United States Courts
Southern District of Texas
ENTERED

FEB 18 2005

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
MARK NEWBY, ET AL., Plaintiffs VS. ENRON CORPORATION, ET AL., Defendants	§ § § § § § § § §	CIVIL ACTION NO. H-01-3624 AND CONSOLIDATED CASES
SAMUEL GIANCARLO, Individually and on Behalf of All Others Similarly Situated, Plaintiffs, VS. UBS FINANCIAL SERVICES, INC., UBS SECURITIES, L.L.C., UBS AG and UBS O'CONNOR, L.L.C., Defendants.	§ § § § § § § § § § § § §	CIVIL ACTION NO. H-03-4359 COORDINATED CASE

MEMORANDUM AND ORDER

Plaintiff Samuel Giancarlo has filed this putative class action on behalf of "all persons and/or entities who purchased and/or acquired Enron Corp.'s notes, debt or other debt instruments through [PaineWebber]"[1] and on behalf of "all persons and/or entities who purchased and/or acquired Enron Zero Coupon Convertible Senior Notes due 2021 (Registration No. 333-62168)"

[1] For class claims under the Securities Exchange Act of 1934. #16 at 18.

through PaineWebber[2] during a proposed class period from October 2, 2000 to December 2, 2001, alleging that Defendants perpetrated fraud on their clients and the market in general in violation of §§ 11, 12(a)(2) and 15 of the Securities Act of 1933 ("the 1933 Act), 15 U.S.C. §§ 77(k), 77(l), and 77(o), *et seq.*, of §§ 10(b) and 20(a) of the Securities Act of 1934 ("the 1934 Act"), 15 U.S.C. §§ 78j(b) and 78(t), and of the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. §§ 78(u)(4) 78(a), *et seq.* Giancarlo, himself, purchased only the Enron Zero Coupon Convertible Senior Notes, due 2021, through his account at UBS PaineWebber Inc. ("PaineWebber), formerly known as UBS Financial Services.

Pending before the Court in H-03-4359 is Defendants UBS Financial Services, Inc., UBS Securities LLC, UBS AG, and UBS O'Connor's (collectively, "UBS'")[3] motion to dismiss the original class action complaint (instrument #7) for (1) failure to state

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[2] For class claims under the Securities Act of 1933. #16 at 18.

[3] According to UBS, #8 at 3-4, UBS Financial Securities LLC was formerly known as UBS Warburg LLC ("Warburg"). Warburg and UBS O'Connor LLC are subsidiaries of UBS AG, an international financial institution, which is headquartered in Switzerland. UBS Financial Services, Inc., formerly UBS PaineWebber, Inc., provides brokerage services and investment advice, while UBS Securities LLC functions as a securities and investment banking firm. UBS O'Connor, LLC is a registered investment advisor.

During the class period (October 2, 2000--December 2, 2001) analysts at Warburg allegedly issued opinions called "research notes" about the securities of public companies, including Enron. After UBS AG's acquisition of PaineWebber in November 2000, Warburg provided its Enron research to PaineWebber, which in turn allegedly required its brokers to provide that research to any client whose broker's advice was inconsistent with the Warburg analysis.

a claim under Federal Rule of Civil Procedure 12(b)(6); (2) failure to plead fraud with particularity under Rule 9(b) and the PSLRA; (3) failure to plead scienter, as required by the PSLRA; and (4) failure to comply with applicable statutes of limitations for the 1933 Act claims.

The Court hereby incorporates the law as stated in its prior memoranda and orders in *Newby*, in particular #1194, 1269, and 1999, addressing another MDL 1446 case related to the instant suit, *Lamkin v. UBS PaineWebber Inc.*, H-02-851.

I. Statute of Limitations for 1933 Act Claims

First, UBS' motion to dismiss contends that the 1933 Act claims are time barred. Enron Corporation declared bankruptcy on December 2, 2001. Plaintiff waited almost two years, until October 10, 2003, to file this suit. UBS maintains that many of the facts underlying his claim were public knowledge long before that point. More revealing is the fact that many of the same facts alleged in the instant action filed by Giancarlo were contained in a complaint filed on March 7, 2002, nineteen months earlier than Giancarlo's, by the same attorney, in another putative class action against UBS, but brought on behalf of holders of Enron common stock purchased through PaineWebber accounts, i.e., *Lamkin v. UBS PaineWebber Inc.*, H-02-851, pending before the undersigned judge in this MDL litigation. Furthermore UBS charges that Giancarlo's original complaint copies verbatim from the Second Amended Complaint filed in *Lamkin* on June 24, 2002

(copy filed under #9, Appendix).[4] UBS lists examples of the identical factual allegations in the two complaints. #8 at 9. UBS argues that Section 13, 15 U.S.C. § 77m, which applies to claims under the 1933 Act, requires that all claims under §§ 11, 12(a)(2), and 15 must be "brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . ." UBS contends that the *Lamkin* amended complaint demonstrates that Plaintiff's counsel had actual knowledge of many of the facts at issue here by June 24, 2002, yet waited over a year to file the instant action. Furthermore UBS insists that the expanded statute of limitations[5] under § 804 of Corporate and Criminal Fraud and Accountability Act of 2002, popularly known as the Sarbanes-Oxley Act, does not apply to claims under §§ 11, 12(a)(2), and 15.

