United States Courts
Southern District of Texas
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Michael N. Milby, Clerk

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.	

MERRILL LYNCH'S REPLY REGARDING SUPPLEMENTAL AUTHORITY IN OPPOSITION TO LEAD PLAINTIFF'S AMENDED MOTION FOR CLASS CERTIFICATION

Defendants Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated (together, "Merrill Lynch") respectfully submit this memorandum in reply to Lead Plaintiff's Opposition to Merrill Lynch's Notice of Supplemental Authority in Opposition to Lead Plaintiff's Amended Motion for Class Certification (Docket No. 2318) ("Pl. Opp."). Lead Plaintiff fundamentally misconstrues the recent holding of *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657 (5th Cir. 2004), and misapplies it to the claims asserted against Merrill Lynch in this action.

Lead Plaintiff asserts that Merrill Lynch's Notice of Supplemental Authority in Opposition to Lead Plaintiff's Amended Motion for Class Certification (Docket No. 2286) ("ML Supp.") "ignores three critical points." Pl. Opp. at 1. However, Lead Plaintiff is simply wrong on each of these points.

First, the inquiry Merrill Lynch seeks from this Court is not – as Lead Plaintiff suggests – an "inappropriate inquiry into the merits" of plaintiffs' claims, but rather the "rigorous analysis" of the Rule 23 factors required by the Supreme Court's decision in *General Tel. Co. v. Falcon*, 457 U.S. 147, 161 (1982). Moreover, this inquiry is markedly different from the inquiry a court must make on a motion to dismiss. The court's Rule 23 inquiry is not limited to the pleadings, but requires examination of the proof the parties will offer at trial concerning each disputed claim and defense. A court must "probe behind the pleadings before coming to rest on the certification question," *General Tel. Co.*, 457 U.S. at 160, so that it may "envision the form that a trial . . . would take." *Newton v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 259 F.3d 154, 166 (3d Cir. 2001). Thus, the Committee Notes to the 2003 Amendments to Rule 23(c)(1) stress the "critical need" at the class certification stage "to determine how the case will be tried" by identifying "the nature of the issues that actually will be presented at trial" and "whether they are

susceptible of class-wide proof." Fed. R. Civ. P. 23, Advisory Committee Notes (2003). At the class certification stage, a court should "assess[] which issues will predominate" by "looking beyond the pleadings." *O'Sullivan v. Countrywide Home Loans, Inc.*, 319 F.3d 732, 738 (5th Cir. 2003). *See* Section I., below.

Second, as the Petition for Panel Rehearing by plaintiffs' counsel in *Greenberg* – which counsel also represents Lead Plaintiff here – properly recognized, *Greenberg* did not simply restate existing law regarding the fraud-on-the-market doctrine, but instead "*crafted* three bright-line rules." Petition for Panel Rehearing, at 1 (emphasis added) (attached as Exhibit B to ML Supp.). In its present opposition, Lead Plaintiff ignores the important changes wrought by *Greenberg*, and simply regurgitates this Court's statements regarding fraud-on-the-market from its decision on defendants' motions to dismiss, which were made *before* the announcement of the new rules by the *Greenberg* court and without the now-required analysis.

Moreover, contrary to Lead Plaintiff's assertion, Merrill Lynch's alleged actions in furtherance of the alleged "scheme" *were*, under *Greenberg*, merely "confirmatory." Representations that have "already been digested by the market" do not affect the price of a company's stock and cannot be the basis for a fraud-on-the-market presumption of reliance. *Greenberg*, 364 F.3d at 665-66. Furthermore, to the extent they can be considered "non-confirmatory," the fraud-on-the-market presumption of reliance is still inapplicable. The Fifth Circuit held that in order to "trigger the presumption of reliance," plaintiffs must establish (i) "*actual movement* of the stock price" which is (ii) the direct result of the particular alleged misstatement or act. *Greenberg*, 364 F.3d at 665-66 (emphasis in original). Here, Lead Plaintiff can show neither. *See* Section II., below.

