United States Courts
Southern District of Texas
ENTERED

JAN 28 2003

Michael N. Milby, Clerk of Court

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In Re Enron Corporation Securities, Derivative & "ERISA Litigation	§	MDL-1446
THIS DOCUMENT RELATES TO: All Cases	§	
MARK NEWBY, ET AL., Plaintiffs	§	
VS.	§	CIVIL ACTION NO. H-01-3624 CONSOLIDATED CASES
ENRON CORPORATION, ET AL., Defendants	§	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, ET AL., Individually and On Behalf of All Others Similarly Situated, Plaintiffs,	§	
VS.	§	
KENNETH L. LAY, ET AL., Defendants.	§	

MEMORANDUM AND ORDER OF PARTIAL DISMISSAL OF CLAIMS AGAINST INDIVIDUAL ANDERSEN DEFENDANTS

The above referenced putative class action, brought on behalf of purchasers of Enron Corporation's publicly traded equity and debt securities during a proposed federal Class Period from October 19, 1998 through November 27, 2001, alleges securities violations

#1241

(1) under Sections 11 and 15 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§ 77k and 77o; (2) under Sections 10(b), 20(a), and 20A of the Securities Exchange Act of 1934 ("Exchange Act" or "the 1934 Act"), 15 U.S.C. §§ 78j(b), 78t(a), and 78t-1, and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5; and (3) under the Texas Securities Act, Texas Rev. Civ. Stat. Ann. art. 581-33 (Vernon's 1964 & 2002 Supp.).

Pending before the Court *inter alia* are motions to dismiss pursuant to Rules 8, 9(b), and 12(b)(6) of the Federal Rules of Civil Procedure, section 21D(b)(3) of the Exchange Act, as amended, the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), codified at 15 U.S.C. §78u-4(b)(3)(A), and *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), filed by the Individual Andersen Defendants (Thomas H. Bauer, Michael L. Bennett, Joseph F. Berardino, Deborah A. Cash, Donald Dreyfuss, James A. Friedlieb, D. Stephan Goddard, Jr., Gary B. Goolsby, Gregory W. Hale, Michael D. Jones,[1] Michael M. Lowther, Benjamin S.

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[1] By footnote Michael Jones alone moves to dismiss for defective service of process via mail in contravention of Article 10(a) of the Hague Convention on the Service Abroad of Judicial and Extra-Judicial Documents in Civil or Commercial Matters, Nov. 15, 1965, 20 U.S.T. 361, 362, Art. I, reprinted in 28 U.S.C.A. Fed. R. Civ. P. 4 (West 1992). *See Postal v. Princess Cruises, Inc.*, 163 F.R.D. 497, 499 (N.D. Tex. 1995). Because the issue was not briefed by Jones and because Lead Plaintiff's response, also in a footnote, states that Lead Plaintiff is currently attempting to serve Jones through the Procedures of the Hague Convention, the Court presumes that any defect in service has been cured. If Jones still challenges the propriety of service, he should do so by separate motion and citation to supporting legal authority.

Neuhausen, Richard R. Petersen, John E. Stewart, William E. Swanson, Nancy Temple, and Roger D. Willard)[2](instrument #652) and, by separate instrument, Arthur Andersen Audit Practice Director Michael Odom (#684).

The Court incorporates herein the "Applicable Law" and "Lead Plaintiff's Allegations"[3] sections of its recent memorandum and order dealing with motions to dismiss filed by the secondary actors in this litigation (#1194) and supplements the applicable law with a focus on the claims against the Individual Andersen Defendants.

The Individual Andersen Defendants, all partners of Enron's outside auditor,[4] are sued under § 10(b) and § 20(a), of the

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[2] Danny D. Rudloff and John F. Sorrells, who were originally named as movants, were voluntarily dismissed by Lead Plaintiff. The Court therefore does not address the allegations against them.

[3] Although many parts of #1194 are relevant, pages 230-57 of the slip opinion of that memorandum and order summarize the allegations against Arthur Andersen and its partners. The memorandum and order is now available on Westlaw: *In re Enron Corp. Securities, Derivative & ERISA Litigation*, No. H-01-3624, 2002 WL 31854963 (S.D. Tex. Dec. 20, 2002).

[4] The complaint at 96-100 identifies the Individual Andersen Defendants during the Class Period as follows: Joseph F. Berardino was Chief Executive Officer and managing director of Andersen Worldwide S.C. and a partner in both Andersen Worldwide S.C. and Arthur Andersen LLP (U.S.); Thomas H. Bauer was an Andersen partner on the Enron engagement, oversaw commodity trading at Enron, and worked exclusively on Enron matters; David Duncan, who is not a Movant here, was the head Andersen partner on the Enron engagement, was a partner in both Andersen Worldwide and Arthur Andersen LLP, and served on the Chairman's Advisory Counsel, an elite group of twenty-one worldwide partners; Deborah Cash was head of the energy unit in the Houston office and part of the Enron audit and consulting engagements; Donald Dreyfuss was a partner at Andersen Worldwide's headquarters in Chicago; James A. Friedlieb was a partner in Andersen Worldwide's Chicago headquarters and a partner in Andersen Worldwide and Arthur Andersen LLP; David Stephen

Securities and Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a) respectively, and Rule 10b-5, 17 C.F.R. 240.10b-5.

SUMMARY OF INDIVIDUAL ANDERSEN DEFENDANTS' ARGUMENTS

Individual Andersen Defendants insist that the allegations against them are sparse, conclusory, and inadequate to state a claim against them under § 10(b)of the 1934 Act and Rule 10b-5. They point out that Gregory W. Hale is mentioned in the complaint

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Goddard, Jr. was managing partner for the Houston office since 1997, head of Arthur Andersen's Audit & Business Advisory and Energy practice for the Houston office, a significant participant in the Enron audit and consulting engagements, the managing partner for the Gulf Coast Market Circle, and a partner in both Andersen Worldwide and Arthur Andersen LLP; Gary B. Goolsby was in charge of Global Risk Management and was Consulting Practice Director of the Houston office and an essential member of the Enron audit and consulting engagements; Michael M. Lowther was Arthur Andersen's concurring partner on the Enron audit since 1997 and a partner in both Andersen Worldwide and Arthur Andersen LLP; Benjamin S. Neuhausen was a partner in the Chicago Business Unit Management office and an essential member of the Enron audit and consulting engagements; Michael C. Odom was Audit Practice Director for the Gulf Coast Market Circle and a major participant in the Enron audit and consulting engagements, as well as a partner in both Andersen Worldwide and Arthur Andersen LLP; Richard R. Petersen was a partner in Andersen's Professional Service Group ("PSG," Arthur Andersen's oversight committee); John E. Stewart was a partner and a top audit specialist at the Andersen Chicago headquarters; Michael L. Bennett was a partner in the Houston office and a central participant in the Enron audit and consulting engagements; William E. Swanson was the Audit Division Head for the Gulf Coast Market Circle and a partner in both Andersen Worldwide and Arthur Andersen LLP; Roger D. Willard was a partner involved in the Enron engagement and a member of the Audit and Business Advisory practice in Houston, as well as an essential member of the Enron audit and consulting engagements; Michael D. Jones was a partner in the Houston office who was transferred to London in mid 2001; Gregory W. Hale was a partner based in the Houston office and a significant member of the Enron audit and consulting engagements; and Nancy Temple was an in-house lawyer based in the Andersen Worldwide Chicago headquarters.

only once and is merely identified as a partner of Andersen based in the Houston office and "an integral part of the Enron audit and consulting engagements." Consolidated Complaint (#441) at p. 99, ¶ 93(r). They argue that the same general, boilerplate allegation plus one additional assertion is made against four other partners: (1) Roger D. Willard is charged with holding "a meeting with his managers and staff to ensure 'compliance' with Andersen's document retention policy," in late October 2001, *id.* at ¶ 966; and (2) Michael L. Bennett, D. Steven Goddard, Jr., and Gary B. Goolsby were participants in the February 5, 2001 teleconference meeting where Arthur Andersen management purportedly discussed the risks of continuing to audit Enron.[5] Defendants represent that the complaint also vaguely mentions that William E. Swanson and Michael Odom knew that Sherron Watkins had made allegations of improper accounting against Enron in late summer and early fall of 2001. *Id.* at ¶ 933. The complaint additionally states generally that Odom and Michael M. Lowther were consulted about structuring transactions for Enron and knew that Arthur Andersen auditor Carl Bass had criticized some of the Enron accounting decisions. *Id.* at 952. Lead Plaintiff also vaguely claims that Michael D. Jones was involved in the document destruction beginning October 2001. *Id.* at ¶ 93(g).

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[5]Defendants also emphasize that Lead Plaintiff does not allege that any Plaintiff knew of this October 2001 meeting, or relied upon anything that happened during it or suffered damages in connection with it.

Moreover, Defendants complain, the complaint merely alleges that Joseph F. Berardino was aware of Carl Bass' disapproval of Arthur Andersen's Enron accounting and also participated in the approval of some off-balance-sheet transactions, with no specific facts as to where, how, when or what role or authority he had with respect to them. *Id.* at ¶¶ 93(a), 966.

Debra Cash is also summarily referenced as being involved in approval of such transactions and having knowledge of Bass' and Watkins' criticisms. *Id.* at ¶¶ 929, 933, 950.

The complaint, again without particular factual allegations, asserts that Benjamin S. Neuhausen, Richard R. Petersen, and John E. Stewart approved of continued use of mark-to-market accounting and some transaction structures and that the three were also aware of Bass' fault-finding with the Enron accounting. *Id.* at ¶¶ 93(j), (l), (m), 929, 940, 950. With the same lack of specificity the complaint also contends that Thomas Bauer was purportedly privy to Bass' disapproval of Enron accounting, involved in structuring the challenged transactions, and a participant in the alleged document destruction. *Id.* at ¶¶ 929, 932, 940, 950, 952(c).

