

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

----- X
IN RE ENRON CORPORATION :
SECURITIES LITIGATION :
----- X

This Document Relates To: :
MARK NEWBY, et al., individually and :
on behalf of all others similarly situated, :
Plaintiffs, :
v. :
ENRON CORPORATION, et al., :
Defendants. :

Consolidated Civil Action
No. H-01-3624

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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. :
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**REPLY MEMORANDUM OF LAW OF MERRILL LYNCH & CO., INC. AND
MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED IN FURTHER
SUPPORT OF THEIR MOTION TO DISMISS THE AMENDED COMPLAINT**

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United States Courts
Southern District of Texas
FILED

JUL 31 2003

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Michael N. Milby, Clerk of Court

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MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED IN FURTHER
SUPPORT OF THEIR MOTION TO DISMISS THE AMENDED COMPLAINT**

Defendants Merrill Lynch & Co., Inc. ("ML & Co.") and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S" and, together with ML & Co., "Merrill Lynch") respectfully submit this reply memorandum of law in support of their motion, pursuant to Fed. R. Civ. P. 12(b)(6) and 9(b), to dismiss with prejudice Plaintiffs' First Amended Consolidated Complaint for Violations of the Securities Laws (the "Amended Complaint").

PRELIMINARY STATEMENT

When all its rhetoric is put to the side, plaintiffs' Memorandum in Opposition to the Bank Defendants' Motions to Dismiss the First Amended Consolidated Complaint ("Ps' Br.") fails to address in any meaningful way the arguments put forward by Merrill Lynch in support of its motion to dismiss plaintiffs' Amended Complaint. Because plaintiffs cannot state a claim against Merrill Lynch for a primary violation of § 10(b) of the Securities Exchange Act, plaintiffs' Amended Complaint should be dismissed with prejudice.

Plaintiffs seek to evade the pleading requirements to establish a primary violation of § 10(b) set forth by this Court in its December 19 Order merely by pointing to their allegations concerning statements allegedly made by Merrill Lynch in analyst reports and offering documents for public sales of Enron securities. As this Court has already determined, however, plaintiffs' allegations concerning Merrill Lynch's statements in those reports and offering documents are "insufficient to create a strong inference of scienter" as to Merrill Lynch. December 19 Order at 294. Absent additional allegations of fraud by Merrill Lynch, plaintiffs thus cannot even plead that Merrill Lynch is primarily liable for a violation of § 10(b).

Plaintiffs' newly added allegations concerning two transactions, the Nigerian Barge Transaction and the Power Swaps, cannot satisfy the requirements of *Central Bank* and the test established by this Court in its December 19 Order to establish a primary violation of § 10(b). In their Opposition, plaintiffs have failed to identify *any* conduct by Merrill Lynch in connection with the Nigerian Barge Transaction and the Power Swaps that was itself manipulative or deceptive. Instead, plaintiffs have only alleged that Merrill Lynch *participated in* transactions that were first proposed *by Enron* and that were later misrepresented *by Enron* on its financial statements. As Merrill Lynch stated in its Opening Brief, this is precisely the type of conduct

that is perhaps actionable by the SEC as aiding and abetting, but that cannot form the basis for a private action for violation of § 10(b).

Plaintiffs have also wholly failed to demonstrate that any statements or conduct by Merrill Lynch *caused* the collapse in Enron stock and plaintiffs' alleged losses. Indeed, plaintiffs do not dispute that the Nigerian Barge Transaction and the Power Swaps were first disclosed to the public in April and August 2002, well after other allegations of fraud precipitated Enron's collapse and bankruptcy. Because plaintiffs cannot plead that Merrill Lynch's conduct was in any reasonably direct, or proximate, way responsible for plaintiffs' losses, plaintiffs cannot establish a cause of action for violation of § 10(b) against Merrill Lynch.

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

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

A. Merrill Lynch is Not Liable Under § 10(b) or Rule 10b-5(b) for Statements Made in Analyst Reports or in Offering Documents for Enron Securities.

Plaintiffs contend that Merrill Lynch, in its motion to dismiss the Amended Complaint, "utterly ignores" its supposed liability under § 10(b) and Rule 10b-5(b) for "making materially false and misleading representations to investors" through analyst reports and offering documents for public offerings by Enron. Ps' Br. at 103. In plaintiffs' view, this Court need not even determine whether plaintiffs' allegations concerning the Nigerian Barge Transaction and the Power Swaps are sufficient to state a claim for primary liability against Merrill Lynch under § 10(b) and Rule 10b-5(a) and (c) because plaintiffs' allegations concerning Merrill Lynch's alleged statements in analyst reports and offering documents--standing alone--have adequately stated a claim for a primary violation by Merrill Lynch under § 10(b) and Rule 10b-5(b).