Finally, Lead Plaintiff's allegation that its action against Merrill Lynch "rests principally on [Merrill Lynch's] role as a primary violator in a scheme to defraud, not on misrepresentations," Pl. Opp. at 1,[1] does not – by this Court's own ruling – absolve plaintiffs of the requirement to show reliance.[2] For the same reason, Lead Plaintiff's "scheme" allegations do not prevent the application of *Greenberg* to this action. According to the First Amended Consolidated Complaint ("Am. Compl."), Merrill Lynch's role in this "scheme" was to allow Enron to meet previously-disclosed earnings estimates (*see* Section III), the "*classic example*" of "confirmatory" statements. *Greenberg*, 364 F.3d at 668 n.16 (emphasis added). The principles espoused in *Greenberg* depend on the absence of market movement, not on whether the alleged fraud is based on misrepresentations or a so-called "scheme."

ARGUMENT

I. Inapplicability of the Fraud-on-the-Market Presumption Is An Appropriate Basis for Denying Class Certification in This Circuit.

Lead Plaintiff suggests that the fraud-on-the-market analysis for purposes of class certification is the same analysis that the Court conducted in addressing loss causation on Merrill Lynch's motion to dismiss. In ruling on the motion to dismiss, however, the Court emphasized that "loss causation is a 'practical requirement' that 'ought not place unrealistic burdens on the plaintiff *at the initial pleading stage*,'" and thus, appropriately "[v]iew[ed] the pleading in a light

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1 Tellingly, Lead Plaintiff asserts in its opposition brief that "Plaintiffs' case against Merrill Lynch is . . . that Merrill Lynch worked with Enron to inflate [its] publicly issued financial results." Pl. Opp. at 5. Thus, even by Lead Plaintiff's own theory, the "scheme" in which it alleges Merrill Lynch's participation was one to make *misrepresentations*.

2 Memorandum and Order re Secondary Actors' Motions to Dismiss, entered December 20, 2002 (Docket No. 1194) ("December 20 Order"), at 61 (to establish "primary liability as to each defendant," the plaintiff must show a "misstatement (or omission) or . . . a manipulative or deceptive act in furtherance of the alleged scheme . . . *and* . . . reliance") (emphasis added).

most favorable to Lead Plaintiff." Memorandum and Order re Merrill Lynch and Deutsche Bank Entities, entered March 29, 2004 (Docket No. 2036) ("March 29 Order"), at 16 (citation omitted; emphasis added). At the class certification stage, however, "where . . . certification is dependent on invocation of the fraud-on-the-market doctrine, the plaintiff must adduce admissible evidence" to show an entitlement to the presumption of reliance. *DeMarco v. Lehman Bros. Inc.*, No. 03 Civ. 3470 (JSR), 2004 WL 1506242, at *4 (S.D.N.Y. July 6, 2004); *see also Hevesi v. Citigroup Inc.*, 366 F.3d 70, 79 (2d Cir. 2004) (noting that a "District Court's extension of the fraud-on-the-market doctrine . . . is closely connected to its certification decision," and that the defendants "offered a substantial legal argument" that whether plaintiffs are entitled to rely on a presumption of reliance "must be thoroughly tested at the certification stage").

Indeed, courts in this Circuit have repeatedly "look[ed] beyond the pleadings" in performing the Rule 23 analysis in order to "'understand the claims, defenses, relevant facts, and applicable substantive law.'" *O'Sullivan*, 319 F.3d at 738 (citing *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 744 (5th Cir. 1996)). Such an inquiry "does not resolve the case on its merits," but rather, assists the court in "identifying the substantive issues that will control the outcome [and] assessing which issues will predominate." *Id.* This is consistent with the notion that courts "must conduct a 'rigorous analysis of the Rule 23 prerequisites' before certifying a class." *O'Sullivan*, 319 F.3d at 738 (citing *Castano*, 84 F.3d at 740); *see generally General Tel. Co.*, 457 U.S. at 161.

