December 19 Order at 276-77.

With regard to the allegations against Merrill Lynch, the Court held that "[t]he complaint fails to assert any specific facts to give rise to actual knowledge of or reckless disregard of fraud." December 19 Order at 294. Having found that plaintiffs had insufficiently pled Merrill Lynch's scienter, the Court did not address whether Merrill Lynch's alleged conduct could constitute a primary violation of Section 10(b). Rather than grant Merrill Lynch's motion to

dismiss, however, the Court took notice of certain allegations concerning two transactions involving Merrill Lynch that had been reported in the press, and the Court denied Merrill Lynch's motion, "provided that Lead Plaintiff supplements its complaint." *Id.* On Merrill Lynch's motion for reconsideration, the Court clarified that, if plaintiffs amended their complaint with additional allegations concerning Merrill Lynch, "Merrill Lynch will then have an opportunity to challenge the adequacy of that new pleading through another motion to dismiss." Order, dated January 23 and entered January 27, 2003 (Docket #1238), at 3.

On May 14, 2003, plaintiffs filed their Amended Complaint. This motion focuses on the sufficiency of the new allegations as the other allegations do no more than repeat the matters previously found insufficient by the Court.

C. Allegations in the Amended Complaint Concerning Merrill Lynch

As suggested by the Court in its December 19 Order, the Amended Complaint adds allegations about two transactions that Merrill Lynch and Enron entered into near the end of 1999. Am. Compl. ¶ 742.7. Plaintiffs contend that these transactions enabled Enron to recognize profits of approximately $72 million. *Id.* Plaintiffs allege that "[n]either of the 'transactions' had any economic purpose whatsoever, other than to increase Enron's stock price and generate present and future fees for Merrill Lynch." *Id.*

1. The Nigerian Barge Transaction

In the first transaction (the "Nigerian Barge Transaction"), plaintiffs allege that Enron asked Merrill Lynch to purchase a power project involving three gas turbine power plants mounted on barges anchored off the coast of Nigeria. Am. Compl. ¶¶ 742.8-742.9. Enron allegedly needed to sell the barges before the end of 1999 so that it could book $12 million in earnings. *Id.* Plaintiffs allege, however, that "[t]he 'sale' was obviously a fake one" because Enron promised Merrill Lynch that it would be "taken out" of the transaction within six months

at a fixed rate of return. *Id.* ¶ 742.10. This promise was allegedly made in "an oral side agreement," and was not incorporated into the transaction documents. *Id.* ¶ 742.12.

Plaintiffs contend that Merrill Lynch knew that the transaction was a "sham" and that "the obvious sole purpose of the deal was to manipulate Enron's reported profits." Am. Compl. ¶ 742.10. They purport to quote from a document written by James Brown of Merrill Lynch, who wrote that the transaction presented "reputational risk" because Merrill Lynch would be participating in "Enron income stmt. manipulation." *Id.*[3]

Plaintiffs allege that on June 29, 2000, within six months from the original sale, LJM2 acquired Merrill Lynch's interest in the barges for an amount that provided the agreed-upon rate of return to Merrill Lynch. Am. Compl. ¶ 742.15.

Plaintiffs do not allege that Merrill Lynch directed or contrived the Nigerian Barge Transaction. *See* Am. Compl. ¶ 742.9 ("McMahon[, Enron's Executive Vice President,] pitched the deal to Merrill Lynch investment banker Robert Furst . . . ."). They also do not allege that Merrill Lynch participated in any way in recording the transaction in Enron's books, or that it made representations concerning the nature of the transaction to Enron's accountants or auditors (or to anyone else, for that matter). Plaintiffs also do not allege that that there was anything unlawful about Merrill Lynch investing in the barges and Enron giving a guaranty, provided that the transaction was accounted for properly (presumably, in plaintiffs' view, as a loan). *See* Am. Compl. ¶ 742.10.