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[4] *See generally* the Court's memorandum and order denying UBS' motion to dismiss in *Lamkin*, also incorporated herein, *see* #1832 in *Newby;* a copy has been submitted by UBS in an appendix, #9 in H-03-4359. Because the Court has summarized the facts in that case in detail and because of the similarity of facts here, the Court does not reiterate them but refers the parties to #1999 and to the original complaint in the instant suit.

[5] For private causes of action alleging "fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws," Section 804 amended 28 U.S.C. § 1658 by adding subsection (b) to lengthen the limitations/repose period: suit must be brought not later than the earlier of two years after discovery of the facts constituting the violation or five years after the violation. Public Company Accounting and Investor Protection Act of 2002, Pub. L. 107-204, Title VIII, § 804, 116 Stat. 745, 801, codified in part at 28 U.S.C. § 1658(b).

Plaintiff concedes that the *Lamkin* complaint asserted many of the same facts and, indeed, argues that because the undersigned judge found that *Lamkin* complaint pled fraud and scienter adequately, so should the pleading in Giancarlo's complaint be sufficient.[6] Giancarlo also contends that his allegations are based on a significant amount of evidence "that came to light after the filing of the *Lamkin* complaint" and that his "complaint specifies in much greater detail and with much greater particularity the fraud perpetrated by Defendants on Plaintiff and the United States securities market." #16 at 7.

This Court has analyzed the reach of § 804 of the Sarbanes-Oxley Act in substantial detail in #1999 at 31-59 in *Newby* and concluded that its expanded statute of limitations does not apply to §§ 11 and 12(a)(2) claims, and thus to derivative

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[6] Giancarlo, like Lamkin, paints a picture of a very subservient PaineWebber obsequiously playing to Enron for lucrative business. Warburg persisted in its "Strong Buy" rating until November 28, 2001, even after the SEC began formally investigating Enron and after the stock had dropped to about $1.00, when Warburg's Ron Barone finally lowered the recommendation to "Hold." Enron declared bankruptcy only four days later.

UBS distinguishes this suit from *Lamkin*, in which this Court found that a strong inference of scienter was raised by allegations showing that PaineWebber "was totally controlled by Enron's need to feed the frenzied Ponzi scheme." #8 at 16, n, 6, citing #1999 at 18. In contrast, UBS emphasizes that here Plaintiff's claims "relate only to Enron debt securities already owned by UBS, not to sales of common stock on Enron's behalf or through Enron's employee stock option plan."

Nevertheless the Court observes that the fact that PaineWebber owned the unsecured debt securities at issue provides a motive on the part of UBS to "unload" by fraudulent misrepresentation the significant amount of unsecured Enron debt that PaineWebber had purchased earlier, especially, as alleged, if UBS now knew the actual financial condition of Enron and UBS's vulnerability.

claims under § 15. Section 804 of the Sarbanes-Oxley Act expressly applies only to "a private right of action that involves a claim of fraud, deceit, manipulation or contrivance." Claims under § 11 and § 12(a)(2) may sound in negligence or strict liability and do not require a showing of fraudulent intent. *See* #1999 at 35-40.

The *Lamkin* amended complaint also demonstrates that Plaintiff's attorney was on actual notice of Plaintiff's 1933 Act claims prior to October 10, 2002, more than a year before he filed this suit. Moreover, finding more evidence and more detail about violations is not the test of when limitations begins to run, nor can it postpone that trigger date. The Court agrees with Defendants that the amended *Lamkin* complaint shows that Plaintiff's counsel had actual knowledge of the alleged 1933 Act violations well over a year before filing suit for Giancarlo.

In sum, the Court finds that the §§ 11, 12(a)(2), and 15 claims here are time-barred.

II. Standing:

Second, with respect to claims under the Securities Exchange Act of 1934,[7] UBS maintains that Plaintiff, who seeks to

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[7] Because the Court has found that the 1933 Act claims are time-barred it does not address the standing issue for the class defined by Plaintiff for those claims. The 1933 Act by its express language limits standing to sue under §§ 11 and 12(a)(2) to those who purchased the security *at issue*, and a § 12(a)(2) claim can only be asserted against the seller from whom the plaintiff purchased. *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 861 (5th Cir. 2003). Section 10(b) applies to purchasers **and sellers** and has a much wider array of defendants on which liability may be imposed.

represent a class which purchased and/or acquired Enron Corp.'s notes, debt or other debt instruments through PaineWebber accounts from October 2, 2000 to December 2, 2001, including debt securities Plaintiff never owned, lacks standing to represent purchasers of Enron debt securities other than of the type he bought, i.e., the Enron Zero Coupon Notes. UBS cites *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742 (1975)("plaintiffs who were not themselves purchasers or sellers of the stock in question" may not assert claims under § 10(b)); *Smith v. Ayers*, 977 F.2d 946, 950 (5th Cir. 1992)("The *Blue Chip Stamps* decision was intended to tightly restrict the availability of Rule 10b-5 actions."). " . . . [A] person cannot predicate standing on injury he does not share. Standing cannot be acquired through the back door of a class action." *Brown v. Sibley*, 650 F.2d 760, 771 (5th Cir. 1981). *See* this Court's examination of standing and class representation in #1999 at 63-66, 72-97 (dealing mainly with § 12(a)(2) claims).