Thus, this court's rejection of the presumption of reliance at the class certification stage would not, as Lead Plaintiff suggests, be "an inappropriate inquiry into the merits of plaintiff's claims." Pl. Opp. at 1-2 (citing *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 722 (11th Cir. 1987)). Indeed, what the *Kirkpatrick* court found "inappropriate" was that the district court had

based its denial of class certification "solely on its conclusion that the plaintiffs' allegations lacked evidentiary support." *Kirkpatrick*, 827 F.2d at 722, 723 ("the court's rejection of the fraud-on-the-market [presumption of reliance] was based upon nothing other than the court's assessment of the plaintiffs' likelihood of success on the claims").

Here, Merrill Lynch is not arguing that the plaintiffs cannot prove reliance *at all*, but merely that *Greenberg* requires them to do so *individually*, and that such necessity of proof renders the action inappropriate for class treatment under controlling Fifth Circuit precedent. *Castano*, 84 F.3d at 745; ML Supp. at 2-3 n.2 (collecting cases).[3]

II. The Fraud-on-the-Market Presumption Is Inapplicable Under *Greenberg*, Rendering Class Certification Inappropriate.

The Fifth Circuit in *Greenberg* announced at least two new rules regarding the fraud-on-the-market presumption of reliance: first, that the presumption is *never* available to "confirmatory statements" – *i.e.*, statements that are consistent with information already digested by the market; and second, that even for non-confirmatory statements, plaintiffs are not entitled to a presumption of reliance unless they can demonstrate an actual, material price decline that was caused by the revelation of the truth about the particular misrepresentation or act at issue. And, as Merrill Lynch explained in its supplemental papers, if plaintiffs are not entitled to the fraud-on-the-market presumption of reliance, then individual issues will predominate and a class may not be certified against Merrill Lynch.

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[3] Similarly, that the *Greenberg* decision partially granted summary judgment – rather than denied class certification – does not render it any less authoritative here. The *Greenberg* decision stands for the principle that the fraud-on-the-market presumption of reliance is not applicable to "confirmatory" information, or even "non-confirmatory" information where plaintiffs fail to show a sufficient causal nexus to price decline. In the instant case, the presumption of reliance is inapplicable for the same reasons as in *Greenberg*. The fact that plaintiffs are instead required to prove reliance individually precludes class certification.

As discussed *supra*, the *Greenberg* test is stricter than that applied by the Court in addressing loss causation in the March 29 Order. There, the Court acknowledged that "information about Merrill Lynch's individual role . . . may not have been made public until long after the Enron bankruptcy," but held that, for purposes of *pleading* loss causation, a price decline upon the general revelation of Enron's "deceptive business practices" was sufficient. March 29 Order, at 17. *Greenberg*, however, makes clear that, to determine the applicability of the fraud-on-the-market presumption of reliance, the Court must carefully examine *each* allegedly fraudulent representation or act separately, to determine (i) whether it is *non-confirmatory*, and, if so, (ii) whether plaintiffs have shown sufficient stock price movement upon revelation of the truth about that particular representation or act. Indeed, *Greenberg* mandates that, in order to obtain a presumption of reliance, plaintiffs must disaggregate multiple items of negative information, and "demonstrate that there is a reasonable likelihood that the cause of the decline in price is due to the revelation of the truth [about the particular representation or act] and not the release of the unrelated negative information. In the absence of such a showing the invocation of the presumption of reliance would be based solely on speculation." *Greenberg*, 364 F.3d at 665.