Plaintiffs' argument misconstrues this Court's December 19 Order and its own Amended Complaint.

First, contrary to plaintiffs' contention, this Court has *not* determined that the alleged statements concerning Enron by underwriters, including Merrill Lynch, in analyst reports and offering documents are sufficient themselves to support a claim for primary liability under § 10(b). Plaintiffs' claims based on alleged misrepresentations by Merrill Lynch in analyst reports and Enron offering documents cannot be maintained because plaintiffs' failed in the Consolidated Complaint and the Amended Complaint to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Indeed, in its December 19 Order the Court acknowledged that plaintiffs' allegations contain "many" "conclusory or boiler plate allegations." *In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 692 (S.D. Tex. 2002).

With regard to alleged statements by Merrill Lynch and other secondary actors in analyst reports and offering documents, the Court stated that "a specific analysis of each statement, which would be *required* if [plaintiffs] were asserting only claims of a material misrepresentation or omission under Rule 10b-5(b)," was not necessary only because plaintiffs' original complaint focused primarily on pleading "acts, deceptive devices, contrivances, and scheme and/or course of business to defraud the public," all of which are alleged violations of Rule 10b-5(a) and (c). *Id.* at 689. Thus, it was allegations that the Court deemed to be of "direct participation" in a scheme to defraud that the Court relied on in denying the motions by many secondary actors to dismiss the original complaint. The Court did not determine that plaintiffs' allegations concerning analyst reports and offering documents are sufficient to state a claim, and indeed they are not. In fact, as to Merrill Lynch, the court expressly determined that the

Consolidated Complaint, which included the same allegations concerning analyst reports and offering documents that plaintiffs now contend are sufficient to support a claim for fraud in the Amended Complaint (but did not contain allegations concerning the Nigerian Barge Transaction or the Power Swap), "fail[ed] to assert any specific facts to give rise to actual knowledge of or reckless disregard of fraud." *Id.* at 703.¹

According to plaintiffs, Merrill Lynch is "liable to the Class for making false and misleading statements in analysts' reports written and issued by Merrill Lynch, which helped to artificially inflate the trading price of Enron's publicly traded securities." Amended Complaint ¶ 749. Plaintiffs purport to identify roughly a dozen analyst reports and two "statements to the media" dating from January 1999 to October 2001, which were allegedly devised by Merrill Lynch to inflate Enron's stock. *Id.* at ¶ 746. These allegations, however, fail to state a claim under Section 10(b).

Under Rule 9(b) and the PSLRA, plaintiffs in securities fraud actions must "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *In re BMC Software Sec. Litig.*, 183 F. Supp. 2d 860, 865 n.14 (S.D. Tex. 2001) (quoting *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997)); *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

¹ In their Opposition, Ps' Br. at 102, plaintiffs contend that this Court "recognized" that "Merrill Lynch repeatedly issued false statements about Enron and its financial condition to the market via analyst reports and securities offering documents." But this is not so, and plaintiffs do not cite to any finding--legal, factual or otherwise--of the Court for this proposition. Instead, plaintiffs cite to the portion of the Court's December 19 Order that summarizes *plaintiffs' allegations* in the Consolidated Complaint, not the Court's rulings. *Enron*, 235 F. Supp. 2d at 651 (citation to section of the Court's opinion entitled "Lead Plaintiff's Allegations in Consolidated Complaint").

misleading"). Plaintiffs' Complaint fails to satisfy this threshold pleading requirement given the "puzzle-style" pleading it employs. *See, e.g., In re Splash Tech. Holdings Inc. Sec. Litig.*, 160 F. Supp. 2d 1059, 1073-75 (N.D. Cal. 2001). With respect to the allegedly fraudulent statements issued by Merrill Lynch analysts, once again "plaintiffs have left it up to defendants and the court to try to figure out exactly what the misleading statements are, and to match the statements up with the reasons they are false or misleading." *Id.* at 1074 (quoting *In re AutoDesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 841 (N.D. Cal. 2000)).