Also conclusorily charged with involvement in the document destruction were James A. Friedlieb, Donald Dreyfuss, and Nancy Temple. *Id.* at ¶¶ 68, 93(e)-(f), 95, 964, 966. Lead Plaintiff additionally alleges, "On 10/16/01, after a meeting with high level partners in Chicago, including Friedlieb and Dreyfuss, Arthur Andersen attorney Nancy Temple sent an e-mail message to the Enron

team suggesting changes to memoranda . . . to 'add back' Carl Bass's previously omitted criticisms to earlier memos . . . ." *Id.* at ¶ 966. Finally Berardino is summarily charged with "review[ing] and approv[ing] Andersen's destruction policy," a statement insufficient to plead scienter. *Id.* at ¶¶ 93(a), 966. Defendants emphasize that there are no specific details provided as to what Friedlieb or Dreyfuss said, did or knew with respect to the partner meeting nor any connection between that meeting and any events occurring after it.

Furthermore, Defendants object, Lead Plaintiff relies on Bauer's deposition to claim that Bauer has admitted destroying documents, but does not address Bauer's testimony therein that he routinely followed the firm's document retention policy and was not told to stop until November 9, 2001, when his counsel so instructed him. At the deposition Bauer also stated that the destroyed documents did not relate to any of the issues raised in the complaint and were only preliminary drafts of work product, for which final versions had been preserved. Similarly, although Lead Plaintiff claims that Odom also followed the document retention policy, the complaint never alleges that Odom thought doing so was improper.

Defendants additionally maintain that any claim based on the alleged document destruction is not actionable because there is no causal connection between it and any claim that Enron stock was inflated as a result of misrepresentations in Andersen's audit opinions, the last of which was incorporated into a registration

statement issued on July 25, 2001, three months before the destruction purportedly commenced. Thus no plaintiff could have relied on the document destruction allegations or been damaged thereby in connection with his purchase of Enron securities. Even Temple's alleged e-mail message in October 2001 occurred months after the July 25, 2001 alleged misrepresentation.

Moreover, Individual Andersen Defendants challenge Lead Plaintiff's attempt to allege scienter by asserting that some Defendants were aware of Carl Bass' criticism of some aspects of the Enron accounting because Bass disagreed with other Arthur Andersen auditors about appropriate treatments under GAAS and GAAP. They insist that GAAS and GAAP are not a fixed set of calculations that allow for only one possible accounting treatment of a transaction, but that they offer a range of acceptable procedures.[6]

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[6] *See, e.g., Thor Tool Co. v. Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979); *Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 315 (5th Cir. 1988); *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 675 n.22 (3d Cir. 2002). In *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1021 (5th Cir. 1996), the Fifth Circuit noted,

> [A] difference in judgment about generally accepted accounting principles does not establish conscious behavior on the part of Defendants. The term generally accepted accounting principles, as we have often noted, is a term of art encompassing a wide range of acceptable procedures, such that an ethical, reasonably diligent accountant may choose to apply to any of a variety of acceptable procedures when that accountant prepares a financial statement.

Defendants maintain that "debate among accountants about the proper application of GAAP to particular transactions is a sign of diligence, not of fraud" and that GAAS, AU § 230.07, requires an auditor "to exercise professional skepticism." #651 at 16 n.9.

This Court has previously concluded in light of the totality

Similarly, although Lead Plaintiff alleges that "PSG partners Stewart, Petersen and Neuhausen continued to approve Enron's use of mark-to-market accounting as Enron became more egregious in revenue recognition," Defendants object that Lead Plaintiff does not allege that such accounting is inherently fraudulent. Moreover, insist the Andersen Defendants, GAAP requires application of mark-to-market accounting for contracts involving energy trading and risk management. *See* EITF 98-10: Accounting for Contracts Involved in Energy Trading and Risk Management Activities, Nov. 18-19, 1998, Tab 57 to the Master Appendix (multi-volume, #1199), dated May 8, 2002, filed in connection with Certain Defendants Joint Brief Relating to Enron Disclosures.[7] In addition, Defendants emphasize that Lead Plaintiff has not identified the transactions for which Stewart, Petersen, and Neuhausen approved the mark-to-market accounting, or what they knew that alerted them to find that the accounting was fraudulent or when they knew that it was.

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of circumstances alleged by Lead Plaintiff that the complaint's specific assertions of noncompliance with multiple accounting principles in numerous transactions along with allegations giving rise to a strong inference of scienter are sufficient to state a claim against Arthur Andersen under § 10(b).

[7] Defendants' joint Master Appendix and Master SEC Appendix were originally incorrectly docketed as exhibits to a single motion. That error has been corrected and they have been renumbered as #1199 and 1200 respectively, but the date of filing, May 8, 2002, remains the same. In case there should be any confusion, the Court would point out that the instruments on the docket sheet are listed in order of date of filing, not in order of instrument number.

Regarding the February 5, 2001 teleconference meeting, Defendants charge that Lead Plaintiff is "attempt[ing] to twist Andersen's diligence in evaluating the risk of retaining Enron as a client into an indication of fraud. Risk assessment is part of an annual consideration regarding whether the firm should retain a client." #651 at 19-20.

Moreover, Defendants maintain that in the summer of 2001, after Sherron Watkins challenged the "very issues that caused Enron's collapse" to Arthur Andersen's James Hecker. Hecker immediately informed other partners on the Enron engagement team and held an emergency meeting to discuss Watkins' concerns, as conceded by Lead Plaintiff. Furthermore, within three months Enron did announce that it would restate its prior financial statements. In addition, Individual Andersen Defendants emphasize that there are no allegations that any of them made any public statements about Enron's finances after becoming aware of Watkins' concerns. Nor does Watkins' August 2001 communication establish scienter as to any of the Individual Andersen Defendants during the Class Period.

The Andersen partners claim that there are only two allegations that reference any of them with respect to specific transactions and that even these fail to distinguish the roles of the Defendants named or to plead anything but conclusory allegations that the individuals were "heavily involved" or "deeply involved" in a transaction; moreover, Lead Plaintiff does not plead

facts reflecting anything that the individual Defendants knew that might have made them think the accounting was improper:

> Defendants David Duncan, Cash, Stewart and Neuhausen and others were heavily involved in the structuring of the entity, the decisions to allow Enron to improperly account for the LJM2 entity, and were aware of Bass's disagreement with the LJM2 accounting beginning in 00. (¶ 950)
>
> Andersen also made the decision to allow Enron to improperly avoid recording individual impairment charges for Raptor investments that had significantly and permanently declined in value. Andersen e-mails between Cash, David Duncan and Stewart throughout the Class Period reveal that defendants David Duncan, Cash, Lowther, Odom, Stewart and others were aware that Bass thought the Raptor accounting was improper. (¶ 952(c))

In sum, Individual Andersen Defendants object first that the complaint is "defective" because it fails to specify which claims are being brought against which Defendants, in violation of Fed. R. Civ. P. 8. Second, with respect to § 10(b) and Rule 10b-5, Defendants insist that Lead Plaintiff has not alleged that any Individual Andersen Defendant made a false statement, has not alleged that plaintiff investors relied on any false statement made by Individual Andersen Defendants, and has not pleaded facts raising a strong inference of scienter with respect to any of them. The only challenged misrepresentations are the financial statements of Enron audited by the Arthur Andersen firm or public statements made by the entity, and Lead Plaintiff's allegations about them are characterized by Defendants as "a gross form of the group published information doctrine--attributing all statements made by an entity to any individual associated with it," or guilt by association. Defendants' Reply Memorandum (#927) at 2. Defendants additionally

argue that Lead Plaintiff uses group pleading to assert that eight Individual Andersen Defendants participated in the February 5, 2001 meeting and discussed the risks of keeping Enron as a client, without specifying anyone's role or the particular statements made. Instead Lead Plaintiff makes merely a boilerplate allegation that "significant discussion ensued regarding the propriety of the very accounting issues that ultimately caused the collapse of Enron . . . ." Complaint at ¶ 930.[8] Defendants challenge the "implicit premise" of the complaint that

> if they state a claim against Andersen or Enron or some other entity or group, they have stated a claim against Individual Defendants. This is not the law. Having made the choice to sue *individuals*, it is plaintiffs' obligation to allege *every* element of *every* claim against *every* Individual Defendant. They have not done so.

Defendants' Reply Memorandum (#927) at 4.

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[8] The group pleading doctrine, which is discussed in more detail *infra*, generally applies only to written documents such as prospectuses, registration statements, annual reports, or press releases. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987); *Blake v. Dierdorff*, 856 F.2d 1365, 1369 (9th Cir. 1988). It clearly does not apply to oral statements by identified individuals because they are not "group published." *See, e.g., In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1240 (N.D. Cal. 1994)(holding "that oral statements attributable to individual defendants are actionable, if at all, only against those defendants"); *Elliott Assocs., L.P. v. Covance, Inc.*, No. 00 Cov. 4115 SAS, Fed. Sec. L. Rep. (CCH) par. 91,269, 2000 WL 1752848, *12 (S.D.N.Y. Nov. 28, 2000)("To allow group pleading in the context of oral statements would unduly expand its ambit beyond that contemplated by the Second Circuit when it adopted the theory."); *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp.2d 527, 544 (S.D. Ohio 2000); *In re Securities Litig. BMC Software, Inc.*, 183 F. Supp. 860, 915 (S.D. Tex. 2001). Here Lead Plaintiff has not identified the specific speakers or statements and appears to be trying to make an end-run around the pleading requirements imposed by Rule 9(b) and the PSLRA for a § 10(b) claim against the Individual Andersen Defendants.

Moreover, if no individual Defendant made a statement, no one had a duty to correct one, insist the Individual Andersen Defendants. *Id.* at 10.

Furthermore, Defendants argue,

> Far from alleging a manipulative or deceptive act by each defendant in furtherance of a scheme, plaintiffs allege merely the status of the individuals as partners of Andersen, and offer general allegations regarding participation in Andersen's audits; allegations regarding attendance at internal meeting and discussions regarding Enron as a client; and allegations of disagreements among or knowledge of disagreements among certain partners concerning the application of generally accepted principles. The acts alleged are, for the most part, non-specific, random and isolated but, most importantly, they are not manipulative or deceptive.

Id. at 8.