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[3] In fact, the full quote from Mr. Brown's notes – which the Court can consider because it is "explicitly relied on in the complaint," *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 882 (S.D. Tex. 2001) (Harmon, J.) – states that Mr. Brown was concerned about "*aid[ing]/abet[ting]* Enron income stmt. manipulation." Declaration of Stephen M. Loftin, executed June 18, 2003 ("Loftin Decl."), Ex. A (emphasis added).

2. The Power Transactions

Plaintiffs also allege that at the end of 1999, Merrill Lynch entered into a series of power contracts with Enron extending four years into the future (referred to by plaintiffs as the "Power Swaps"), allegedly enabling Enron to recognize $60 million in profits. Am. Compl. ¶¶ 742.16, 742.20. Plaintiffs allege that, as with the Nigerian Barge Transaction, Merrill Lynch conditioned its participation in the Power Swaps on "Enron's secret agreement" to cancel the transactions after Enron reported its 1999 earnings. *Id.* ¶ 742.20.

Plaintiffs allege that in April 2000, the Power Swaps were cancelled, and Merrill Lynch received $8 million for its participation in the transaction. Am. Compl. ¶ 742.20.

Once again, plaintiffs do not allege that Merrill Lynch itself directed or contrived the Power Swaps. *See* Am. Compl. ¶ 742.17 ("Enron requested the Merrill Lynch act as a strawman . . . ."). They again do not allege that Merrill Lynch was in any way involved with recording the transaction in Enron's books, or with reviewing the correctness of Enron's accounting. Indeed, plaintiffs acknowledge that Merrill Lynch received a written acknowledgement from Enron's Chief Accounting Officer, Richard Causey, stating that Enron had not relied on Merrill Lynch for accounting advice in connection with the transactions. Am. Compl. ¶ 742.19. Once again, viewing plaintiffs' allegations in the most favorable light possible, plaintiffs allege, in essence, that Merrill Lynch participated in the Power Swaps, knowing that Enron intended to recognize income from the transactions, and knowing that Enron and Merrill Lynch planned to cancel the transaction after Enron's 1999 results were announced.

D. The SEC Complaint

Plaintiffs' allegations concerning the Nigerian Barge Transaction and the Power Swaps largely track allegations made by the SEC in a complaint filed against Merrill Lynch and four of its former employees on March 17, 2003 (the "SEC Complaint," attached as Exhibit B to the

Loftin Declaration). In the SEC Complaint, based on Merrill Lynch's participation in the Nigerian Barge Transaction and the Power Swaps, the SEC asserted four claims: (1) aiding and abetting violations of Section 10(b) and Rule 10b-5; (2) aiding and abetting violations of Section 13(a) of the Exchange Act and SEC Rules 12b-20, 13a-1 and 13a-13; (3) aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and SEC Rule 13b2-1; and (4) aiding and abetting violations of Section 13(b)(5) of the Exchange Act.

On the same day as the SEC Complaint was filed, the SEC and Merrill Lynch entered into an agreement settling the claims against Merrill Lynch without any admission of wrongdoing by Merrill Lynch.

ARGUMENT

I.

PLAINTIFFS' CLAIMS AGAINST MERRILL LYNCH ARE BARRED BY THE SUPREME COURT'S DECISION IN *CENTRAL BANK*

A. A Primary Violator Must Engage in Conduct that is Deceptive or Manipulative

The dispositive issue on Merrill Lynch's motion to dismiss the Amended Complaint is the Supreme Court's decision in *Central Bank*. *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 this issue discussed by the Court in the December 19 Order, 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, 815 (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., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998), the defendant "effect[ed] the very buy and sell orders that artificially manipulated USE's stock price upward." 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 *In re Blech Sec. Litig.*, 961 F. Supp. 569, 584 (S.D.N.Y. 1997) (*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.