Plaintiffs' Amended Complaint recites various statements allegedly attributable to Merrill Lynch analysts that were in some manner false or misleading. *See* Amended Complaint ¶¶ 130, 142, 147, 149, 162, 181, 201, 208, 209, 226, 228, 250, 266, 321, 362. Although plaintiffs at times quote Merrill Lynch's reports, plaintiffs never state whether the quoted portion, some portion of the quote, or the bolded portion of the quote, is allegedly false. Further, Merrill Lynch's allegedly false or misleading statements are listed together with statements attributed to all of the other defendants over periods of up to 12 months. Just as in *Splash Tech.*, plaintiffs then plead the false or misleading nature of all the defendants' statements in overarching paragraphs in which the reader is challenged to match the false statement previously alleged with the defendant and the precise "reason" that makes the statement false. *See Splash Tech.*, 160 F. Supp. 2d at 1074; Amended Complaint ¶¶ 130, 142, 147, 149, 162, 181, 201, 208, 209, 226, 228, 250, 266, 321, 362. This manner of pleading fails to give even the most basic notice to

defendants of the claims against them and, accordingly, falls well short of compliance with the requirements of the PSLRA and Rule 9(b). *See Splash Tech.*, 160 F. Supp. 2d at 1074-75.²

Second, plaintiffs' Amended Complaint fails to tie Merrill Lynch to a single Enron securities offering within the applicable limitations period. Plaintiffs allege only that Merrill Lynch served as a lead underwriter for Enron's offering of its common shares in February 1999. That offering falls more than three years before April 2002, when plaintiffs first asserted their claims against Merrill Lynch, and is thus time barred under the three year statute of limitations applicable to this action. *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991); *De La Fuente v. DCI Telecom.*, 259 F. Supp. 2d 250 (S.D.N.Y. 2003) (The "Sarbanes-Oxley Act also does not change the statute of limitations for suits filed prior to the law's passage" on July 30, 2002.). In addition, for the reasons stated in the reply memorandum of law of defendant Citigroup at 11-40, plaintiffs' claims against newly-added defendant MLPF&S are time barred.

B. Plaintiffs Fail To Allege That Merrill Lynch Engaged In Manipulative Or Deceptive Conduct With Respect To Any Alleged Scheme to Defraud.

As Merrill Lynch stated in its Opening Brief, both established case law and this Court's December 19 Order hold that primary liability for a violation of § 10(b) of the Securities

² Furthermore, the bulk of the quotations from Merrill Lynch analyst reports are merely "[v]ague optimistic statements [that] are not actionable because reasonable investors do not rely on them in making investment decisions." *Kurtzman v. Compaq Computer Corp.*, Civ. A. No. H-99-779, slip op. at 52 (S.D. Tex. Mar. 30, 2002) (Harmon, J.) (citation omitted); *see also In re Merrill Lynch & Co., Inc.*, 02 MDL 1484 (MP), 02 CV 3210 (MP), 02 CV 3321 (MP), 2003 U.S. Dist. Lexis 11005, at *54 (S.D.N.Y. June 30, 2003) (Pollack, J.) (finding that "[t]he extensive use of generalized plural nouns . . . combined with the use of vague modifiers . . . and a marked absence of named particulars--are a dead giveaway that the complaints are skirting the pleading requirements imposed by Rule 9(b) [and] the Reform Act").

Exchange Act and Rule 10b-5 can lie only where a defendant engaged in an act (whether in the form of a misrepresentation or omission, scheme, artifice, practice or device) that operates as a fraud and that itself deceives investors. *See* Opening Brief at 13; *Enron*, 235 F. Supp. 2d at 591 ("scheme" liability is sufficient where "each defendant committed a manipulative or deceptive act in furtherance of the scheme") (quoting *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)); *id.* at 693 (" . . . 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."); *In re Homestore.com Sec. Litig.*, 252 F. Supp. 2d 1018, 1040 (C.D. Cal. 2003) ("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.").