The Court finds that UBS is confusing two issues here, (1) standing and (2) the requirements for class representation.

To satisfy the constitutional requirements for individual standing under Article III of the United States Constitution, at minimum a plaintiff must assert that he has "suffered an 'injury in fact,'--an invasion of a legally protected interest that is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical. Second there must be a causal connection between the injury and the conduct

complained of . . . . Third, it must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision." *James v. City of Dallas, Tex.*, 254 F.3d 551, 563 (5th Cir. 2001)(*quoting indirectly Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992)), *cert. denied*, 534 U.S. 1113 (2002).

The Court concludes that Defendants read *Blue Chip* too narrowly. Section 10(b) and Rule 10b-5 prohibit deceptive practices "in connection with the purchase or sale of **any** security [emphasis added by the Court]." The case holds that only plaintiffs who actually purchased or sold "any security," as the statute broadly, expressly, and unambiguously provides, as opposed, for instance, to those who would have purchased or would have sold had they known the truth, those who decided not to buy or sell a security because of misrepresentations, or those who held securities and were injured by insider sales or breaches of fiduciary duty by corporate officers, are entitled to sue under the statute according to the holding of *Blue Chip*, 421 U.S. at 747 (adopting the rule of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Consistent with the purpose of the 1934 Act to protect actual participants in the securities market, *Blue Chip* limited "the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates.". In other words, *Blue Chip* confers standing under § 10(b) based on the act of actually purchasing or selling securities, and on direct injury

in connection with that purchase or sale.[8] As alleged in this action Giancarlo did purchase the Enron Zero Coupon Notes during the proposed class period.

Giancarlo has pled the requisite injury under § 10(b) and Rule 10b-5 and has standing to bring a cause of action under § 10(b) and Rule 10b-5 at least based on the Zero Coupon Notes, and, depending on a showing at the class certification hearing, perhaps some or all of the other debt securities purchased by the putative class members.

Giancarlo has asserted that material representations and omissions, as well as deceptive devices, contrivances, scheme, and conduct, by UBS, done intentionally or with severe reckless disregard of the truth, and targeting PaineWebber account holders, related to the financial health of Enron **generally**; this identical conduct deceived many into purchasing various Enron debt securities through their PaineWebber accounts during the proposed class period at an inflated market price, and, with the subsequent collapse of Enron, these account holders were injured. The issue of whether Giancarlo may represent all types of debt securities purchasers with PaineWebber accounts in the putative class for §

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[8] In support of the high court's purchaser/seller requirement for § 10(b) standing and of an expansive reading of "any security," this Court notes that in adopting that standing requirement in *Blue Chip*, the Supreme Court relied upon the text of § 18 of the Securities Exchange Act, 15 U.S.C. § 78r, which provides that a person who makes false statements filed with the SEC is "liable to any person . . . who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement." *Blue Chip*, 421 U.S. at 735-36.

10(b) and § 20(a) claims requires the kind of scrutiny and the standards applied to class certification.

Moreover, the issue of class representation is premature. A review for purposes of Rule 12(b)(6) looks at the face of the pleadings. The question of class representation requires looking beyond the pleadings to probe the factual and legal issues of the plaintiff's cause of action, even an evidentiary hearing, when an appropriate motion is filed to certify a class and/or to appoint Giancarlo as the representative plaintiff of purchasers of debt securities, persuaded by UBS to purchase such through PaineWebber accounts during the relevant period. *Manual for Complex Litigation* § 21.21 and § 21.26 (4th ed. 2004); *Castano v. American Tobacco Co.*, 84 F.3d 734, 744 (5th Cir. 1996)(the court "must understand the claims, defenses, relevant facts and applicable substantive law in order to make a meaningful determination of certification issues."); *Krogman v. Sterritt*, 202 F.R.D. 467, 471 (N.D. Tex. 2001). The party seeking class certification, here Giancarlo, "bears the burden of establishing that *all* requirements of rule 23(a) have been satisfied." *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 481 (5th Cir. 2001), *rehearing and rehearing en banc denied*, 279 F.3d 313 (5th Cir. 2002). When the issue is ripe in this suit, to determine whether there is a class or subclass which Giancarlo might be able to represent and the scope of it, in addition to the language of § 10(b) and Rule 10b-5 and case law construing it, the requirements of commonality, typicality, and adequacy of Rule 23(a) would

apply. Giancarlo must also satisfy one of the requirements of Rule 23(b). For purposes of initially stating a claim under Rule 12(b)(6), however, the Court finds that he has satisfied pleading requirements.