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); *In re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2000 WL 1727377, at *19-20 (N.D. Cal. Sept. 29, 2000) (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); *Advanced Laser Prods., Inc. v. Signature Stock Transfer, Inc.*, No. Civ. A. 3:98-CV-1624-D, 1999 WL 222385, at *2 (N.D. Tex. Apr. 12, 1999) (defendants alleged to have "fenced" stolen securities were not primarily liable because "the acts on which [plaintiff] bases the claims do not involve the element of deception by [defendant]. Deception is required to state a cause of action under § 10(b) and Rule 10b-5."); *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 December 19 Order, this Court 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." December 19 Order at 58-59 (quoting *Cooper*, 137 F.3d at 624); *see also* December 19 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). *Accord Homestore*, 252 F. Supp. 2d at 1040 ("Those who actually 'employ' the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators.").[4]

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[4] Elsewhere, the December 19 Order 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. December 19 Order at 30; *see also id.* at 276. Indeed, the December 19 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). If this language were applied literally, it would clearly be an erroneous statement of the law following *Central Bank*. *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*."). We do not

[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." December 19 Order at 52 (quoting SEC *amicus* brief). 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.

As the December 19 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. December 19 Order at 60 (citing *SEC v. U.S. Envtl.*). "[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.

B. <u>Merrill Lynch's Alleged Conduct Was Not Manipulative or Deceptive</u>

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 transactions with Enron that were later misrepresented *by Enron* in its financial statements. Although plaintiffs assert that the transactions were "shams," there is nothing inherently fraudulent or wrongful about entering into transactions with promises by Enron to cancel or reverse the transactions; any impropriety is a result only of Enron's alleged failure to account for the transactions properly. There is no specific allegation that Merrill Lynch's role in the Nigerian Barge Transaction or

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understand that the Court's use of ambiguous language at several points in the December 19 Order was intended to announce a standard at odds with the law described above.

Power Swaps was anything more than as a passive, commercial counterparty, and it is not alleged to have created, structured, or directed the alleged misstatements or the transactions themselves. There can be no primary liability in such circumstances.[5]

Clearly, Merrill Lynch's roles in the Nigerian Barge Transaction and the Power Swaps do not constitute "manipulative" conduct because, as this Court has 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." December 19 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").

The schemes or devices involved in such cases were in and of themselves manipulative. No second step was necessary; the activities *themselves* deceived the market. This factor is critical in establishing Section 10(b) liability. The Supreme Court emphatically underscored just this point in *Central Bank*, emphasizing that there is *no* Section 10(b) liability "for acts that are

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[5] Similarly, there can be no primary liability based on Merrill Lynch's alleged role as placement agent for, and limited partner in, LJM2 because there was nothing inherently fraudulent or wrongful about the capitalization of LJM2. Rather, it was the subsequent transactions between Enron and Enron-related SPEs that in turn had dealings with LJM2 – and, more precisely, *Enron's alleged failure to account for those transactions properly* – that caused a misstatement of Enron's financial statements and the alleged harm to plaintiffs. As a throwaway, plaintiffs point to Merrill Lynch's alleged termination of analyst John Olson (an event outside the statute of limitations and apparently unrelated to any claims), even though Mr. Olson's termination had no bearing whatsoever on the alleged improper accounting by Enron in its financial statements. *See* Am. Compl. ¶¶ 742.2-742.4.

not *themselves* manipulative or deceptive within the meaning of the statute." 511 U.S. at 177-78 (emphasis added). Correlatively, as discussed above, primary liability is imposed only on the person or entity that actually engaged in the manipulative or deceptive act.

By contrast, neither of the transactions alleged here directly affected the market for Enron securities. The "deception" did not occur until Enron allegedly misreported them. There is no allegation, nor could there be, that the transactions themselves – as opposed to Enron's disclosures – deceived any investor. 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. Rather, plaintiffs allege that Enron designed the transactions and proposed them to Merrill Lynch. *See* Am. Compl. ¶¶ 742.9, 742.17. Even assuming, as we must for purposes of this motion, that "[n]either of the 'transactions' had any economic purpose whatsoever" other than to fraudulently inflate Enron's financial results (Am. Compl. ¶ 742.7), 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. Any "deception" of the market thus was the act of Enron, not of Merrill Lynch.