In their reply, Defendants complain that only in Lead Plaintiff's Opposition to their motions[9] does Lead Plaintiff assert for the first time that the Individual Andersen Defendants (none identified) "substantially participated" in drafting the false statements contained in Enron's interim financial reports and reviewed and edited Enron's press releases about quarterly results, none of which are identified. *Id.* at 9.[10] Defendants correctly

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[9] Defendants observe, "it is axiomatic that [a] Complaint cannot be amended by the briefs in opposition to a motion to dismiss." *In re Baker Hughes Sec. Litig.*, 136 F. Supp.2d 630, 646-47 (S.D. Tex. 2001). Nevertheless, the Court notes that it may grant leave to a party to amend its pleadings where justice requires under Fed. R. Civ. P. 15(a).

[10] Defendants also complain that Lead Plaintiff's Opposition has modified the allegations in the complaint in a significant way. The complaint alleged that Nancy Temple instructed Andersen personnel to delete "from draft accounting memoranda" their conclusion that an imminent press release was false. An internal memorandum is not an actionable public statement. In its response

point out that this Court has previously held that under § 10(b) scienter cannot be adequately pleaded merely through general allegations about a defendant's executive position, day-to-day responsibilities, access to information, or dependency of his compensation on continued business from Enron. They complain that Lead Plaintiff assumes "that the mere allegation of a general role in Enron audits, combined with a general allegation of accounting errors, is effective to plead scienter with respect to each of the Individual Andersen Defendants." *Id.* at 13.

Nor, Defendants maintain, has Lead Plaintiff adequately pleaded the degree or type of control required for "controlling person" liability under § 20(a) against any individual Andersen Defendant.[11] They contend that of all of them, the complaint expressly named only Berardino[12] as a controlling person and

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in opposition, Lead Plaintiff omits the "draft accounting memoranda." Moreover, the complaint fails to identify to whom Nancy Temple spoke or to delineate the role of any individual Defendant that allegedly drafted the release. Lead Plaintiff also improperly cites the Andersen trial transcript, which Defendants argue is not within the scope of this Court's review. Lead Plaintiff, moreover, selectively quotes from that transcript and ignores portions that show that some of the individual Defendants disagreed with statements in the press release and that Enron was informed of that disagreement. *U.S. v. Arthur Andersen* Trial Transcript, 5/14/02 at 1793:24-1800:7 (Testimony of David Duncan).

[11] Although Defendants argue that there can be no § 20(a) liability imposed against them because Lead Plaintiff has not pleaded an underlying claim of § 10(b) fraud against Arthur Andersen, in its previous memorandum and order the Court concluded that it has.

[12] The complaint also expressly identifies as Arthur Andersen controlling persons under § 20(a) Defendants Philip A. Randall, Roman W. McAlindon, who are not involved in the motions being reviewed in this memorandum and order, and C.E. Andrews, against

otherwise only conclusorily stated that "defendants violated §§ 10(b) and/or 20(a) of the 1934 Act." Complaint at ¶ 995. Only in Lead Plaintiff's Opposition (#840) does Lead Plaintiff attempt to clarify the uncertainty by asserting that all Individual Andersen Defendants are liable as controlling persons under § 20(a). Moreover, Lead Plaintiff fails to plead adequately that any of them was a controlling person because Lead Plaintiff fails to plead an underlying primary violation by a controlled person and particularized facts, including the power to control or influence corporate policy directly or indirectly, regarding the controlling person's culpable participation in the fraud that he perpetuated. *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996). Instead the complaint merely asserts that Berardino was CEO and Managing Partner and "was involved in Andersen's firm-wide policy and procedures." Complaint at ¶¶ 93(a) and 97. Nor does Lead Plaintiff adequately allege that Berardino had the authority to control transaction(s) in dispute, i.e., the audits or issuance of audit reports. There are no allegations that any of the other Defendants had any general control over the firm or day-to-day control over identified audits.

SUPPLEMENTAL APPLICABLE LAW

Group Pleading Doctrine

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whom Lead Plaintiff has dismissed its claims (#499 and 526).

Under the judicially created "group pleading" doctrine, a plaintiff may rely on the presumption that the higher executives of a corporation directly involved in its day-to-day management may be personally liable for material misrepresentations or omissions in public statements such as prospectuses, registration statements, annual reports, press releases or other group-published information, attributed to or issued by the corporation. *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987)("In cases of corporate fraud, where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other 'group-published' information, it is reasonable to presume that these are the collective actions of the officers."); *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp.2d 910, 915-16 (N.D. Tex. 1998); *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 759 (N.D. Cal. 1997). In other words, under the group pleading theory a court may apply the presumption and "not consider the liability of each individual defendant, but may attribute all the statements to all the defendants as 'collective actions.'" *In re Cabletron Systems, Inc.*, 311 F.3d 11, 40 (1st Cir. 2002).

William O. Fisher, in *Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the 'Group Pleading' Protocol in 10b-5 Cases*, 56 Bus. Law 991, 1032-33 (May 2001), identifies as the purpose of the doctrine "to permit plaintiffs to name at the outset of a case defendants whose precise roles plaintiffs will not

know until discovery, but who, because of their positions, are so likely to be proper defendants that plaintiffs appropriately name them without pleading specific facts tying them to the fraud."

Prior to the passage of the PSLRA, the Ninth and the Second Circuits were the only federal appellate courts to apply the doctrine to corporate fraud cases; since then, the Tenth Circuit has adopted the Ninth Circuit's test in *Tandem*.[13]

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[13] The widely varying applications of the doctrine, which the Court will not discuss in detail here because the Court rejects post-PSLRA application of the group pleading doctrine, demonstrate the doctrine's lack of clear parameters and the uncertainty of or lack of uniformity in the outcome, as well as the ease with which the exception can swallow the general rule that a plaintiff alleging fraud must plead particular facts linking each defendant to the purported fraud. Realizing the need for restrictions on such a potentially catchall exception, courts have tried to substantially restrict the field of defendants beyond *Tandem*'s "narrowly defined group" with "direct involvement in the day-to-day affairs" of the corporation as well as in "its financial affairs in particular" with very different results. *Tandem*, 818 F.2d at 1440. There are divergent holdings as to whether secondary actors, e.g., outside professionals including lawyers and accountants, or outside directors, or corporate officers in general are excluded or under what circumstances they are not. For instance, the Ninth Circuit has held that the presumption may apply to members of the corporation's board of directors, but not to outside directors without a showing that the outside directors participated in the day-to-day corporate business or that they had a special relationship with the corporation, such as involvement in or preparation of communication of the group information at specified times, i.e., "operational involvement." *Blake v. Dierdorff*, 856 F.2d 1365, 1369 (9th Cir. 1988); *In re GlenFed Inc. Sec. Litig.*, 60 F.3d 591, 593 (9th Cir. 1995)(same); *Berry v. Valence Tech., Inc.*, 175 F.3d 699, 706 (9th Cir. 1999)(same), *cert. denied*, 528 U.S. 1019 (1999).

The Second Circuit originally stated that "no specific connection between fraudulent representations in the Offering Memorandum and particular defendants is necessary where, as here, defendants are insiders or affiliates participating in the offer of the securities in question," but subsequently narrowed its test to require specific allegations showing that the defendants were not merely affiliates, but insiders or linked in an identified way to

This Court has previously held that the group pleading did not survive the passage of the PSLRA because the doctrine appears contrary to the PSLRA's express pleading requirements and its intent. *See, e.g., In re Securities BMC Software, Inc.*, 183 F. Supp.2d 860, 902 n.45 (S.D. Tex. 2001). As further observed by William O. Fisher,

> The rationale for the protocol is completely at odds with the discovery stay that the PSLRA imposes at the outset of a case while defendants test the factual allegations of a complaint with motions to dismiss. That stay is designed to stop "sue first and ask questions later" tactics. As the Ninth Circuit stated, Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed. [*Medhekar v. U.S. District Court for the N.D. of California*, 99 F.3d 325, 328 (9th Cir. 1996).] The reasoning for the stay is unreservedly hostile to the notion of "group pleading," which is precisely that plaintiffs should be able to name defendants without having "actual knowledge" that those defendants made the statements that plaintiffs claim are wrong. [footnotes omitted]

56 Bus. Law at 1053. Moreover, the Court's current research demonstrates that nearly all of the district courts within the Fifth Circuit which have addressed the question have come to a similar conclusion. *See, e.g., Coates*, 26 F. Supp.2d at 916 ("The

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a purported misrepresentation or omission in the Offering Memorandum of a limited partnership. *See, e.g., Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986); *DiVittorio v. Equidyne Extractive Industries, Inc.*, 822 F.2d 1242, 1248-49 (2d Cir. 1987); *Ouaknine v. MacFarlane*, 897 F.2d 75, 80 (2d Cir. 1990).

The passage of the PSLRA apparently has not affected application of the group pleading doctrine in the Ninth and Second Circuits. *See, e.g., In re Secure Computing Corp. Sec. Litig.*, 120 F. Supp.2d 810, 821 (N.D. Cal. 2000); *In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 142 (S.D.N.Y. 1999).

PSLRA codifies a ban against group pleading."); *Kunzweiler v. Zero.Net, Inc.*, No. CIV. A. 3:00-CV-2553-P, 2002 WL 1461732, *13 n.15 (N.D. Tex. July 3, 2002); *Barrie v. InterVoice-Brite, Inc.*, No. CIV. A. 301CV1071D, 2002 WL 1841631, *11-12 (N.D. Tex. Aug. 8, 2002); *In re Netsolve, Inc. Sec. Litig.*, 185 F. Supp.2d 684, 698 (W.D. Tex. 2001). Furthermore, this Court's recent review of growing case law has not persuaded it to change its decision.[14] Finally, not only has the Fifth Circuit not addressed the effect of the PSLRA on the doctrine, but this Court has been unable to find

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[14] Since the passage of the PSLRA, only two appellate courts have addressed the question whether the group pleading doctrine survives. The First Circuit, noting the "great debate about the doctrine's continued existence," has recently observed that it previously "recognized a very limited version of the group pleading doctrine for securities fraud" in rejecting dismissal "where defendants signed [an] annual report and allegedly had access to contrary information." *Cabletron*, 311 F.3d at 40, *citing Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 367-68 (1st Cir. 1994). This Court would emphasize that *Serabian* is a pre-PSLRA case. Furthermore in *Cabletron*, the First Circuit expressed reticence about applying the presumption after the passage of the PSLRA; therefore the panel "set the issue aside without deciding it" because without relying on the group pleading doctrine, it was able to find that the complaint alleged a claim against all but one defendant. *Id.*

In 1997 the Tenth Circuit adopted the "group-published documents" exception to the rule that fraud must be pled with particularity. *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1254 (10th Cir. 1997)(holding that "[i]dentifying the individual sources of statements is unnecessary when the fraud allegations arise from misstatements or omission in group-published documents such as annual reports, which presumably involve collective actions of corporate directors or officers.").