As one of the four prerequisites for class certification,[9] the commonality requirement "is met when there is 'at least one issue whose resolution will affect all or a significant number of the putative class members.'" *Forbush v. J.C. Penney Co.*, 994 F.2d 1011, 1106 (5th Cir. 1993), *quoting Stewart v. Winter*, 669 F.2d 328, 335 (5th Cir. 1982); *see also Mullen v. Treasure Chest Casino, LLC*, 186 F.3d 620, 625 (5th Cir. 1999), *cert. denied*, 528 U.S. 1159 (2000); Fed. R. Civ. P. 23(a)(2). Therefore "'the threshold of 'commonality' is not high." *Forbush*, 994 F.2d at 1106. Here Giancarlo's complaint at ¶ 11 lists as some of the questions of law and fact that are common to all putative class member PaineWebber account holders purchasing Enron debt through those accounts during the relevant class period the following:

> (1) whether Defendants violated federal securities laws by their acts or omissions complained of herein; (2) whether Defendants participated in and pursued an illegal course of conduct as alleged herein; (3) whether statements issued to the investing public, and specifically to Defendants' customers who

[9] The four prerequisites for class certification under Rule 23(a) are numerosity, commonality, typicality, and adequacy. Numerosity, which is not a test to qualify a representative plaintiff, is defined by the rule as "the class is so numerous that joinder of all members is impracticable." No particular number is required. *Zeidman v. J. Ray McDermott & Co.*, 651 F.2d 1030, 1038 (5th Cir. 1981).

> purchased Enron debt, UBS OC Notes or Warburg Notes during the Class Period, contained misrepresentations or omissions of material information as complained of herein; (4) whether the market price of Enron stock during the Class Period was artificially inflated due to the material misrepresentations and omissions alleged herein, and (5) the extent and nature of the damages the Class Members have sustained as a result of the material misrepresentations and omissions alleged herein.

Typicality is satisfied when the class representative's claim arises from the same event or course of conduct and is based on the same legal or remedial theories as those of the class members. *Mullen*, 186 F.3d at 625. Rule 23(a)(3) requires that "the claims or defenses of the representative parties [be] typical of the claims or defenses of the class." Fed. R. Civ. P. 23(a)(3). As with commonality, typicality, too, is not a demanding test. *Id.* As discussed in *Lehocky v. Tidel Technologies, Inc.*, 220 F.R.D. 491, 500 (S.D. Tex. 2004),

> Typicality does not mean that the claims of the representative parties be identical to those of the absent members. *See Phillips v. Joint Legislative Comm. on Performance & Expenditure Review*, 637 F.2d 1014, 1024 (5th Cir. 1981). Rather, typicality may be satisfied where the representative plaintiffs' claims arise out of the same event or course of conduct as the other members' claims and are based on the same legal theory. *See Ligon v. Frito-Lay, Inc.*, 82 F.R.D. 42, 47 (N.D. Tex. 1979)(finding "a class representative and a class member must be similarly, not identically, situated"). Factual differences will not defeat typicality. [*Stirman v. Exxon Corp.*, 280 F.3d 554, 562 (5th Cir., 2002.] The typicality requirement protects class members from representations by a party who is "preoccupied" with a defense which is only applicable to himself. *Warren v. Reserve*

> *Fund Inc.*, 728 F.2d 741, 747 (5th Cir. 1984). Thus, class certification is not appropriate where a class representative is subject to unique defenses that threaten to become the focus of the litigation. *See Zachery v. Texaco Exploration & Prod. Inc.*, 185 F.R.D. 230, 240 (W.D. Tex. 1999).

Id. Here Giancarlo has alleged that the claims of the putative class arose out of the same course of conduct and fraudulent recommendations from analysts of UBS Defendants, acting with scienter, on which the class relied in deciding to buy Enron debt securities during the proposed class period through their PaineWebber accounts and were injured as a result. The class claims are based on the same legal theories as those of the proposed class representative.

Adequacy requires that "the representative parties will fairly and adequately protect the interests of the class." Fed. Rule 23(a); *Payne v. Travenol Laboratories, Inc.*, 673 F.2d 798, 810 (5th Cir. 1982), *cert. denied*, 459 U.S. 1038 (1982). A named plaintiff is inadequate[10] only if the differences between the named plaintiff and the class members create conflicts between the interests of the named plaintiff and those of the class members. *Mullen*, 994 F.2d at 620. A class representative may not represent

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[10] The second prong of adequacy of representation is whether the plaintiff's attorney is qualified to prosecute the suit. *Jenkins v. Raymark Indus., Inc.*, 782 F.2d 468, 472 (5th Cir. 1986); *Berger v. Compaq Computer Corp.*, 257 F.3d at 479 ("Rule 23(a)'s adequacy requirement encompasses class representatives, their counsel, and the relationship between the two."). Because this question does not relate to the adequacy of Giancarlo to represent the class, the Court does not address it. The Court notes, however, that there have been no challenges to the adequacy of Giancarlo's counsel thus far.

a class that includes persons whose interests substantially conflict with his own. *Payne*, 673 F.2d at 810, *quoting* 7 C. Wright & A. Miller, *Federal Practice & Procedure* §1768 at 638 (1072)("It is axiomatic that a putative class representative cannot adequately protect the class if his interests are antagonistic to or in conflict with the objectives of those he purports to represent."). Furthermore, in securities class actions, the PSLRA additionally mandates that class representatives be informed, active and able parties who direct the litigation. *Berger*, 257 F.3d at 483 ("the PSLRA raises the standard adequacy threshold"), *denying petition for rehearing en banc*, 279 F.3d 313 (5th Cir. 2002)(insisting it has not changed the standard for or added additional requirements for adequacy under Rule 23(a)(4) for class representatives). Thus far there have been no specific or particularized objections that Giancarlo has unique defenses or that his interests are in conflict with those of the proposed class or that he is not sufficiently knowledgeable about the law suit and motivated to direct the litigation on behalf of the class.