Lead Plaintiff also contends that, even if it cannot show an actual movement of Enron's stock price as a result of Merrill Lynch's conduct, it is entitled to a presumption of reliance simply based on its allegation that "[h]ad the market known of the deception, the stock price would have reflected that." Pl. Opp. at 4. This, however, is precisely what the Fifth Circuit held was insufficient: "It is this *actual movement* of stock price which must be shown by fraud-on-the-market plaintiffs, and a plaintiff cannot relieve himself of this obligation by referring to

'special circumstances' in an attempt to explain non-movement of the stock price." *Greenberg*, 364 F.3d at 663 (quoting *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 419 (5th Cir. 2001)).

A. Lead Plaintiff's Allegations Relate Solely to "Confirmatory Information."

Lead Plaintiff's allegations against Merrill Lynch principally involve its alleged participation in the Nigerian barge and power swaps transactions, which Lead Plaintiff alleges were part of a "scheme" to "manipulate Enron's 4thQ and year-end 99 earnings *so that Enron would meet Wall Street's estimates*." Am. Compl. ¶ 742.5 (emphasis added). In other words, the alleged scheme was one to enable Enron to issue "confirmatory" earnings information. As the *Greenberg* court held, a statement that a company's "earnings were in line with [prior] estimates . . . is the *classic example* of confirmatory information." *Greenberg*, 364 F.3d at 668 n.16 (emphasis added). Accordingly, no presumption of reliance is available as to Lead Plaintiff's claims based on these transactions, and class treatment is therefore precluded.

Trying to salvage class certification as to a portion of its claims, Lead Plaintiff insists that Merrill Lynch's research analyst reports – which Lead Plaintiff must acknowledge presents an ordinary, fraudulent misrepresentation claim – include more than just information that Enron had already announced to the public (*i.e.*, more than just "confirmatory" information). However, Lead Plaintiff ignores that the bulk of the Merrill Lynch analyst statements that are quoted in the Amended Complaint *are* mere repetitions of Enron information. ML Supp. at 5 & n.6 (citing Am. Compl. ¶¶ 130, 142, 147, 149, 162, 181, 201, 208-09, 226, 250, 266, 321, and 362). Indeed, the balance of Lead Plaintiff's allegations are that Merrill Lynch engaged in acts which enabled Enron to announce that it was "meeting analysts' estimates," ML Supp. at 5-6 (citing Am. Compl. ¶¶ 742.5, 742.16, 742.18, and 742.22), which, again, "is the *classic example* of confirmatory information." *Greenberg*, 364 F.3d at 668 n.16 (emphasis added). Thus, insofar as

plaintiffs' claims are based on such confirmatory statements, the presumption of reliance does not apply and class certification is inappropriate. *Id.* at 666 ("confirmatory information cannot be the basis for a fraud-on-the-market claim").

B. There Was No "Actual Movement" in Stock Price Resulting from Any Non-Confirmatory Misstatements.

Lead Plaintiff's opposition brief highlights those very few Merrill Lynch analyst statements that arguably "embellish" Enron's information. But even if these few statements can be considered "non-confirmatory," Lead Plaintiff cannot invoke the fraud-on-the-market presumption of reliance unless it demonstrates that Merrill Lynch's "embellishments," distinct from all other pieces of information then available to the market, including statements from Enron and recommendations from other financial analysts, caused a significant movement in the price of Enron's stock. *Greenberg* requires both a demonstration of "*actual movement* of the stock price" in connection with the misrepresentation or act,[4] and a showing "that it is more probable than not that it was this [particular misrepresentation or act], and not other unrelated [misrepresentations or acts], that caused" that movement. *Greenberg*, 364 F.3d at 666.