As noted, district courts within the Ninth and Second Circuits have continued to apply the doctrine.

any instance in which it earlier adopted and/or applied the group pleading presumption.[15]

The Court is aware that on the surface this Court's rejection of the group pleading doctrine and its adoption and application of the SEC's standard for pleading a primary violation of §10(b) to entities whose employees created or were substantially involved in the formulation of a material misrepresentation for inclusion in a document intended for investor consumption, but that were not expressly identified at the time the document is issued, may appear to be inconsistent. Both involve the transfer of culpability from an individual to an entity or vice versa. Nevertheless the distinctions between the two are significant. The Court has applied the SEC standard to Lead Plaintiff's pleading that an entity-employer, such as a bank, Vinson & Elkins or Arthur Andersen, is liable for a firm-issued (i.e., group-issued) material misrepresentation. To reverse the transfer and impose liability for a primary violation under § 10(b) by the employer on an

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[15] If the group pleading doctrine were still applicable after the 1995 enactment of the Private Securities Litigation Reform Act ("PSLRA") (mandating that untrue statements or omissions be identified and the reason(s) why they are misleading be pleaded with particularity and that scienter must be pleaded through specific facts giving rise to a strong inference that the defendant acted with the required state of mind), a plaintiff would be relieved of the burden that he bears under the PSLRA or Rule 9(b) of identifying the speaker of a materially misleading statement and showing that he in particular made it with scienter. Nevertheless the plaintiff would still have to allege the circumstances in which the statement was made, explain the defendant's contribution or participation in some way to the making of such statement, and demonstrate the falsity of the material misrepresentation or omission with particularity.

individual employee, however, the Court concludes that there must be a showing that the individual employee, himself, violated the securities statute(s) through substantial participation in the fraud. For the same reason it rejects the group pleading presumption that without proof of their individual culpability, executives are liable for group-published misrepresentations.

The difference between imposition of liability on a corporation or entity for what an employee has done, as opposed to imposition of liability on an individual for what was done in the corporation's name, conforms to established legal concepts. For instance, under traditional agency principles a master is strictly liable for the torts of his servants committed while the servants acted within the scope of their employment,[16] even though the master/employer is not at fault.[17] Restatement (Second) of Agency

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[16] "Within the scope of employment" means that the act committed by the servant was "of the same general nature as that authorized." Note 5 of Restatement (Second) of Agency § 219(1). Whether the act was within the scope of an individual's employment depends on such factors as the time, place and purpose of the act, the similarity of the act to others that the servant is authorized to perform, whether the act is generally performed by servants, the degree the servant departed from usual methods, and whether the master might reasonably expect the servant to to perform the act. *Arguello v. Conoco, Inc.*, 207 F.3d 803, 810 (5th Cir. 2000), *citing Domar Ocean Transportation Ltd. v. Independent Refining Company*, 783 F.2d 1185, 1190 (5th Cir. 1986)(*in turn citing* Prosser and Keeton, *The Law of Torts* at 502 (5th ed. 1984) and Restatement (Second) of Agency § 228)), *cert. denied sub nom. Escobedo v. Conoco, Inc.*, 531 U.S. 874 (2000).

[17] As comment k to Restatement (Second) of Agency § 219 explains,

> The conception of the master's liability to third persons appears to be an outgrowth of the idea that within the

§ 219 (1958). Thus, as an example, in Title VII and § 1981 cases, an employer may be vicariously liable for the discriminatory actions of its supervisory employees under agency principles. *See, e.g., Faragher v. City of Boca Raton*, 524 U.S. 775, 807 (1998); *Grant v. Lone Star Co.*, 21 F.3d 649, 652 (5th Cir.), *cert. denied*, 513 U.S. 1015 (1994); *Flanagan v. Aaron E. Henry Comm. Health Services Center*, 876 F.2d 1231, 1235 (5th Cir. 1989).

Furthermore, "[c]orporations, by their very nature cannot function without human agents. As a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts." *See, e.g., Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995); *cited by Probst v. Ryder Truck Rental, Inc.*, No. CIV. A3:97-CV-2521-P, 1999 WL 184127, *9 (N.D. Tex. 1999). *See also Stop & Shop Companies, Inc. v. Federal Ins. Co.*, 136 F.3d 71,

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> time of the service, the master can exercise control over the physical activities of the servant. From this, the idea of responsibility for the harm done by the servant's activities followed naturally. The assumption of control is a usual basis for imposing tort liability when the thing controlled causes harm. It is true that normally one in control of tangible things is not liable without fault. But in the law of master and servant the use of the fiction that "the act of the servant is the act of the master" has made it seem fair to subject the non-faulty employer to liability for the negligence and other faulty conduct of his servants. It is probably true that before the nineteenth century the master was not normally responsible for the uncommanded acts of the servants, at least for those which did not enure to the master's benefit. However, with the growth of large enterprises, it became increasingly apparent that it would be unjust to permit an employer to gain from the intelligent cooperation of others without being responsible for the mistakes, errors of judgment and the frailties of those working under his direction and for his benefit.

74 (1st Cir. 1998)("[W]hile a corporation does have a noncorporeal and independent existence, it can conduct its affairs only through its officers and employees."). The same is true of partnerships. *See, e.g., Thomas v. Ross & Hardies*, 9 F. Supp.2d 547, 556 (D.Md. 1998)(Under basic agency law, the general rule is that a partner is an agent for the partnership and the partnership is liable for the wrongful act of its partners committed in the ordinary course of the business of the partnership, even if the agent's fraudulent act is committed solely for the benefit of the agent)(citing 59A Am. Jur. 2d Partnership § 650 (1987). "With fraud claims it is especially appropriate to hold a partnership liable when it benefitted from the fraudulent acts of its partners." *Id., citing* 59A Am. Jur. 2d Partnership § 670.

Nevertheless the reverse is not true; there is no rule of law[18] that a nonculpable employee or agent can be held personally and vicariously liable for the acts of its master/employer/principal or for the acts of other employees. *See, e.g., Rhyce v. Martin*, 173 F. Supp.2d 521, 537 (E.D. La. 2001). Without requiring the pleading of a specific factual basis demonstrating an individual's personal participation in tortious conduct, application of the group pleading doctrine might well result in a presumption that an innocent and unknowing officer of a corporation or firm is liable for group-published information created by another, which offends the pleading requirements under the PSLRA and Rule 9(b).

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[18] The Court notes that the group pleading doctrine is a pleading rule and not a substantive rule of law.

Controlling Person Liability Under § 20(a) of the 1934 Act

A. Evidentiary Burden

The Court first observes that it has previously found that Lead Plaintiff has satisfied pleading requirements and stated a primary violation claim against Arthur Andersen under § 10(b), an essential predicate for derivative, controlling person liability under § 20(a). Thus the Arthur Andersen partnership, itself, may serve as the "controlled person" and its allegedly wrongful acts may give rise to the joint and several liability of one or more Individual Andersen Defendants if Lead Plaintiff states and proves a claim against them as controlling persons.

Section 20(a) of the Exchange Act provides, "Every person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a). The term "controlling person" encompasses "every person who controls directly or indirectly." 15 U.S.C. §78t(a). In the absence of a statutory definition of "control," the SEC has defined the word as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether

through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12(b)-2(f), *quoted in G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957 (5th Cir. 1981). Furthermore, the legislative history of the controlling person provision indicates control can be shown by ownership of stock, agency, a lease or a contract, and that the concept of control should be broadly construed with sufficient flexibility to cover many situations, not necessarily only those foreseen at the time of enactment. Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 Notre Dame L. Rev. 263, 274 (1997), *citing* H.R. No. 73-1383, 73 Cong. 2d Sess. 26 (1934); James Lockhart, J.D., Annotation, *Liability of Issuer of Securities, Parent Corporation, Subsidiary or Affiliate, or Other Similar Entity as "Control Person" Under § 15 of the Securities Act (15 U.S.C.A. § 77O) and § 20(A) of Securities Exchange Act (15 U.S.C.A. 78T(A)*, 182 A.L.R. 387, §2[a] & nn. 6,7 (2002).

The requirements for demonstrating controlling person liability vary widely, depending upon the court. Although the Fifth Circuit Court of Appeals has not clearly defined its position, and indeed has not addressed the question since 1993,[19] the Fifth Circuit has required more than identifying the status or position of the alleged controlling person. *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509-10 (5th Cir. 1990)(". . . [S]tatus

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[19] *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 620 (5th Cir. 1993), *cert. denied sub nom. Turnbull v. Home Ins. Co.*, 510 U.S. 1177 (1994).

alone will not automatically cause [a defendant] to be deemed a Section 15 or 20 controlling person."). To plead a *prima facie* case of control by a defendant, a plaintiff must allege facts showing that the defendant "had the requisite power to directly or indirectly control or influence corporate policy." *Partridge*, 636 F.2d at 958; *McNamara v. Br-X Minerals Ltd.*, 46 F. Supp.2d 628, 637 (E.D. Tex. 1999); *Kunzweiler v. Zero.Net, Inc.*, No. CIV.A.3:00-CV-2553-P, 2002 WL 1461732, *13 (N.D. Tex. July 3, 2002). Nevertheless, the panel in *Partridge* emphasized, "Neither th[e] definition [of "control" by the SEC in 17 C.F.R. § 240.12(b)-2(f)] nor the statute appears to require participation in the wrongful transaction. Fifth Circuit case law appears to follow the plain meaning of the statute in this respect." 636 F.2d at 958.