A recent decision by Judge Pechman in the Central District of California is directly on point, and therefore warrants an extended discussion. In that case, *In re Homestore.com, Inc. Sec. Litig.*, a number of "business partners" and "third party vendors" of Homestore.com,

including AOL Time Warner, were alleged to have engaged in "barter transactions," "buying revenues," and "triangular transactions" or "round-tripping" with Homestore that created revenue for Homestore and enabled it to meet its revenue targets. 252 F. Supp. 2d at 1022-26. The court discussed *Central Bank* at length, and dismissed the Section 10(b) and Rule 10b-5 claims against these secondary actors. The court based its decision on three grounds:

> First, the parties have not cited, and the Court is unaware of, any post-*Central Bank* case that has ever held that a simple business partner to a corporation is liable to the shareholders of that corporation for securities fraud. The Court declines the invitation to be the first. Second, no matter how a "scheme" is defined, *Central Bank* dictates that only those participants who commit "primary violations" of the securities laws may be held liable; those who merely facilitate or participate cannot. Third, in this case, the shareholders of Homestore were damaged by their reliance on statements and material omissions made by Homestore, not the "scheme" itself.

Id. at 1037-38.

The court then elaborated on each of its reasons. First, with respect to claims against an "outsider," the court stated:

> [T]he Court is unaware of any case since *Central Bank* that has ever held that outside business partners, no matter how involved they were in fraudulent transactions with a corporation, can be held liable in a private action brought by the shareholders of that company. . . .
>
> . . . . [P]ersons "outside" a corporation have been held liable as primary violators in private actions brought by shareholders of that corporation if those persons substantially and directly participated in the creation of false or misleading statements to the investing public. . . . [I]n every post-*Central Bank* case cited to the Court where an "outsider" has been held liable as a primary violator, that outsider had some type of special relationship with the corporation, *i.e.*, accountant, auditor, etc.
>
> . . . . [T]he language of the Supreme Court [in *Central Bank*] does not suggest, and the subsequent case law does not support, the notion that a business partner with no special relationship with a corporation, let alone its shareholders, can be held liable for the material misstatements or omissions of that corporation or its officers, no matter how much it assisted or participated in transactions that

> led to that statement or omission. Such a holding would broaden the scope of the securities acts so as to haul into court anyone doing business with a publically [*sic*] traded company.

Id. at 1038-39.

Second, with respect to the definition of a primary violator after *Central Bank*, the court stated:

> What is clear, however, is that *Central Bank* requires a plaintiff to allege that each and every defendant committed its own independent primary violation of securities laws in order to state a claim. . . . [O]f the many participants in a "scheme," there may be primary violators and secondary violators. Those who actually "employ" the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators. In the present case, the primary architects of the scheme are the officers of Homestore who designed and carried out the schemes to defraud. The Court holds that other actors, such as AOL and its employees who actively participated in the triangular transaction scheme, did not "employ" the scheme to defraud investors, and are therefore secondary violators. Therefore, they are "aiders and abettors" within the meaning of *Central Bank*.

Id. at 1040.

Finally, the court addressed the fact that Section 10(b) and Rule 10b-5 extend to conduct beyond the making of a material misstatement or omission:

> It is true that no "statement" is required to state a claim under Rule 10b-5 *in general*. For example, a person may be liable for a manipulative "act" or deceptive scheme that operates a fraud on another with respect to the purchase or sale of a security. *SEC v. Zandford*, 535 U.S. 813, 122 S. Ct. 1899, 1903 (2002) (broker held liable for conversion of securities from elderly person). In addition, a person may be held liable under Rule 10b-5 for insider trading, which has been considered a deceptive "device." *No. 84 Employer-Teamster v. America West*, 320 F.3d [920,] 937 [(9th Cir. 2003)]. However, in each of these examples, *it was the act or device that actually caused the damage to the injured party.*
>
> In the present case, plaintiff suffered damage through its reliance on false or misleading statements, not from the "scheme" itself. Thus, the scheme is one step removed from the injured party. *The scheme was not complete until the statement was made.* Essentially what plaintiff alleges is a scheme to make a