Furthermore Rule 23(b) requires that certification of a class requires not only satisfying Rule 23(a) factors, but also "predominance" and "superiority": to maintain a class the court must find "that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members and that a class is superior to other available methods for the fair and efficient adjudication of the

controversy." These requirements are "far more demanding" than the factor of commonality under Rule 23(a). *Amchem Products v. Windsor*, 521 U.S. 591, 624 (1997). Such questions as whether the class members relied on materially different representations or omissions or conduct or whether there are differences in individual reliance would need to be carefully examined. Plaintiff now alleges fraud-on-the-market as the basis of class reliance and the same misrepresentations and action to UBS's account holders, to satisfy commonality. His obligation to prove that the market for Enron debt was open and efficient is for another day.[11] Facially at this stage of the litigation, a class action appears to be a superior method of dealing with the litigation in light of the numerous PaineWebber-account purchasers of Enron debt securities during the class period.

In sum, as noted, facially the complaint meets the elements and the issue of class representation is not yet ripe in this action. There are obvious potential matters that must be explored for a class representative of a § 10(b) claim for investors who purchased different debt securities than those Giancarlo bought, perhaps at different prices, perhaps in reliance

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[11] As noted earlier, the fraud-on-the-market theory of reliance is rebuttable. Although some courts have concluded that stock traded in one of the major exchanges over the counter is *per se* traded in an efficient market, the majority examine each case and the development of the market for a particular stock, and they examine various factors including the stock's average trading volume, the number of analysts that followed and reported on the stock, the number of market makers, eligibility to file an S-3 Registration Statement, and the response of the stock price to unexpected new events, among others. *See Krogman*, 202 F.R.D. at 473-78.

on different representations or market factors, and perhaps suffered different losses.

III. Inadequate Pleading of 1934 Act Claims:

Third, UBS argues that the 1934 Act claims fail because Plaintiff fails to plead actionable misstatements, reliance on those statements by Plaintiff, and scienter.

UBS charges that Plaintiff does not identify any statements by UBS or its employees relating to the Enron **debt** securities, but only statements relating to Enron **stock**, thus bootstrapping on *Lamkin*.[12] Plaintiff disagrees and contends that Warburg's rating system (STRONG BUY, BUY, HOLD, REDUCE, and SELL) relates to return potential in a twelve-month period and that a "STRONG BUY" rating by a purportedly independent and knowledgeable investment analyst could reasonably be viewed as a strong endorsement of the company, not just its stock. Complaint at ¶ 146. This Court finds Plaintiff's argument to be persuasive because the rating system was a representation of the financial health of Enron generally and could reflect and affect (as well as conceal) the actual value of all Enron securities, whether debt or equity. As noted, the statute refers to "any security," and the definition of "security" in the 1934 Act, 15 U.S.C. § 78c(a)(10), is inclusive: "any note, stock, treasury stock,

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[12] Analogizing Enron common stock and the debt securities, the *Giancarlo* complaint at ¶ 18 states, "Defendants perpetrated the fraud by recommending and advising Giancarlo and the Class Members, orally and/or in writing, that Enron common stock (and by extrapolation, Enron debt) was a "STRONG BUY" . . . ."

security, future, bond, debenture, . . . investment, contract, . . . or, in general, any interest or instrument commonly known as a 'security.'"

UBS also argues that challenged statements and reports by Ron Barone rating Enron stock a "strong buy" were not guarantees, but nonactionable statements of opinion, projections of future performance, and recommendations, and that Plaintiff has not alleged that he relied on them. Moreover Barone's statements and research notes, insists UBS, contain sufficient cautionary language regarding risks and negative facts to be protected by the "bespeaks caution" doctrine.

The bespeaks caution doctrine and its statutory safe harbor counterparts, 15 U.S.C. § 77z-2(c)(1)(A) and(B) and § 77u-5(c)(1)(A) and (B), will not protect a defendant if the plaintiff pleads facts demonstrating that the statement was made with actual knowledge that it was false. *See, e.g., Southland Securities Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 371 (5th Cir. 2004). The same is true of opinions and projections. As the Fifth Circuit opined,

> The safe harbor has two independent prongs: one focusing on the defendant's cautionary statements and the other on the defendant's state of mind. . . . Under the first prong there is no liability if, and to the extent that, the forward-looking statement is (i) 'identified as a forward looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement,' or (ii) 'immaterial.' [15 U.S.C. §§ 77z-2(c)(1)(A), 77u-5(c)(1)(A).] Under the second prong, there is no liability if

> the plaintiff fails to prove that the statement (ii) if made by a natural person was made with actual knowledge that the statement was false or misleading, or (ii) if made by a business entity, was made by or with the approval of an executive officer of that entity with actual knowledge by that officer that the statement was false or misleading. *Id.* at §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B). The requirement for "meaningful" cautions calls for "substantive warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boiler plate litany of generally applicable risk factors.