A number of Circuit Courts of Appeal agree, but with significant variations. *See Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985)("[P]laintiffs must establish, first, that the defendant lender 'actually participated in (*i.e., exercised* control over) the operations of the corporation *in general*; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he *need not prove that this later power was exercised.*'"), *cert. denied sub nom. Metge v. Bankers Trust Co.*, 474 U.S. 1057 (1986); *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 877, 880-81 (7th Cir. 1992)(quoting *Metge* test and observing, "We have long viewed the statute as remedial, to be

construed liberally, and "'requiring only some indirect means of discipline or influence short of actual direction to hold a 'control person' liable.'"), *cert. denied*, 509 U.S. 904 (1993); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990)(*en banc*)(rejecting requirement of actual culpable participation or the exercise of actual power for liability under § 20(a)), *cert. denied*, 499 U.S. 976 (1991); *In re Villa*, 261 F.3d 1148, 1152 (11th Cir. 2001)("a defendant is liable as a 'controlling person' if he had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws, and had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability"; "a 'controlling person' may include not only partners or principals under agency law, but also any person who has the power to control the conduct of another person who has violated securities laws"), *cert. denied sub nom. Hoffend v. Villa*, 122 S. Ct. 2328 (2002); *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998)(plaintiff alleging controlling person liability is not required to show that "the defendant actually or culpably participated in the primary violation").

By way of comparison the Second and Third Circuits have adopted the more restrictive requirement of active participation in the operations of the corporation and in the underlying primary violation and actual control over the transaction at issue by the

defendant, also known as the "culpable participation" test. *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996)(for *prima facie* case of controlling person liability a plaintiff must show (1) "control of the primary violator by the targeted defendant" and (2) "that the controlling person was 'in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person"), *cert. denied*, 522 U.S. 812 (1997); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 885 (requiring control and culpable participation), *remanded*, 527 F.2d 891 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976). The First Circuit requires not only that the controlling person have the general power to control the company, but he must also have actually exercised that control over the company. *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 (1st Cir. 2002).

While the Fifth Circuit has explicitly rejected as an element of a claim under §20(a) actual participation by the controlling person in the specific transaction or action constituting the primary violation, it is unclear whether the Fifth Circuit has rejected the first prong of the Eighth Circuit's test in *Metge* (i.e., "the defendant [] actually participated in *(i.e. exercised)*, even requires general control of the corporation in general." *Metge*, 762 F.2d at 631. In *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187 (5th Cir. 1979), *affirmed in part, vacated and remanded in part on rehearing*, 611 F.2d 105 (5th Cir. 1980), after the district court had found that the chairman of the board of

Outdoor Resorts demonstrated that he was entitled to the statutory defenses that he acted in good faith and without inducing securities law violations and "could not have 'enforce(d) a system of control that would act as a curb on the sales personnel,'" the Fifth Circuit held that the district court's finding was not clearly erroneous and concluded, "As a director without effective day-to-day control and without knowledge, he was not liable as a controlling person." *Id.* at 195. In 1990, in *Partridge*, 636 F.2d at 959 n.24, the panel observed that *Cameron* "is ambiguous on whether 'effective day-to-day control' is required," but did not decide the issue because it found that the defendant in *Partridge* "had enough of that control under the case law from other circuits surveyed in the text." In addition, *id.* at 959 n.25, the *Partridge* panel observed that the *Cameron* court "did not say which factor [effective day-to-day control or lack of knowledge of the violation] is determinative or whether both are necessary," nor did it "define 'without knowledge,' which might or might not describe reckless behavior." The *Partridge* panel therefore "decline[d] to draw any guidance from this language [in *Cameron*]." *Id.* That same year in *Dennis*, 918 F.2d at 509-10, the appellate court suggested that *either* influence over corporate policies *or* knowledge of the acts by the controlled person(s) giving rise to the predicate § 10(b) violation might satisfy the requirements for derivative controlling person *liability*. Furthermore, for a *prima facie* case of controlling person liability under § 20(a), *Dennis* interpreted

Partridge to require a showing of "actual power or influence over the controlled person." 918 F.2d at 509. In 1993, the appellate court again expressed uncertainty, stating "the law is somewhat more unsettled as to prong one" than prong two ("the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but [plaintiff] did not need to prove that this later power was exercised") of the *Metge* test. *Abbott*, 2 F.3d at 619-20. The appellate court also noted that "*Dennis* does not accurately reflect our rejection in *Thompson* of a 'culpable participation' requirement." *Id.* at 620 n.18. Nevertheless, the panel chose "not [to] resolve the inconsistency" because it determined that the plaintiffs in that suit failed to establish that the defendant had the power to control the corporation. *Id.*

Defendants have cited a Second Circuit case in arguing that Lead Plaintiff must, but in the complaint fails, to allege particularized facts demonstrating the controlling person's culpable participation in the fraud that he perpetuated. *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997). Their contention lacks merit because, as this Court has indicated, the Fifth Circuit has rejected the requirement that a plaintiff must show that the controlling person actually participated in the underlying violation, and appears to insist that a plaintiff need only demonstrate that the controlling person possessed "the power to

control [the primary violator], [but] not the exercise of the power to control." *See In re Enron Corp. Sec., Derivative & ERISA Litigation*, No. H-01-3624, 2002 WL 31854963, *26, *citing Partridge*, 636 F.2d at 958 (a plaintiff must allege facts showing that the defendant "had the requisite power to directly or indirectly control or influence corporate policy"), and *Abbott*, 2 F.3d at 620 (5th Cir. 1993)(actual participation in the underlying § 10(b) violations is not required; whether effective day-to-day control of the general operations and affairs of the company is necessary to impose controlling person liability is uncertain).

b. Pleading Burden: Federal Rule of Civil Procedure 9(b) or 8?

There is also significant disagreement among the courts over the applicability of Rule 9(b)'s particularized pleading requirements[20] to controlling person liability under §20(a). *See generally*, 182 A.L.R. 387 at §2[a], §4. The Fifth Circuit has not directly addressed the question.

This Court notes that heightened pleading standards imposed by Rule 9(b) and the PSLRA apply only to circumstances constituting the alleged misstatement of material fact or fraudulent action at

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[20] Rule 9(b) provides

> **Fraud, Mistake, Condition of Mind.** In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

issue under § 10(b),[21] and not even to every element under that statute (e.g., reliance). Given the lack of clarity in the Fifth Circuit's pronouncements concerning what it requires for a *prima facie* case of derivative controlling person liability, and, in contrast, its clear and explicit rejection, as a *prima facie* element, of both culpable participation in the primary violation (i.e., participation in the fraud) by the controlled person and actual exercise of the controlling person's power to control, the Court strongly doubts that the Fifth Circuit would find Rule 9(b) applicable.

Moreover, the legislative history behind the controlling person provisions of both the 1933 and 1934 Acts indicates that Congress sought to reach persons who tried to evade responsibility under common law of agency by standing behind the scenes and having "dummies" under their control commit the primary violations.[22] Because without discovery, it would be extremely

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[21] *See, e.g., Romine v. Acxiom Corp.*, 296 F.3d 701, 704-05 (8th Cir. 2002)("The structure and legislative history of [the PSLRA] persuade us that §78u-4 applies only to fraud actions brought under the Securities Exchange Act of 1934. *Compare* Pub. L. 104-67 § 101(a) *with* § 101(b); 109 Stat. 737-49; *see* 1995-2 U.S.C.A.A.N. 679, 705, 740.

[22] *See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1115-16 (5th Cir. 1980). The Fifth Circuit explained,

> Congress enacted § 15 to prevent persons from evading liability for violations of the registration requirements of the Securities Act by employing others to act in their stead. . . . Congress's specific purpose in enacting § 15 was to impose liability upon persons who controlled corporations

committing violations of the Securities Act but who might attempt to evade liability under common law principles by utilizing "dummies" that would act in their place and under their control.

Id. at 1115, *citing SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975), and S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).

Section 20(a) was modeled upon § 15 "with the identical purpose of preventing persons from avoiding liability under the provisions of the Securities Exchange Act by utilizing 'dummies' to commit the prohibited acts" *Id.* at 1116, *citing SEC v. Management Dynamics, Inc.*, 515 F2. at 81, and Hearings before the Senate Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), 73 Cong., 1st Sess., pt. 15, at 6571 (1934).

In addition to "dummy directors," §20(a) expands the scope of liability to

> stock exchanges for the acts of brokerage houses they have registered; brokerage firms for the acts of non-agent correspondent brokers and investment advisers on the firm's approved lists; corporations for certain acts of their employees apparently outside the scope of employment; brokerage firms for their employees' misappropriation of their clients' funds under circumstances that appeared clearly beyond the scope of their employment; and directors and officers for the torts of other managers in which they did not participate and in situations where they would not have been viewed as principals in a master-servant relationship. Section 20(a) could also allow plaintiffs to reach defendants that control wrongdoers through holding companies, by family connections, or in other nonagency ways. Controlling shareholders could be reached in situations where piercing the corporate veil was not available. . . . In other words . . . [t]he controlling person liability provisions of the 1933 and 1934 Acts were aimed primarily at situations of control over firms (and others) by behind-the-scene actors. To repeat, enactment of the controlling provisions of the 1933 and 1934 Acts "was motivated by the fear that traditional theories of secondary liability, such as agency, would not prove adequate, in every case, to extend liability to those who were 'really responsible' for violations of the securities laws." [footnotes omitted]

difficult to know facts where the controlling person was hiding behind the controlled person, it appears to this Court that Rule 8's notice pleading standard would better effect that purpose.