Plaintiffs have offered only conclusory statements in attempting to allege that Merrill Lynch *itself* committed a fraudulent act that deceived Enron's investors. For instance, plaintiffs state that "Merrill Lynch's conduct here was designed to create a misleading impression about Enron's financial condition," and that "Merrill Lynch's conduct in both transactions was designed to deceive." Ps' Br. at 104, 106. Elsewhere, plaintiffs contend that "Merrill Lynch, by means of these transactions, actively worked to falsify Enron's financial results to meet Wall Street expectations," and that "Merrill Lynch and Enron deliberately manipulated Enron's publicly disseminated financial statements through fraudulent transactions." *Id.* at 107, 108. But merely labeling Merrill Lynch as a participant in a "scheme to defraud" is not sufficient to allege primary liability. *See, e.g., Homestore*, 252 F. Supp. 2d at 1039 ("no matter what the definition of a 'scheme' turns out to be, *Central Bank* requires that a plaintiff allege facts that show a

primary violation of the securities laws *by each and every defendant.*") (emphasis added). Otherwise, allegations labeled as a "scheme" are in actuality no more than those of a hub and spoke conspiracy, which are clearly not actionable after *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). See *Enron*, 235 F. Supp. 2d at 591 ("It is generally agreed that *Central Bank* foreclosed a cause of action merely for conspiracy to violate § 10(b) and Rule 10b-5, in addition to aiding and abetting.") (citing *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 841 (2d Cir. 1998) ("[E]very court to have addressed the viability of a conspiracy cause of action under § 10(b) and Rule 10b-5 in the wake of *Central Bank* has agreed that *Central Bank* precludes such a cause of action.")). Nowhere, however, do plaintiffs explain, beyond conclusory allegations, how Merrill Lynch's conduct could *itself* have been fraudulent or deceptive.

It is undisputed, for instance, that Merrill Lynch had no role in structuring the transactions, or in preparing Enron's financial statements, or in advising Enron on the appropriate accounting treatment for its transactions. In fact, as plaintiffs do not dispute, Enron expressly represented that Merrill Lynch did *not* advise it on its accounting in connection with the Power Swaps. Rather, the most that is alleged is that Merrill Lynch engaged in two transactions with Enron, both in December 1999, that *Enron* proposed and later misrepresented on its financial statements.

Further, Merrill Lynch had no special relationship with Enron or its shareholders. Indeed, in its December 19 Order, the Court rejected plaintiffs "conclusory allegations asserted against all or most of the secondary actor Defendants, such as the long-term, continuous, intimate and exclusive relationships with Enron and daily interaction with Enron's top executives," as "general allegations . . . not sufficient by themselves to raise a strong inference of

scienter." *Enron*, 235 F. Supp. at 694. Conclusory allegations of this nature are, of course, insufficient to suggest a "special relationship." In both the Nigerian Barge Transaction and the Power Swaps, Merrill Lynch was simply a third party who agreed to do business with Enron--purchasing an asset and engaging in energy trading, respectively.

Federal courts have consistently refused to impose liability for a party's participation where the core of the plaintiffs' allegations, no matter how framed, are only that the defendants engaged in activity that another defendant subsequently misrepresented to the public or engaged in activity that allowed another defendant to make misrepresentations. *See, e.g., Homestore*, 252 F. Supp. 2d at 1037-42 (finding that alleging participation by business partners in sham transactions is insufficient to establish liability for a scheme to defraud); *Primavera Familienstiftung v. Askin*, No. 95 Civ. 8905 (RWS), 1996 U.S. Dist. LEXIS 12683, at *20 (S.D.N.Y. Aug. 22, 1996) (dismissing claims against brokers based on the brokers' enabling other defendants to sell interests in certain funds that were misrepresented to customers); *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 368 (1st Cir. 1994) (affirming the dismissal of federal securities fraud claims against two individual defendants and noting that merely "authoriz[ing] or acquiesc[ing] in" the making of an alleged misrepresentation does not give rise to liability under Section 10(b)); *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."); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (affirming summary judgment where the plaintiffs alleged that an outside auditor had privately and verbally approved false and misleading financial statements, knowing that those statements would be disseminated to investors and holding that allowing such a case to proceed would in effect "revive aiding and abetting liability under a

different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank*"); *In re Kendall Square Research Corp. Secs. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (rejecting liability based on the defendants' review and approval of financial statements and prospectuses and structuring of transactions that were improperly reported). Thus, failure to establish an independent violation by a defendant necessarily precludes liability, even if the plaintiff alleges participation in a scheme to defraud.³

In those few cases where primary liability has been imposed based on a party's participation in a scheme to defraud, the relevant defendant has either orchestrated the scheme or has committed a deceptive act that has independent significance apart from the issuance of allegedly false and misleading statements. In *S.E.C. v. First Jersey Securities, Inc.*, 101 F.3d 1450 (2d Cir. 1996), the court found liable the director and 100% owner of a discount broker-dealer that had committed securities fraud. The director argued that he could not be found a primary violator even if the broker-dealer was. *Id.* at 1471. The court disagreed and found the