> deceptive statement or material omission. Yet the principal "wrong" alleged under the rule is the statement, not the scheme. Therefore, it is appropriate to require defendants in this case to be connected in some material way to the drafting of the statements made to the investing public. Here, this means the SEC filings, the press releases, the oral statements of Homestore, and the supporting statements of its auditor, Pricewaterhouse Coopers. Because plaintiff did not (and cannot) sufficiently allege that any of the business partner or third party vendor defendants substantially contributed to those statements, it cannot state a claim against those defendants for damages resulting from reliance on statements or material omissions.

Id. at 1040-41(second and third emphases added).

Here, Merrill Lynch's alleged role in connection with the Nigerian Barge Transaction and the Power Swaps is very similar to the role of AOL and the business partner and third party vendor defendants in *Homestore*. Merrill Lynch had no special relationship with Enron or its shareholders in connection with these transactions; it was simply a third party who happened to do business with Enron. To the extent there was a scheme to defraud, the scheme was dependent on Enron's conduct in (allegedly) accounting for the two transactions improperly and including this improper accounting in its publicly issued financial statements. Enron allegedly designed the transactions and employed the scheme, and Merrill Lynch, at most, participated in or facilitated Enron's scheme. The transactions themselves were not fraudulent or illegal, and the only deceptive aspect of the scheme was the allegedly misleading accounting in Enron's financial statements. As in *Homestore*, Merrill Lynch's conduct was "one step removed" from the fraudulent statements that allegedly caused plaintiffs' injury. Plaintiffs do not and cannot allege that Merrill Lynch contributed to those statements. Indeed, in connection with the Power Swaps, Enron expressly represented that Merrill Lynch had not advised on the accounting for the transaction.

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* December 19 Order at 40. Even assuming that the fraud-on-the-market doctrine could apply, 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").

As this Court observed in the December 19 Order, Congress, in amending the securities laws in 1995, decided 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* December 19 Order at 40 n.23. As noted

above, in the SEC Complaint, based on the very same transactions alleged by plaintiffs in the Amended Complaint, the SEC asserted aiding and abetting claims against Merrill Lynch, and nothing more. Because such claims are not actionable by private plaintiffs under *Central Bank*, plaintiffs' claims against Merrill Lynch must be dismissed.

Accordingly, because there are no allegations in the Amended Complaint 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 to dismiss the Amended Complaint with prejudice.

II.

PLAINTIFFS FAIL TO ALLEGE LOSS CAUSATION AGAINST MERRILL LYNCH

In addition to failing to allege a primary violation of the securities laws by Merrill Lynch, plaintiffs' claim against Merrill Lynch must also be dismissed for failure to plead that any losses they have suffered were caused by Merrill Lynch's alleged conduct. The Nigerian Barge Transaction and the Power Swaps did not become publicly known until, respectively, April and August of 2002, nearly five months and nine months after the class period ended and long after the price of Enron securities had collapsed due to the revelation of other matters. Plaintiffs never plead – and, under these circumstances, they could never prove – that their financial losses were caused by the two alleged transaction engaged in by Merrill Lynch.

Loss causation is an essential element of a claim under Section 10(b) and Rule 10b-5. *See* 15 U.S.C. § 78u-4(b)(4) ("In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."). The Fifth Circuit articulated the loss causation requirement in *Huddleston v. Herman & MacLean*, 640 F.2d 534,

549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983), where it stated:

> Causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? . . . . The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied upon by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted. *See Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting). Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.

(Citation and footnote omitted.)