Lead Plaintiff can make no such showing. Courts in other jurisdictions have acknowledged that "there is a qualitative difference between a statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst," and there is, accordingly, much less reason to presume an "automatic impact on the price of a security" from the analyst statement. *DeMarco*, 2004 WL 1506242, at *3; *see also Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004) (recognizing potential for "a crucial distinction" between statements

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4 This requires plaintiffs to show either a significant increase in stock price when the alleged misrepresentation or act occurred, or a significant decrease in stock price when it is revealed. *Greenberg*, 364 F.3d at 663-65.

of issuers and analysts). Consistent with *Greenberg*, if the analyst's statement has not "materially impacted the market price in a reasonably quantifiable respect," *DeMarco*, 2004 WL 1506242, at *3, a fraud-on-the-market presumption of reliance is unwarranted. Here, plaintiffs have not even attempted to meet the *Greenberg* burden with respect to Merrill Lynch. Therefore, even to the extent Merrill Lynch is alleged to have made "non-confirmatory" statements, plaintiffs are not entitled to a fraud-on-the-market presumption of reliance.

C. Class Certification Is Inappropriate Where There Is No Class-wide Presumption of Reliance, Because Individual Issues of Reliance Predominate.

Absent the fraud-on-the-market presumption, the need for individualized proof of reliance predominates over common issues, and renders class certification inappropriate. *See, e.g., Castano*, 84 F.3d at 745; *Bell v. Ascendant Solutions, Inc.*, No. 01-0166, 2004 U.S. Dist. LEXIS 12321, at *5 (N.D. Tex. July 1, 2004) (denying certification where plaintiffs' experts failed to establish entitlement to presumption of reliance, requiring plaintiffs to prove reliance individually). Lead Plaintiff responds by citing three older, out-of-circuit cases stating that individual issues of reliance are not an impediment to class certification. *See* Pl. Opp. at 2. But Lead Plaintiff never even acknowledges – much less distinguishes – the numerous recent decisions from the Fifth Circuit and district courts within this Circuit that hold to the contrary. *See* ML Supp. at 2-3 n.2 (collecting cases).

Indeed, the older cases cited by Lead Plaintiff are not only from outside this Circuit, but readily distinguishable from the case at bar. For instance, in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), the plaintiff had alleged only nondisclosure, and proof of reliance was *already* unnecessary under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). *See Blackie*, 524 F.2d at 906; *see generally Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 362 (5th

Cir. 1987), *cert. denied*, 108 S.Ct. 1220 (1988).[5] The *Blackie* court's discussion of the fraud-on-the-market presumption was therefore *dicta*.

Similarly, Lead Plaintiff cites to *In re Ramtek Sec. Litig.*, No. C 88 20195 RPA, 1990 U.S. Dist. LEXIS 14947 (N.D. Cal. Sept. 7, 1990) for the proposition that class certification is appropriate "even if the fraud-on-the-market presumption does not apply." *See* Pl. Opp. at 2. However, the *Ramtek* court found a predominance of common issues on the plaintiffs' Section 10(b) claims because the fraud-on-the-market presumption *did apply*, and the defendant's "defense of non-reliance [wa]s not a basis for denial of class certification." *Id.* at **6-7. Here, Merrill Lynch is not asserting at this stage a defense of non-reliance (in an attempt to rebut a presumption of such reliance), nor even that some members of the class may not be able to prove reliance at trial, but rather, that class treatment is inappropriate where they must do so.[6]

III. *Greenberg* Applies To Section 10(b) Claims Based on Allegations of a Fraudulent "Scheme."

Failing to distinguish *Greenberg* on any other grounds, Lead Plaintiff ultimately attempts to do so on the theory that the claims against Merrill Lynch are based on an alleged fraudulent "scheme," whereas *Greenberg* involved alleged misrepresentations. But whether a case is based on a "scheme" or a "misrepresentation," reliance is still a required element of plaintiffs' claim,

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5 Where, as here, the plaintiff asserts both omissions *and* affirmative misrepresentations, the *Affiliated Ute* presumption is, of course, inappropriate. *See Lehocky v. Tidel Technologies, Inc.*, 220 F.R.D. 491, 510 (S.D. Tex. 2004) (holding that plaintiffs "may not rely on the *Affiliated Ute* presumption of reliance in this mixed context"); *Kirkpatrick*, 827 F.2d at 722 (cited by Lead Plaintiff, *see* Pl. Opp. at 1-2).