³ Plaintiffs rely in part on *In re Lernout & Hauspie Securities Litigation*, 236 F. Supp. 2d 161 (D. Mass. 2003). This thinly reasoned case fails to recognize that in every decision addressing the scope of liability under Section 10(b) since *Central Bank*, the Supreme Court has emphasized that the statutory language of Section 10(b) requires "deceptive" conduct within the meaning of the statute. See *S.E.C. v. Zandford*, 535 U.S. 813 (2002) (specifically recognizing that a broker's selling of his customer's securities for the purpose of stealing the proceeds was not only unlawful, but also deceptive); see also *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001) (selling securities while secretly never intending to honor them is deceptive); *United States v. O'Hagan*, 521 U.S. 642 (1997) (secretly using misappropriated confidential information for trading purposes involves deception). In *Lernout* the court found liability without finding the existence of a deceptive act by the relevant defendant that had independent significance apart from the issuance by another defendant of allegedly false and misleading statements to the investing public on which the public allegedly relied and by which it supposedly was harmed. The holding in *Lernout* is erroneous and at odds with the great weight of authority on this subject, including other authority within the First Circuit. See, e.g., *In re Kendall Square*, 868 F. Supp. at 28; *Serabian*, 24 F.3d at 368.

director liable because the fraudulent scheme had been "coordinated from First Jersey headquarters" and "could only have occurred at the direction of First Jersey's upper-level management." *Id.* The court further concluded that liability was appropriate because the director "'was intimately involved in' the decisions to commit fraud and because "he *orchestrated* First Jersey's balkanization of its branches in order to keep customers in the dark." *Id.* at 1472 (emphasis added). Liability was thus appropriate because the director created and carried out the scheme to defraud even though he had not actually made misrepresentations to customers.

Likewise, in *Zanford*, the court imposed liability where the "respondent engaged in a fraudulent scheme in which he made sales of his customer's securities for his own benefit." 535 U.S. at 825. The respondent in that action had misappropriated the proceeds from sales of securities in customers' investment account. There was no question that the defendant was a primary actor. The only issue was whether the theft was "in connection with" a securities transaction, as required by Rule 10b-5, which the Court found it was. *Id.* at 825.

In addition, as stated in Merrill Lynch's Opening Brief, neither of the transactions alleged here directly affected the market for Enron securities. Plaintiffs contend that the only fact that matters is that "that the market was deceived." Ps' Br. at 107. This completely ignores the reliance requirement under Rule 10b-5 emphasized by the Supreme Court in *Central Bank* which made clear that "[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Central Bank*, 511 U.S. at 180.⁴

⁴ Indeed, the Tenth Circuit cemented the importance of the reliance element, citing it as the one factor that distinguishes primary liability from secondary liability. "The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff.

[Footnote continued on next page]

Plaintiffs' application of the "fraud-on-the-market" theory to Merrill Lynch's conduct is strained. Ps' Br. at 108. This argument ignores the dispositive fact that the market was not manipulated by these transactions, if at all, until *Enron* allegedly misreported them. The deception, if any, was not committed by Merrill Lynch, who was simply a counterparty to these transactions. Merrill Lynch cannot be held responsible, under any theory of liability under § 10(b) and Rule 10b-5, for *Enron's* alleged failure to properly account for these transactions.⁵

In sum, the essence of plaintiffs' Amended Complaint is that Merrill Lynch engaged in two transactions proposed and structured by Enron and that Enron subsequently misrepresented those transactions to the public in its financial statements. There are no allegations that Merrill Lynch orchestrated a scheme to defraud, or even any part of such a scheme, as in *First Jersey Securities*. Similarly, in contrast to *Zanford*, there are no allegations that Merrill Lynch breached some sort of duty to plaintiffs in the transaction, as no such duty exists — all apart from the fact that the defendant in *Zanford* was clearly a primary actor. Neither Merrill Lynch's participation in the Nigerian Barge Transaction or in the Power Swaps qualifies as a primary violation, and, to the extent that the transactions were used to further a scheme to defraud by Enron, *Central Bank* precludes liability based upon them. Accordingly, the Court should grant Merrill Lynch's motion to dismiss the Amended Complaint with prejudice.