A final reason why this Court concludes that the Fifth Circuit would decide that Rule 9(b) does not apply to pleading a § 20(a) claim is that the Fifth Circuit has held that § 15 of the Securities Act of 1933 and § 20(a) of the Exchange Act of 1934 are analogous and should be interpreted in the same manner. Pharo *v. Smith*, 621 F.2d 656, 673 (5th Cir. 1980); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 & n.22 (1981). Unlike §10(b), Section 11 claims may, but need not, be fraud-based and have no scienter requirement. The Fifth Circuit has held that where a complaint does not allege that the defendants are liable for fraudulent or intentional conduct under Section 11, especially where it disavows and disclaims any allegations of fraud in its strict liability 1933 Securities Act claims, as Lead Plaintiff has done, the claims do not "sound in fraud" and they cannot be dismissed for failure to satisfy Rule 9(b) if they can state a negligence claim under § 11. *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 368 (5th Cir. 2001)("The proper route is to disregard averments of fraud not meeting Rule 9(b)'s standard and then ask whether a claim

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Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 Ohio St. L.J. 1325, 1410 (1997).

has been stated."). *See also In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 315-16 (8th Cir. 1997)(holding that § 11 claims do not require evidence of fraud and therefore notice pleading standard of Rule 8, rather than the particularity requirements of Rule 9(b) govern pleading), *cert. denied*, 524 U.S. 927 (1998); *Romine*, 296 F.3d at 704-05; *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp.2d 371, 429-30 (S.D.N.Y. 2001); *In re CINAR Corp. Sec. Litig.*, 186 F. Supp.2d 279, 307-08 (E.D.N.Y. 2002). Thus controlling person liability under § 15 also does not appear to be subject to Rule 9(b), and by analogy, neither would pleading the same under § 20(a).

Other courts have reached the same conclusion about the nonapplicability of Rule 9(b) to controlling person liability. *See, e.g., Derensis v. Coopers & Lybrand Chartered Accountants*, 930 F. Supp. 1003, 1013 (D.N.J. 1996)(Despite Rule 9(b)'s requirement of pleading fraud with particularity, "there is 'an overwhelming trend in [the Third Circuit] to allow section 20(a) actions to withstand rule 9(b) motions based on simple pleading of control"; "plaintiff 'need only plead circumstances establishing control because : (1) the facts establishing culpable participation can only be expected to emerge after discovery; and (2) virtually all of the evidence, should it exist, is usually within the defendant's

control'" [citations omitted])[23]; *Chu v. Sabratek Corp.*, 100 F. Supp.2d 827, 843 (N.D. Ill. 2000)(stating that "§ 20(a) does not have a scienter requirement" and "liability is premised on a defendant's position in the corporate hierarchy"; stating "we know of no heightened pleading standards applicable to § 20(a) claims" and applying "the Federal Rules' liberal pleading standards" to § 20(a) claim)[24]; *In re Washington Public Supply System Sec. Litig.*, 623 F. Supp. 1466, 1470-71 (W.D. Wash. 1985)("It is not clear that Rule 9(b) applies to the claim brought under § 20 . . . . Technically, the strict pleading requirements are probably properly applied to the § 10(b) and Rule 10b-5 claims, but not to the § 20 claim.")[25], *aff'd*, 823 F.2d 1349 (9th Cir. 1987); *Duncan v. Pencer*,

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[23] In *Derensis*, the plaintiff alleged that the defendants as directors and members of the Audit Committee "reviewed and approved the misleading financial statements and public disclosures including reports filed with the SEC" and that they "had access to adverse non-public information." 930 F. Supp. 1013. In the face of a Rule 9(b) challenge, the court found that these allegations were sufficient to allege culpable participation (required by the Third Circuit) and control to state a claim under §20(a). *Id.*

[24] The Seventh Circuit applies a two-prong test for determining whether a defendant is liable as a control person: he must exercise control over the general operations of the defendant corporation and have the power to direct or prevent the underlying primary violation of §10(b). 100 F. Supp. at 843.

[25] The court observed that in contrast to the Second Circuit, "[t]he Ninth Circuit has adopted a more relaxed interpretation of the requirements of Rule 9(b) that is more in keeping with the spirit of the liberal federal rule of notice pleading and consistent with Rule 8(a) [citations omitted]." 623 F. Supp. 1471. The Ninth Circuit views Rule 9(b) as not requiring "pleading of detailed evidentiary matter . . . . Although mere conclusory allegations of fraud are not sufficient, it is an adequate averment

No. 94 Civ. 0321 (LAP), 1996 WL 19043, *18 (S.D.N.Y. Jan 18, 1996)("A Section 20(a) claim does not implicate Rule 9(b)'s heightened pleading requirements because it does not require an averment of fraud."), *citing Food and Allied Serv. Trades Dept., AFL-CIO v. Millfeld Trading Co., Inc.*, 841 F. Supp. 1386, 1391 (S.D.N.Y. 1994)(concluding that individual defendants' positions as "Treasurer, Chief Financial Officer, and Secretary of the defendant company strongly suggest that each of them possessed the power to direct the management and policies" of the company violating the statute)[26]; *Dietrich v. Bauer*, 76 F. Supp.2d 312, 333 (S.D.N.Y. 1999)(control status for liability under § 20(a) can be inferred directly, without additional facts, from defendants' positions as owner and president of brokerage firm; only where a defendant "does not clearly occupy control status" must the plaintiff plead facts from which it can be inferred); *In re Tel-Save Sec. Litig.*, 1999 WL 999427 (E.D. Pa. 1999).

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where plaintiffs have stated the time, place and nature of the alleged fraudulent activities. The Complaint must sufficiently identify the circumstances constituting the fraud to allow the defendants to adequately prepare their answers [citations omitted]." 623 F. Supp. at 1471.

[26] Since this opinion was issued, the Second Circuit has required allegations of culpable participation in the primary violation in addition to allegations of control. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997).

Thus if not subject to Rule 9(b), pleading a controlling liability claim would be governed by Rule 8.[27] As discussed *supra*, various courts have established different pleading and evidentiary standards to establish controlling person liability under § 15 and §20(a). Some of these specific pleading requirements, however, appear to have been implicitly overruled recently by *Swierkiewicz v. Sorema N.A.*, 122 S. Ct. 992 (2002), which distinguishes evidentiary and pleading burdens and clarifies the minimal requirements for notice pleading under Rule 8.

In *Swierkiewicz* a former employee had sued his employer for national origin and age discrimination under Title VII and the Age Discrimination in Employment Act. The Supreme Court reversed the Second Circuit, which in compliance with its established precedent, had affirmed the district court's dismissal of the suit for failing to allege facts constituting a *prima facie* case of discrimination, and thus failing to raise an inference of discrimination, under the shifting-burden-of-proof framework established in *McDonnell Douglas Corp. v. Green*, 411 U.S. 802 (1973). *Swierkiewicz*, 122 S. Ct. at 995-96. The Supreme Court concluded that under Rule 8, an employment discrimination complaint does not have to include

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[27] Rule 8(a) in relevant part requires "a short and plain statement of the claim showing that the pleader is entitled to relief." Rule 8(e)(1) states, "Each averment of a pleading shall be simple, concise and direct. No technical forms of pleading or motions are required." Furthermore, Rule 8(f) mandates, "All pleadings shall be so construed as to substantial justice."

specific facts, but need only contain a "short plain statement of the claim showing that the pleader is entitled to relief" under Rule 8(a)(2). 122 S. Ct. at 995. It emphasized that a "*prima facie* case relates to the employee's burden of presenting evidence" in contrast to his pleading burden. *Id.* at 997. In the context of a motion to dismiss under 12(b)(6), based on the sufficiency of the pleading before discovery and before evidence is offered, however, it is well established that "[t]he issue is not whether a plaintiff will ultimately prevail, but whether the claimant is entitled to offer evidence to support its claims." *Id., citing Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974).[28]

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[28] Some of the reasoning for the decision in *Swierkiewicz* applies only to a prima facie case in employment discrimination cases. For example, the Supreme Court emphasized that the shifting burden under *McDonell Douglas* does not apply to all such actions and that a plaintiff can prevail when he has direct evidence of discrimination without ever having to, or being able to, prove all the elements of a *prima facie* case. *Id.* at 997. Moreover the *McDonell Douglas* test has always been viewed as flexible: "the precise requirements of a prima facie case can vary depending on the context and were 'never intended to be rigid, mechanized or ritualistic." *Id., citing Furnco Constr. Corp. v. Waters*, 438 U.S. 567, 577 (1978). Because "the prima facie case operates as a flexible evidentiary standard, it should not be transposed into a rigid pleading standard for discrimination cases." *Id.* at 998. Indeed the courts in the Second Circuit have continued to view the holding in *Swierkiewicz* narrowly and limit it to employment discrimination cases. *See, e.g., Internet Law Library, Inc. v. Southridge Capital Management, LLC*, 223 F. Supp.2d 474, 487 (S.D.N.Y. 2002)("plaintiffs' reliance on *Swierkiewicz* is misplaced as the decision does not address control person liability in any way and the Second Circuit has clearly ruled that a plaintiff must adduce facts showing culpable participation in order to establish a prima facie case of control person liability."); *Bogart v. The City of New York*, No. 00 Civ. 7417(DLC), 2002 WL 1561065 (S.D.N.Y.

The Supreme Court emphasized that Rule 8(a)(2), by its express language, is a "simplified notice pleading standard" that "applies to all civil actions, with limited exceptions," i.e., those enumerated in Rule 9(b), and requires merely a statement that "'give[s] the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Id.* at 998, *citing Conley v. Gibson*, 355 U.S. 41, 47 (1957). This "standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Id. See also Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168-69 (1993)("[F]ederal courts and litigants must rely on summary judgment and control of discovery to weed out unmeritorious claims sooner rather than later."). Moreover, if the type of action at issue is not among those identified in Rule 9(b) (e.g., municipal liability under 42 U.S.C. §1983 or employment discrimination under Title VII), then the complaint need satisfy only Rule 8. *Swierkiewicz*, 122 S. Ct. at 998.

Under Rule 8, "'[a] court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts

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July 16, 2002)(in a suit alleging hostile work environment based on religious and ethnic discrimination, the court sated, "*Swierkiewicz*, however, has no relevance to the grounds on which Bogart[] requests to amend his complaint to add a First Amendment claim, a Fourteenth Amendment claim," etc.). For reasons explained *infra*, this Court finds the language in *Swierkiewicz* to sweep far more broadly than employment discrimination law.

that could be proved consistent with the allegations.'" *Id.*, *citing Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984). Where the allegations fail to provide sufficient notice, a defendant may move for a more definite statement under Rule 12(e), or for summary judgment under Rule 56. In sum, "[t]he liberal notice pleading of Rule 8(a) is the starting point of a simplified pleading system, which was adopted to focus litigation on the merits of a claim." *Id.* at 999. In response to the contention that permitting a party to proceed on spare, largely conclusory allegations of employment discrimination " will burden the courts and encourage disgruntled employees to bring unsubstantiated suits," Justice Clarence Thomas, writing for the Court, responded, "Whatever the practical merits of this argument, the Federal Rules do not contain a heightened pleading standard for employment discrimination suits [or any other kind of suit not enumerated in Rule 9(b)]. A requirement of greater specificity for particular claims is a result that 'must be obtained by the process of amending the Federal Rules,' and not by judicial interpretation." *Id.* Thus because Rule 8(a)'s pleading standard does not address the merits of a claim, even where on the face of the complaint recovery appears "very remote and unlikely," a complaint may satisfy the test if it provides the defendant with fair notice of the claims against it and the grounds upon which those claims rest, i.e., if

any set of facts might prove consistent with the allegations. *Id.*, *citing Scheuer*, 416 U.S. at 236; *Hishon*, 467 U.S. at 73.