6 In any event, the *Ramtek* court's pronouncement – in the context of the plaintiffs' common law claims – that "the issue of reliance is not even one that need be considered at the class certification stage," *id.* at *11, is clearly in conflict with the settled law of this Circuit. *See* ML Supp. at 2-3 n.2 (citing, *inter alia*, *Castano*, 84 F.3d at 745).

and *Greenberg* does not suggest that any different analysis of the fraud-on-the-market presumption of reliance would apply to a "scheme" than to a "misrepresentation." Lead Plaintiff, likewise, offers no explanation as to why the analysis should be different.[7]

Moreover, and as stated at Part II.A., *supra*, Lead Plaintiff's allegations that Merrill Lynch – by participating in the Nigerian barge and power swaps transactions – assisted in a "scheme" to enable Enron to issue false earnings statements and meet analysts' estimates, are the "classic example of confirmatory information." *Greenberg*, 364 F.3d at 668 n.16.

Thus, it is ultimately unavailing to construe plaintiffs' claims as alleging a fraudulent scheme or manipulative conduct. Plaintiffs' allegations do not describe a scheme that "artificially affect[ed] market activity" in Enron stock, and thus their claims do not fit within the definition of "manipulation," which the Supreme Court has recognized is "virtually a term of art." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977). Properly understood, plaintiffs allege that Merrill Lynch assisted Enron in a scheme to make misstatements.[8] In short, the heart

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7 Indeed, for this Court to hold otherwise would give rise to the same concerns that led the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), to reject aiding and abetting liability under the securities laws. That is, just as "the critical element [of] reliance [] would be eliminated if liability were imposed for aiding and abetting," December 20 Order, at 40 (citing *Central Bank*, 511 U.S. at 180), the same critical element would be vitiated if plaintiffs could obtain the fraud-on-the-market presumption of reliance without satisfying the *Greenberg* prerequisites merely by alleging a fraudulent "scheme" to make misstatements.

8 *See generally* "Annual Review of Federal Securities Litigation," 59 Bus. Law 689, 880 n.1193 (February 2004) (suggesting that "*Enron's* analysis" [in 235 F.Supp.2d 549 (S.D. Tex. 2004)] of "10b-5 liability without regard to misstatements is hard to understand" to the extent that (i) "the Enron plaintiffs did not allege manipulation of th[e] sort" defined in *Santa Fe*, (ii) "[t]he SPE transactions had no effect on Enron's security prices that was independent of th[e alleged] misstatements and omissions," and (iii) liability for "participation in a scheme" relating to "false financial numbers . . . seems a lot like aiding and abetting").

of plaintiffs' claims against Merrill Lynch is "confirmatory" whether it is construed as a misrepresentation case or as a scheme case.

CONCLUSION

For these reasons and those set forth in Merrill Lynch's prior briefs, there is no basis for certifying a class with respect to any of the claims against Merrill Lynch.

Dated: August 24, 2004

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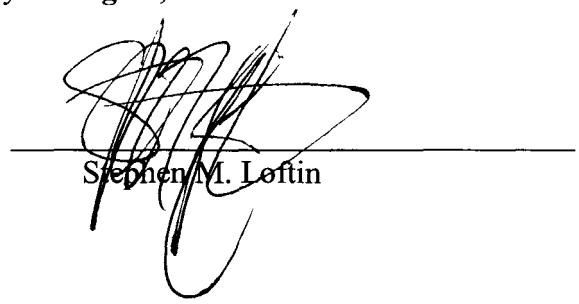
CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing instrument, **Merrill Lynch's Reply Regarding Supplemental Authority In Opposition To Lead Plaintiff's Amended Motion For Class Certification**, was served upon all known counsel of record by website, http: //www.esl3624.com, on this the, on this the **24th** day of **August, 2004**.



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