[Footnote continued from previous page]

Reliance only on representations made by others cannot itself form the basis of liability." *Anixter*, 77 F.3d at 1225.

⁵ Unable to circumvent the Rule and the current case law, plaintiffs resort to the superficial argument that § 10b is "designed to be a catch-all." Plaintiffs' Brief at 109. The cases cited in support of this overarching principle, however, are pre-*Central Bank*. Even pre-*Central Bank* cases have recognized the limits of Section 10(b)'s "catchall" reach. See *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.").

II. THE AMENDED COMPLAINT SHOULD BE DISMISSED BECAUSE PLAINTIFFS FAIL TO ALLEGE LOSS CAUSATION

As discussed in Merrill Lynch's Opening Brief, plaintiffs have failed to adequately allege that Merrill Lynch's alleged conduct was the legal cause of any losses they suffered. Contrary to plaintiffs' contentions, mere allegations that a defendant's allegedly fraudulent conduct "caused the market price of the stock to be artificially inflated," Ps' Br. at 113, are not sufficient to satisfy the requirement of loss causation. As the Fifth Circuit held 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), even if plaintiffs' investment decision is induced by defendant's alleged fraud, if that fraud is not "the proximate reason for [plaintiffs'] pecuniary loss, recovery under the Rule is not permitted." *Id.*; *see also Nathenson v. Zonagen Inc.*, 267 F.3d 400, 413 (5th Cir. 2001) ("the term 'transaction causation' is used to describe the requirement that the defendant's fraud must precipitate the investment decision On the other hand, 'loss causation' refers to *a direct causal link between the misstatement and the claimant's economic loss.*") (citing *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1117-18 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989)) (emphasis added).

In their Opposition, plaintiffs attempt to cure the deficiency in their Amended Complaint by contending that they have, by implication, alleged that Merrill Lynch's conduct caused them pecuniary loss. Plaintiffs contend that Enron's collapse was caused by the exposure of "the existence of the fraudulent scheme in which Merrill Lynch was a primary actor." Ps' Br. at 112. But--even ignoring for the moment that Merrill Lynch has established in Section I above that it was not a primary actor--it is undisputed, as Merrill Lynch stated in its Opening Brief at 24, that the Nigerian Barge Transaction and the Power Swaps were not disclosed until April and August 2002, respectively, long after Enron filed for bankruptcy and the plaintiffs' putative class period

closed. Plaintiffs cannot show therefore that any price inflation even remotely related to the conduct of *Merrill Lynch* was "removed from the market price" of Enron stock, "causing plaintiffs a loss" in the Fall of 2001. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997). As a result, plaintiffs cannot establish loss causation.

Moreover, Plaintiffs' allegations regarding artificial market inflation with respect to the Nigerian Barge Transaction and the Power Swaps are demonstrably wrong. Plaintiffs allege that Enron's stock price increased 27% as a result of the Barge and the Energy Transactions in December 1999. Amended Complaint ¶ 742.22. The facts show the contrary. Enron's 1999 year end financials were announced on January 18, 2000. Enron's stock price actually *dropped* the next day from \$55.50 to \$53.50⁶. The stock price increase that plaintiffs are trying to attribute to Merrill Lynch is provably attributable to other events, namely Enron's statements at an Enron-hosted analyst conference on January 20, 2000, two days *after* Enron's announcement of its 1999 earnings. During that conference, Enron announced an agreement with Sun Microsystems that provided for accelerated development of broadband internet services. As reported by the press, Enron shares *rose 26%* based on its statements at the conference regarding the technological capabilities, value and expected financial performance of Enron's Broadband Services Business. *See* Steve Klein, *Enron Shares Soar 26% on Bandwidth Trading Plans*, Bloomberg News, Jan. 20, 2000. The statements made by Enron at the January 20 conference are now the subject of a fraud indictment by the Department of Justice against Enron executives. The indictment, which plaintiffs incorporate by reference in their Complaint, charges that

⁶ *See, e.g., Jeradi v. Mylan Labs., Inc.*, 230 F.3d 594, 600 n.3 (3d Cir. 2000)(a court ruling on a motion to dismiss may take judicial notice of New York Stock Exchange prices).

Enron's false *statements to analysts about its broadband business on January 20, 2000*, caused Enron's stock price to increase from \$54 to \$67 on January 20, and to over \$72 on January 21. See Amended Complaint ¶ 83(k) & Ex. B.