Thus, as clarified in *Swierkiewicz*, a plaintiff does not need to allege facts to support every element of a *prima facie* case of a cause of action governed by Rule 8's notice pleading standard.

c. Statutory Defense to Controlling Person Claim

Controlling person liability, while derivative, is not strict liability; the alleged controlling person has a statutory affirmative defense if he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. §78t(a). Once a plaintiff establishes the defendant's ability to control, the burden shifts to the defendant to show that it acted in good faith or that it did not induce the underlying § 10(b) violation. *Partridge*, 636 F.2d at 958. Furthermore, the Fifth Circuit has held that recklessness is an appropriate standard for determining whether the defendant acted in good faith. *Id.* at 959. The Fifth Circuit's rationale was that recklessness is consistent with the Circuit's precedent and "[i]t would be anomalous to require intent under the controlling person doctrine, while holding noncontrolling persons liable for severe recklessness. . . . Furthermore, what would be the purpose of the controlling person provision if intent were required[;] the provision would hardly make anyone liable who would not be so

otherwise. . . . . [H]ad Congress meant to require intentional misdoing, we assume it would have done so explicitly. [citations omitted]" *Id.* at 959-60.

COURT'S DECISION

Section 10(b) and Rule 10b-5 Claims

Putting aside the allegations against Arthur Andersen and the collective "Andersen partners," which relate to the liability of the firm, the Court has focused upon the allegations relating to each individual Andersen Defendant to determine if Lead Plaintiff has pleaded particular facts against each partner sufficient to state a claim against each individually under § 10(b) and Rule 10b-5. *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)(*Central Bank* "does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme"). While Lead Plaintiff conclusorily asserts that all Individual Andersen Defendants were participants in a scheme to defraud, after carefully reviewing the consolidated complaint, the Court concurs with the Individual Andersen Defendants that Lead Plaintiff has failed to satisfy the particularized pleading requirements of the PSLRA and Rule 9(b) to state a claim of a primary violation of § 10(b) and Rule 10b-5 against any of them individually.

Most of Lead Plaintiff's allegations are collective claims, i.e., against Arthur Andersen as an entity, and the claims against the partners individually are fatally vague and conclusory. Lead Plaintiff fails to identify any person who personally performed the purportedly fraudulent accounting or auditing, no less under what factual circumstances. Lead Plaintiff fails to allege that any partner specifically directed a particular auditor to perform a specific action with regard to Enron's accounting or auditing. Although Lead Plaintiff vaguely claims that Stewart, Petersen, and Neuhausen approved use of mark-to-market accounting, that technique is not necessarily inherently fraudulent, although it is obviously vulnerable to abuse. Nevertheless the complaint does address in detail how mark-to-market accounting was abused in various applications, although it does not identify by whom. More important, Lead Plaintiff provides no details about Stewart's Petersen's and Neuhausen's roles in that approval, including specifically what each approved, where, when, and for what purpose (with respect to which SPEs or partnerships for which transactions), who was directed by them to apply the method improperly, why it was improper under the circumstances, and why or how each Defendant knew or was recklessly indifferent to that fraudulent application of mark-to-market accounting. Indeed Lead Plaintiff does not identify a single instance when any of the three named partners personally sanctioned use of the mark-to-market

technique in a fraudulent manner, supported by specific facts, for an identified transaction or venture.

The same pleading deficiency is true of Lead Plaintiff's nonspecific assertion that Cash, Duncan, Lowther, Odom and Stewart were "deeply involved" in and approved the accounting for the Raptors.

Carl Bass' criticism of Enron-related accounting is not specifically delineated and the generalized description of its content is ambiguous, weakening the import of his removal by Berardino and Odom in the context of § 10(b)'s heightened pleading standards. To state a claim under §10(b), Lead Plaintiff would have had to, but has failed to, identify and support with specific facts the circumstances earlier in the Class Period under which identified Andersen officials with scienter affirmatively suppressed or deleted information about particular improprieties in Enron-related accounting that had been brought to their attention by Bass and to allege that this concealment of Bass' criticism was material and caused misleading information to be released to the public, with the participating partners' knowledge that investors would rely on that information in purchasing or selling Enron securities.

The only partner identified as signing Arthur Andersen's certification of Enron's Form 10-Ks, the basis of alleged misrepresentations under §10(b), is David Duncan, who is not a

Movant here. Nor has Lead Plaintiff provided any details about which of the partners were involved in the drafting of which Enron reports, press releases, etc. While the collective actions of Arthur Andersen's employees in accounting and auditing Enron's books, in certifying Enron's financial statements for 1997-2000 as being in compliance with GAAP and its audits of financial statements in compliance with GAAS, and in consenting to having those financial statements included in registration statements, prospectuses, and shareholders' reports, together, do support claims for potential liability of the Arthur Andersen firm under § 10(b) and Rule 10b-5, the lack of specificity about each partner's involvement to demonstrate his personal culpability warrants dismissal of claims against each, individually.

Similarly, the alleged document destruction in the fall of 2001 does not constitute a primary violation of § 10(b) made in connection with the purchase or sale of securities.[29] Even if it were, Lead Plaintiff fails to satisfy the reliance element under § 10(b) for that destruction. The allegations relating to document destruction and concealment of the alleged fraud are relevant to scienter, but without a primary violation of § 10(b) by each Individual Andersen Defendant, state of mind is of little import.

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[29] For the same reason, the Court has disregarded arguments that particular Individual Andersen Defendants are jointly and severally liable as controlling persons under § 20(a) for the document destruction, no less allegedly ordering it.

The last purported misrepresentation was issued by Arthur Andersen in a registration statement issued on July 25, 2001. Thus also reflecting scienter, but failing to state a claim of violation of § 10(b), are the complaint's allegations that months later, on October 16, 2001, toward the end of the Class Period when an SEC investigation was imminent, after reminding Andersen personnel about the document "retention" policy and after a meeting with high level partners in Chicago, Nancy Temple, in order to make it appear that Andersen partners had been more critical of the accounting for Enron (i.e., had performed due diligence), sent an e-mail suggesting that Carl Bass' prior e-mail criticisms of internal memoranda, should not be deleted after all, but that their contents should now be included in a memorandum currently being drafted by top Andersen officials.

The various internal e-mails sent among the Andersen partners, including those referring to Bass' and Watkins' criticism of Arthur Andersen's accounting for Enron-controlled partnerships and SPEs, also relate to scienter; the same is true of the alleged discussions by the partners involved in the teleconference meeting on February 5, 2001.

The allegations regarding the partners' purported discussions of the risk of continuing to represent Enron and Bass' ongoing adverse comments, while listing a number of attendees, fail to link them individually to or describe the contents of specific

statements. Nor does Watkins identify any Individual Andersen Defendant as being involved in the worrisome accounting practices of which she complained to Hecker and Lay. Moreover allegations that certain partners had knowledge of Bass' or Watkins' criticism of improper accounting practices are of no import to stating an individual claim against each unless Lead Plaintiff can also allege with specificity a primary violation of § 10(b) by the same individual(s).

Lead Plaintiff also argues that accountants have a duty "to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying" and that "[t]he importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted." *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043-44 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *see also United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976)(holding that an accountant had a duty to correct earlier financial statements which he himself had audited and upon which he issued his certificate); *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 549 (S.D.N.Y. 1977). Because Lead Plaintiff has not identified who did the auditing, who certified the audits, who consented to have the reports included in registration statements, or, in other words,

who actually committed a primary violation of § 10(b), any continuing duty to disclose or correct should be imposed on the firm of Arthur Andersen rather than personally on individuals who may not be, and were not identified as, the specific firm members responsible for the underlying, original misrepresentation or deceptive act. The Court notes that in all the cases cited by Lead Plaintiff regarding an independent public accountant's continuous duty to disclose, the duty was imposed on the accounting *firm*, with the exception of *Natelli*, in which the plaintiff identified the individual accountant on whom the plaintiff sought to place the duty to correct as the same person who had made the earlier inaccurate financial statements and certified them.

Controlling Person Liability Under § 20(a)

This Court has previously found that Lead Plaintiff has stated a claim against Arthur Andersen, as an entity, for a primary violation § 10(b) of the 1934 Act. Thus the firm may serve as the "controlled person" for controlling person liability if Lead Plaintiff can state a claim against any of the Individual Andersen Defendants under § 20(a).

Although Odom objects that Lead Plaintiff has not alleged that any Individual Andersen Defendant had the power to control the operations of Arthur Andersen as a whole (including foreign affiliates), this Court notes that it is highly unlikely in a firm

as large, complex, and widespread as Arthur Andersen that any single individual would have control of every particular division or engagement. Instead, the Court presumes that decision-making and policy-making powers would have to have been divided and delegated among numerous individuals and groups. *See, e.g.*, Carson, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 Notre Dame L. Rev. at 277-78 ("In larger organizations, authority to control may be split along divisional . . . [or] functional lines . . . [and s]uch segmentations of authority to control in a particular organizational framework would not preclude other persons having actual control with respect to a particular segment"; "the more complex the organizational framework, the more likely it is that the managerial functions executive officers are authorized to perform, of necessity, will be shared."). Thus the Court finds that allegations of control over the accountants and auditors involved in the Enron engagements or the policies affecting them would be sufficient here to demonstrate controlling person liability under § 20(a).