Id. at 371-72. Thus if Plaintiff alleges sufficient facts to show (but he need not prove at this stage of the litigation) that Defendants made such statements knowing they presented a materially fraudulent picture of Enron's financial stability and the value of its securities or acted with severe recklessness, Defendants' insistence they were mere opinion or projections or accompanied by meaningful cautionary statements or that its alleged misconduct was adequately disclosed is ineffective to support dismissal of the claims at this time.

Violations of § 10(b)

To UBS's assertion that Plaintiff has failed to plead any material misrepresentation or omission, Plaintiff responds, as this Court has held, that Section 10(b) and Rule 10b-5 can be violated by conduct (manipulative or deceptive contrivance, or scheme to deceive, or course of business that would operate as a fraud or deceit upon Plaintiff in connection with his purchase of the Enron debt securities), as well as by material misstatements and omissions. #1194 at 29-39. *SEC v. Zandford*, 535 U.S. 813,

820 (2002)("neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the [1934] Act.").[13] Giancarlo insists that he has alleged both kinds of violations.

This Court observes that the allegations here are *inter alia* against PaineWebber as a broker and Warburg as an underwriter.

Although there is substantial variation among courts,[14] the Fifth Circuit has held that under Texas law a broker has a fiduciary duty to its client, but that

> [it]t is clear that the nature of the fiduciary duty will vary, depending on the relationship between the broker and the

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[13] In *Zanford*, to effectuate the remedial purpose of the 1934 Act the Supreme Court deferred to the SEC's broad and flexible construction of § 10(b)'s ambiguous phrase, "in connection with the purchase or sale of any security," and concluded that a securities broker, who engaged in a fraudulent scheme in which over a two year period he repeatedly sold his customer's securities with the intent at the time of the sales to steal and did pocket the proceeds for his own benefit, violated § 10(b) because his breaches of fiduciary duty coincided with the securities transactions.

Plaintiff's allegations of a fraudulent scheme in which securities transactions and breaches of fiduciary duty coincide can be analogized to the situation in *Zandford*: with alleged knowledge that Enron's financial state was precarious, with its "Strong Buy" recommendation UBS induced the purchase of Enron debt securities from PaineWebber itself over the class period by the putative class members, in order to unload the unsecured debt the broker had previously purchased and for its own gain, and that UBS' conduct constituted a course of business that operated as a fraud or deceit on broker PaineWebber's account-holder clients.

[14] State laws differ on whether a broker/client relationship is a fiduciary one. *See, e.g.*, Gerald F. Rath, *et al.*, *Selected Issues in Broker/Customer Litigation*, SJ084 ALI-ABA 133, 159-61 (May 13-14, 2004); Jerry W. Markham, *Court Decisions on Fiduciary Duty for Commodity Trading*, 13 Commodities Reg. § 6:9 (Apr. 2004).

> investor. Such determination is necessarily particularly fact-based. And although courts draw no bright-line distinction between the fiduciary duty owed customers regarding discretionary as opposed to nondiscretionary accounts, the nature of the account is a factor to be considered . . . .

Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F. 2d 523, 530 (5th Cir. 1987), *cert. denied*, 487 U.S. 1205 (1988); *see also Martinez Tapia v. The Chase Manhattan Bank, N.A.*, 149 F.3d 404, 412 (5th Cir. 1998). Factors would include whether the broker is authorized to make independent decisions or whether he may act only at the investor's direction, whether the investor is a sophisticated and alert business person. *Romano*, 834 F.2d at 530; *Martinez Tapia*, 149 F.3d at 412. Moreover, because necessarily "financial investment involves risks," the plaintiff investor who sues for fraud or misrepresentation resulting in his investment's loss "must himself exercise due diligencè to learn the nature of his investment and the associate risks": he "must exercise due diligence to discover the alleged fraud and cannot close his eyes and simply wait for facts supporting such a claim to come to his attention." *Martinez Tapia*, 149 F.3d at 409. Such a fact-specific evaluation is not appropriate at this stage of the litigation, but after discovery, may potentially be addressed on summary judgment.