Plaintiffs also contend that Merrill Lynch's arguments concerning loss causation are "premature." But a recent decision by Judge Milton Pollack of the Southern District of New York, dismissing with prejudice pursuant to Rule 12(b)(6) a class action securities fraud complaint for failure to allege loss causation demonstrates that failure to plead loss causation can be fatal to plaintiffs' claims at the pleading stage. See *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, Master File No. 02 MDL 1484 (MP), 2003 U.S. Dist. LEXIS 11005 (S.D.N.Y. June 30, 2003) ("*24/7 Real Media, Inc.*"). See also *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, Master File No. 02 MDL 1484 (MP), 2003 U.S. Dist. LEXIS 11113, at *53 (S.D.N.Y. July 2, 2003) ("*Global Technology Fund*") (finding no loss causation because "Merrill Lynch and the Fund are not the insurers of Plaintiff's investment in a highly speculative sector of the market where the omissions complained of are not adequately alleged to have been the proximate cause of the loss" and holding that "Plaintiff's failure to plead sufficient facts to show loss causation requires dismissal of her Rule 10b-5 claims"). Similarly, here, plaintiffs have utterly failed to plead facts alleging Merrill Lynch caused their losses, as Merrill Lynch's alleged participation in the Nigerian Barge Transaction and Power Swaps was irrelevant to the dramatic drop in Enron's stock price during the putative class period.

Finally, plaintiffs' allegations that the price of Enron's stock was artificially inflated due to Merrill Lynch's fraudulent research reports also are not sufficient to allege the loss causation necessary to state a § 10(b) claim against Merrill Lynch. As Judge Pollack recently explained in

24/7 Real Media, Inc., allegations of price inflation alone are not sufficient to satisfy the loss causation requirement:

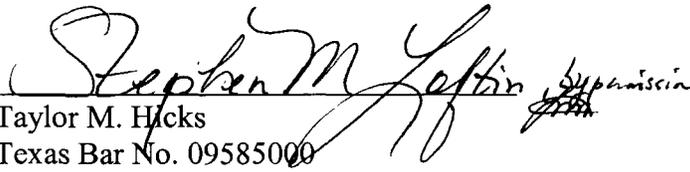
[P]laintiffs have not alleged there was any link between the alleged overly optimistic ratings and the financial troubles of 24/7 or Intereliant that led to their financial demise in the wake of the bursting bubble, nor any facts demonstrating that they were the cause.

Id. at *30-31. Judge Pollack concluded that "if merely alleging artificial inflation was sufficient, then there would be no need for any of these cases to discuss the importance of considering whether there was the presence of any intervening factors." *Id.* at *33. *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'").⁷ Plaintiffs merely allege that Merrill Lynch is "liable to the Class for making false and misleading statements in analysts' reports written and issued by Merrill Lynch, which helped to artificially inflate the trading price of Enron's publicly traded securities." Amended Complaint ¶ 749. They provide no details regarding exactly how any alleged statements by Merrill Lynch resulted in changes to Enron's stock price or how they can know that the changes were the result of Merrill Lynch's statements rather than other causes. These allegations are insufficient to satisfy the loss causation requirement of a Section 10(b) claim.

⁷ Indeed, plaintiffs' allegations of loss causation are inextricably premised on a "fraud on the market" theory. For example, plaintiffs allege that Merrill Lynch inflated trading prices through analyst reports that misled the public and caused plaintiffs' damages. Ps' Br. at 111. Plaintiffs are precluded from relying on the "fraud on the market" theory to show loss causation. As Judge Pollack states, "[t]o permit plaintiffs to allege artificial inflation through the fraud on the market theory to satisfy loss causation would improperly conflate both the 'but for' transaction causation and the loss causation elements into one." *24/7 Real Media*, 2003 U.S. Dist. Lexis 11005, at *35; *see also Robbins*, 116 F.3d at 1448.

Respectfully submitted,

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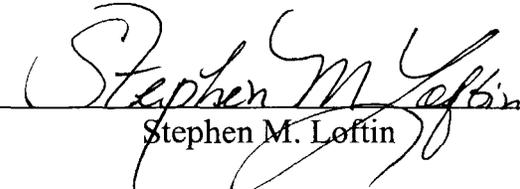
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CERTIFICATE OF SERVICE

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 **31st** day of **July, 2003**.

Please See Attached Service List


Stephen M. Loftin *by permission*

The Service List

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Office of the Clerk