Carson provides insightful discussion of the nature of the authority of "control persons" within a corporation "to control the corporation's 'direction of . . . management and policies'" that would also be true in a large limited liability partnership the size of Arthur Andersen. In language that appears to this Court not only to follow the directive of the Fifth Circuit, but to flesh

out and comply with the spirit, substance, and reasoning of its holdings regarding controlling person liability, Carson explains,

> Ordinarily, this "direction" is set within corporations by those persons authorized to control organizational decision-making processes. Organizational decision-making processes have been characterized as having four steps: initiation, ratification, implementation, and monitoring. Initiation involves the generation of proposals for organizational endeavors, while ratification involves the process of approving which of the initiatives are to be implemented. Implementation can be described as the execution or management of organizational policies and decisions, while monitoring involves oversight of these implementing or managing organizational policies and decisions. The primary control functions in corporate organizations are ratification and (especially) management and monitoring.
>
> The decisional actors within formal organizational hierarchies with authority to ratify, manage and monitor are majority shareholders, boards of directors, and executive officers. . . .
>
> [A] person should be presumed to be a controlling person under sections 15 and 20(a) if they occupy a status or position that ordinarily bestows authority to control the primary violator generally, or specifically with respect to the matter or affairs that produced the Securities Act violation. . . . A section 15 or 20(a) complaint based on authority to control, then, should not have to make specific allegations concerning any actual exercise of control by the defendant over the Securities Act violator. Plaintiff, however, should be required to identify the de jure source of authority to control--the status or position--and allege conduct that facilitated the Securities Acts violations, or allege a failure to exercise authority to prevent the violations, or both. The presumption of controlling person status, based on occupying a position or status that ordinarily conveys authority to control, should be rebuttable by a showing of a lack of authority in fact or that other persons controlled the primary violators to the exclusion of defendants.

Carson, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 Notre Dame L. Rev. at 281-83 (endnotes omitted).

As noted, under Fifth Circuit precedent, controlling person liability requires more than merely identifying a defendant's place in the hierarchy of the company or his job title, but precisely how much more is not clear. In various cases the Fifth Circuit has provided possible alternative or overlapping bases: day-to-day control of the corporation's operations (*Cameron*, 608 F.2d at 195); knowledge of the underlying primary violation by the controlled person (*id.; Partridge*, 636 F.2d at 959 n.25; *Dennis*, 918 F.2d at 509-10); or facts showing the defendant had the requisite power directly or indirectly to control or influence corporate policies (*Partridge*, 636 F.2d at 958; *Dennis*, 918 F.2d at 509-10). Moreover, the Court has indicated in its discussion of Rule 8 pleading requirements and *Swierkiewicz*, 122 S. Ct. 992, that Lead Plaintiff is not required to plead facts supporting every element of a *prima facie* case of control liability under § 20(a), but only to give Individual Andersen Defendants fair notice of Lead Plaintiff's claims and the grounds upon which they rest.

Applying Carson's analysis and Rule 8's simple pleading standard, the Court finds that in the cases of most of the Individual Andersen Defendants, Lead Plaintiff, in addition to stating their positions as upper echelon partners ("the de jure

source of authority to control") and distinguishing the ways each was involved in the Enron engagement, has made sufficient general allegations regarding "the conduct that facilitated the Securities Act violations," that suggest the partners had the power to control and/or, in fact, did "control" Enron's auditor by initiating, ratifying, and implementing Arthur Andersen's policies, or overseeing and monitoring those effectuating Andersen's policies and decisions. *Id.* *See, e.g., Kunzweiler v. Zero.Net, Inc.*, No. CIV.A.3:00-CV-2553-P, 2002 WL 1461732, *13-5 (N.D. Tex. July 3, 2002).

As the basis for a claim that individual Andersen partners controlled Arthur Andersen, Lead Plaintiff's Opposition (#840 at 62) first summarizes what is implicit or obvious in the complaint,

> The Andersen Partners comprised the Enron engagement and audit team. The decision to certify Enron's financial statements on Andersen's behalf rested with them. Under these circumstances it is clear that the Andersen Partners "possessed the power to direct or cause the direction of the management" of Andersen and had "the power to influence and control" its actions.

Lead Plaintiff has identified the top Andersen executives who participated in the teleconference on February 5, 2001, including Individual Andersen Defendants Swanson, Stewart, Jones, Bauer, Lowther, Odom, Goolsby, Goddard, and Bennett. Lead Plaintiff has asserted generally that these partners discussed whether to retain Enron as a client in light of alleged, specific, improper actions

by Enron and others to defraud investors and enrich alleged Ponzi scheme participants. According to the complaint, Arthur Andersen had to be aware of this alleged wrongful conduct because it performed accounting, auditing and consulting services for Enron that concealed the debt by moving it off Enron's balance sheets to those of the purportedly illegitimate SPEs and recorded sham profits on the books. The complaint's allegations that those partners attending the February 5, 2001 teleconference meeting, despite knowledge of these improprieties at the very least because of their participation in that meeting addressing the purported improprieties, nevertheless agreed to retain Enron as a client and to issue a false "clean" audit opinion for Enron for 2000, satisfy requirements for pleading that these partners were controlling persons under § 20(a). As asserted by Lead Plaintiff, their decisions imply that they not only had the power to control, but actually directed the affairs and policies of both the consulting and auditing Enron engagements to sustain the alleged Ponzi scheme and to benefit from it.

CEO Berardino, through his position of power in the partnership, is specifically charged with controlling the affairs of the partnership, commanding Arthur Andersen's management, and determining, ratifying, and implementing policies for the Enron engagement as follows: (1) he purportedly reviewed and approved

Arthur Andersen's document "retention" policy,[30] which was implemented firm-wide to get rid of massive amounts of purportedly incriminating Enron-related documentation between October 23 and November 9, 2001; (2) he met *inter alia* with Enron Chief Accounting Officer Richard Causey, who objected to Carl Bass' criticism of accounting practices on the Enron engagement, and subsequently, pursuant to a request from Enron, effected (along with Odom) Bass' removal as PSG advisor to the Enron audit team; and (3) as a top partner in Andersen's PSG, he reviewed the propriety of accounting for Enron's transactions.

Lead Plaintiff asserts that Tom Bauer, a lead partner working exclusively on the Enron auditing and consulting engagements, in addition to attending the teleconference meeting on 2/5/01 and authorizing the issuance of an unqualified audit opinion, directed

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[30]Lead Plaintiff alleges that the phrase, "'complying with the firm's retention policy,' is a mantra that is formally taught and formally and informally enforced by policy and practice at every turn throughout an auditor's career at Andersen" and that "'reminders' about compliance were widely understood within Andersen to be a directive to destroy any incriminating documents at Andersen" despite its "professional responsibility to retain and preserve documents to support and defend the conclusions and work performed during its audit and review services. Andersen's formal and informal document destruction practices are driven by an overwhelming mission to insulate itself from potential legal exposure and outside scrutiny when its audit work comes under fire." Complaint at 475-76. The document destruction *policy*, which had been in place for years and continued to be and which was "taken to new heights" during the Waste Management scandal in 1998, *id.*, should be distinguished from the document destruction *event* that took place in the fall of 2001 in the face of the imminent SEC investigation of Enron, which constituted one instance when the policy was put into play.

the auditing of Enron's commodity trading (which Lead Plaintiff has pleaded in detail was a significant part of the alleged Ponzi scheme).

The Court finds that the allegation that PSG (the oversight committee) partner Carl Bass, located in Houston, directed his negative e-mails regarding accounting improprieties relating to the SPEs to PSG partners Stewart and Neuhausen in Chicago supports the inference that Stewart and Neuhausen also had at least some control over policies and management of the Enron engagement. On the other hand, the mere fact that other partners such as Bauer, Petersen, and Cash were informed about Bass' criticism does not necessarily suggest control, but could be attributed to many reasons other than control. Also with respect to the PSG partners, although the conclusory allegation that Stewart, Petersen and Neuhausen "continued to approve Enron's use of mark-to-market accounting as Enron became more egregious in revenue recognition" during the Class Period fails to state a claim under § 10(b) because of its heightened pleading requirements, it does state a claim of ratification and implementation by controlling persons under § 20(a) and Rule 8.

Once James A. Hecker was warned by Sherron Watkins that she had found improprieties, similar to those discussed at the February 5, 2001 teleconference meeting, in the Enron accounting and would be reporting them in a couple of days to CEO Kenneth Lay, Hecker

immediately called an emergency meeting of Arthur Andersen partners, including Duncan, Swanson, Cash and Odom of the Houston office. It can be inferred therefore that Movants Swanson, Cash, and Odom had policy- or decision-making and management control over the Enron engagement accountants and auditors in Houston.

Moreover, the complaint alleges that e-mails among Cash, Duncan and Stewart throughout the Class Period reveal that Arthur Andersen officials, including Duncan, Cash, Lowther, Odom and Stewart, were responsible for the firm's decision to improperly record individual impairment charges for Raptor investments that had significantly declined in value.

Accordingly, the Court

ORDERS that for the reasons indicated *supra*, the motions to dismiss filed by Individual Andersen Defendants Thomas H. Bauer, Michael L. Bennett, Joseph F. Berardino, Deborah A. Cash, Donald Dreyfuss, James A. Friedlieb, D. Stephan Goddard, Jr., Gary B. Goolsby, Gregory W. Hale, Michael D. Jones, Michael M. Lowther, Benjamin S. Neuhausen, Richard R. Petersen, John E. Stewart, William E. Swanson, Nancy Temple, Roger D. Willard (#651) and Michael Odom (#684) are GRANTED as to the claims under § 10(b).

The Court further

ORDERS that the motions to dismiss claims under §20(a) for controlling person liability are DENIED as to Individual Andersen Defendants Berardino, Bauer, Swanson, Stewart, Jones, Lowther,

Odom, Goolsby, Goddard, Bennett, Neuhausen, Petersen, and Cash, but are GRANTED as to Temple, Dreyfuss, Friedlieb, Willard, and Hale. Thus Lead Plaintiff's claims against Temple, Dreyfuss, Friedlieb, Willard, and Hale, individually, are DISMISSED in full.

SIGNED at Houston, Texas, this 28th day of January, 2003.

MELINDA HARMON
UNITED STATES DISTRICT JUDGE