The suitability rule prohibits a broker from making an unsuitable recommendation, i.e., one which, in light of the particular client's disclosed objectives and background (e.g., goal such as income or tax savings, investment experience,

education, percentage of overall investment), the broker knows or reasonably believes to be inappropriate because of the quality of the stock.[15] *See, e.g., Mauriber v. Shearson/American Express, Inc.*, 567 F. Supp. 1231, 1237 (S.D.N.Y. 1983); *Erdos v. S.E.C.*, 742 F.2d 507, 508 (9th Cir. 1984); *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 5 (1st Cir. 1983). *See generally* Nancy C. Libin and James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?*, 01 Colum. Bus. L. Rev. 601 [at 9-15

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[15] Under the 1934 Act a self-regulating scheme was established by means of self-regulatory organizations ("SROs"), composed of brokers, including the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE"), supervised in turn by the SEC. The SROs have developed rules of professional conduct, industry standards, over which the SEC has plenary power as well as its own power to impose rules, that focused on customer protection and investor rights. The suitability rule imposing an affirmative duty on a broker to "take 'reasonable efforts' to assure that a recommendation is in accordance with a customer's objectives and financial status," is an example. *See* Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. Cin. L. Rev. 527, 533-50 (Winter 2002). Although there is no private right of action for a violation of an SRO rule or regulation provided in the 1934 Act, nevertheless a breach of such a rule can be relevant to a violation of § 10(b):

> Here, courts use SRO rules as evidence of fraud or standards by which to judge whether conduct is consistent with scienter. Scienter requires at least a showing of recklessness, and SRO rules have been used to support a finding that a broker recklessly omitted to disclose a material fact. This approach seems consistent with Congressional intent, as breach of industry standards is not tantamount to showing an intent to defraud, but such a breach does reveal much about a securities professional's state of mind, especially since a professional can be presumed to know industry standards.

Id. at 548-49.

on line] (2001)(publication page references unavailable) (suitability rule *inter alia* requires reasonable investigation of the customer and the issuer). Morever, the suitability rule can be violated where the broker has no reasonable basis to believe that the security is suitable for any investor. *Id.* [at 11 online]. As noted by Libin and Wrona, another factor for the court to consider focuses

> on the incentive that the broker may have had to make a particular recommendation--namely whether the broker received any supplementary compensation for the transaction or was under pressure from the firm to encourage the transaction. Because a broker sometimes earns higher-than-usual commissions, gifts, or prizes for selling (or is otherwise encouraged to sell) securities that the firm is promoting or in which the firm has a large inventory, a broker's recommendation of these securities may raise serious warning signals or red flags. These incentives are often scrutinized because they could compromise the suitability rule's essential requirement that the broker match the customer's investment needs with the most appropriate investment product.

Id. [at 13-14 online].

Under the "shingle" doctrine" of broker conduct, "when a broker-dealer hangs out his shingle he implicitly represents that he will deal fairly with the public." *University Hill Foundation v. Goldman, Sachs, & Co.*, 422 F. Supp. 879, 898 n. 17 (S.D.N.Y. 1976)(and cases cited therein). The doctrine requires that broker-dealers have a reasonable basis for recommendations about securities to their clients; that requirement in turn imposes a duty to conduct a reasonable investigation of a security's issuer. *Id.* at 898. SEC Release No. 4445 (Feb. 2,

1962), states, " . . . [T]he making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such recommendations, which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation." A failure to investigate adequately and independently before recommending the purchase of a security is a violation of the 1933 and 1934 Acts. *In re B. Fennekohl & Co.*, 41 S.E.C. 210, 215-17 (1962); *In re Shearson Hammill & Co.*, SEC Release No. 34-7743 (Nov. 12 1965). In such an investigation a broker must investigate the financial condition of the issuer, especially where the broker has adverse financial information on the issuer. *In re Crow, Brourman & Chatkin, Inc.*, 42 SEC 938, 943 (1966); *In re Cortlandt Investing Corp.*, 44 S.E.C. 45, 51-52 (1969). Factors to be considered in determining whether an investigation is reasonable include "the broker's knowledge and relation to the issuer, the issuer's size and stability, the broker's access to information, the nature of the data on which [the broker] relied, the extent of the broker's planning and participation in the trade, the relative skill in ferreting out the truth, the broker's pecuniary interest in the completion of the transaction, the existence of a relationship of trust and confidence between the broker and the customer, and the presence or absence of warning signs [footnotes omitted]." Arnold S. Jacobs, *What is a "Reasonable Basis"?*, 5D Disclosure & Remedies Under the Securities Laws § 18:9 (July 2004). A greater duty of inquiry may be imposed on a broker where the broker and issuer have a special

relationship, such as a recent investment banking relationship, or an arrangement where the broker works closely with and has intimate knowledge of management activities of the issuer because he has a greater opportunity to investigate. *University Hill Foundation v. Goldman, Sachs, & Co.*, 422 F. Supp. at 898; *Levine v. SEC*, 436 F.2d 88, 90-91 (2d Cir. 1971). *See generally* Rath, et al., *Selected Issues in Broker/Customer Litigation*, SJ084 ALI-ABA at 165-76. Plaintiff's factual allegations here in essence challenge UBS entities' actions as breaches of these duties and rules for brokers and help give rise to a strong inference of scienter.