Allegations that the price of a company's stock was artificially inflated due to the fraudulent conduct of the defendants are *not* sufficient to satisfy the requirement of loss causation. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447-48 (11th Cir. 1997). Rather, plaintiffs show loss causation only if they demonstrate that "this price inflation was removed from the market price of [the company's] stock, causing plaintiffs a loss." *Id.* at 1448. In *Robbins*, a group of investors brought suit under Section 10(b) and Rule 10b-5 against Koger Properties, Inc., its officers, and its independent accounting firm when the price of Koger's stock dropped following a dividend cut. *See id.* at 1445. At trial, the plaintiffs presented evidence that the accounting firm had made fraudulent statements which had inflated the price at which they purchased Koger's stock, but the alleged fraudulent statements had not been discovered until more than one year after the drop in stock price. *See id.* at 1445-46. The district court denied the accounting firm's motion for judgment as a matter of law on loss causation, but the Eleventh Circuit reversed. The Eleventh Circuit, citing *Huddleston*, held that the investors had failed to

satisfy the loss causation requirement because they did not present evidence that the artificial inflation allegedly caused by the accounting firm was removed from the market price of Koger's stock, thereby causing a loss. *See id.* at 1448-49. *See also In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680 (E.D. Pa. 2001) (loss causation not shown where "stock price never 'dropped in response to disclosure of the alleged misrepresentations'").

While *Robbins* was decided following a trial, courts have also dismissed complaints on motions to dismiss for failure to plead loss causation. *See In re Equimed, Inc. Sec. Litig.*, No. 98-CV-5374, 2000 WL 562909, at *8 (E.D. Pa. May 9, 2000) (dismissing Rule 10b-5 claim for failure to plead loss causation; "The purported class period ends in June, 1998, but the government's Medicare/CHAMPUS fraud action was not made public until late August, 1998. Plaintiffs assert that the fraud caused an inflation in Equimed's earnings; they do not allege that filing that action or public disclosure of the fraud caused the price to drop within the class period."); *see also In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d 214, 233 (D.N.J. 2002) (granting motion to dismiss where "[t]he stock price did not drop after investors first received notice" of the allegedly omitted information); *Bastian v. Petren Resources Corp.*, 681 F. Supp. 530, 536 (N.D. Ill. 1988).

Here, all that plaintiffs have pled is that the market price of Enron securities was "artificially and falsely inflated by defendants' wrongful scheme and/or false and misleading statements." Am. Compl. ¶ 997. As *Robbins* makes clear, however, this contention is insufficient to show loss causation. Nowhere in the Amended Complaint do plaintiffs allege – not even in conclusory fashion – that Merrill Lynch's alleged conduct caused them any pecuniary loss. Instead, plaintiffs claim that "Enron's stock collapsed" following Enron's announcement of a restatement of its financial results in October and November 2001, the subsequent downgrade

of Enron's credit rating, and its filing for bankruptcy protection. Am. Compl. ¶ 3; *see also id.* ¶ 66. Plaintiffs have not pled that Merrill Lynch's conduct is "in some reasonably direct, or proximate, way responsible for [their] loss." *Huddleston*, 640 F.2d at 549.

Moreover, in the present circumstances, plaintiffs' failure to plead loss causation is not merely a technical matter that can be cured by repleading. Here, as in *Robbins* and *Equimed*, the "truth" about Merrill Lynch's conduct was not publicly revealed until long after the end of the class period and Enron's bankruptcy filing. The proposed class period ended on November 27, 2001. The Nigerian Barge Transaction did not become public until it was reported in *The Wall Street Journal* on April 9, 2002. *See* Loftin Decl., Ex. C. The Power Swaps were not revealed until a *New York Times* story on August 8, 2002. *Id.*, Ex. D.

Under these circumstances, plaintiffs' claims against Merrill Lynch should be dismissed for failure to plead loss causation.

CONCLUSION

For these reasons, this Court should grant Merrill Lynch's motion to dismiss the Amended Complaint. Because plaintiffs have now had two opportunities to state a claim against Merrill Lynch, and because the conduct alleged can never suffice to constitute a primary violation of the securities laws, dismissal should be with prejudice.

Dated: June 18, 2003

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing instrument was served upon all known counsel of record by e-mail, facsimile or certified mail, return receipt requested, pursuant to the Court's Order dated April 10, 2002 (Docket No. 449), on this the **18th** day of **June, 2003**.

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