Warburger, *inter alia*, served as underwriter of Enron's Whitewing/Osprey Trust offering. Because an underwriter has access to information not generally available to the public and because the public relies on the expertise, integrity, and independent analysis of the underwriter, there is a relationship of confidence and trust with the investing public, and the underwriter is charged with a high standard of professional conduct and reasonable investigatory responsibility. *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1069-70 (7th Cir. 1975), *vacated and rev'd on other grounds*, 425 U.S. 929 (1976)(remanding for reconsideration on the issue of scienter in light of *Ernst & Ernst v. Hochfelsder,* requiring a plaintiff in a private suit for damages under Rule 10b-5 must show that the defendant acted with scienter); *Shores v. M.E. Ratliff Inv. Co.*, No. CA 77-G-0604 S, 1982 WL 1559, *3 (N.D. Ala. Jan. 18, 1982)("As an underwriter,

Ratliff was under a duty to the investing public to make a reasonable investigation of the issuer of the bonds and to disclose material facts that he knew or that were readily ascertainable" and quoting *Sanders*); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). In *Sanders*, brought under §§ 10(b) and 12(2), the Seventh Circuit Court of Appeals described the underwriter's duty:

> An underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity, independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security. And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer.

524 F.2d at 1069-70. In *Chris-Craft* the Second Circuit commented,

> Self regulation is the mainspring of federal securities law. No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. . . . Prospective investors look to the underwriter . . . to pass on the

> soundness of the security and the correctness of the registration statement and prospectus.

Chris-Craft, 480 F.2d at 370. For the SEC's views on the duty of the underwriter *see* Robert J. Haft and Peter M. Fass, *Does An Underwriter Have A Mandatory Duty To Conduct a Reasonable Investigation or Merely a "Waivable" Defense to Civil Liability*, 4A Tax-Advantaged Securities § 8:10 (Sept. 2004)(and cases and releases discussed therein). Moreover an underwriter can be liable for false reports made by its own securities analysts and relied upon by investors. *See, e.g., Cooper v. Pickett*, 137 F.3d 616, 627-29 (9th Cir. 1998)(*en banc*).

Furthermore, an underwriter has a statutory shield from liability under § 11 of the 1933 Act, 154 U.S.C. § 77k(b)(3), if it can establish a due diligence defense that it "had after reasonable investigation, reasonable ground to believe and did believe . . . that the statements [in the registration and prospectus] were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." A negligence standard applies to determine whether the underwriter met this due diligence test, i.e., "the standard of reasonableness . . . required of a prudent man in the management of his own property." 15 U.S.C. §§ 77(k)(b)(3) and 77(k)(c).

Relating to Giancarlo's § 10(b) claims, the Court has reviewed the complaint carefully and finds that Plaintiff has adequately pled such violations. While he has clearly challenged as a fraudulent misrepresentation Warburg's constant and

unwavering position of recommending Enron stock as a "STRONG BUY" during what was, even by objective outward signs, an increasingly precarious period for Enron's financial stability, the violations he asserts are more in the nature of omissions and nondisclosures than misrepresentations to make these Warburg recommendations, in light of the circumstances under which they were made, materially misleading and unsuitable in connection with the sale of the debt securities to the plaintiff class.

While a number of the complaint's allegations are conclusory and refer to conduct constituting normal business practice (e.g., lending Enron money and underwriting its public offerings), insufficient by themselves to state a claim under the statute, a combination of more specific assertions, taken cumulatively, satisfies the heightened pleading requirements for § 10(b).

First, Warburg served as underwriter in and co-manager of an offering related to the purportedly independent Whitewing Special Purpose Entities ("SPEs") offshore, improperly "secured" by Enron stock and central to Enron's scheme to conceal debt and inflate its balance sheet to continue to attract high credit ratings and investors and to perpetuate the purported Ponzi scheme. More specifically, Warburg and UBS AG offered securities in Osprey Trust to institutional investors and used the proceeds to purchase a limited partnership in Whitewing. As the underwriter, Warburg had to be aware these illicit SPEs were structured with financial triggers, points at which Enron's stock

price dropped so low as to necessitate Enron's putting more stock or cash into the SPEs or liquidating these entities, making Enron highly vulnerable, causing its stock price to fall, its debt to come due, and credit agencies to lower its rating. Enron had secretly guaranteed Whitewing investors that if the various assets bought by Whitewing were sold at a loss, Enron would make up the difference with common stock or cash. As co-manager, Warburg had to have knowledge of this risk that if Enron's credit rating dropped, that guarantee would be triggered. Ultimately that risk was realized in October 2001, when some credit rating agencies lowered Enron's rating to junk-bond level and triggered the requirement that Enron immediately pay $690 million of its obligations to Whitewing. Complaint at ¶ 164. That triggered demand was disclosed in Enron's Form 10-Q, filed on October 19, 2001. *Id.* at ¶ 165.

The complaint at ¶ 158 claims that if Defendants performed the due diligence investigation of Enron that they were required to perform relating to the Whitewing/Osprey Trust offering, they discovered or should have discovered the fraud at work:

> Through this investigation, Warburg and UBS AG learned, or through the exercise of reasonableness that a prudent man in the management of his own property would have learned, of (1) Enron's $2.65 billion in off-balance sheet financing, (2) the increase in Enron's liquidity and cash flow, (3) the credit ratio and stock value triggers, upon which event, Enron would be forced to repay debt with cash and (4) the fraudulent improvement of Enron's overall financial appearance through the use of SPEs. Warburg

> and UBS AG's responsibilities as underwriter for Osprey imposed upon them the obligation to discover the fraud that was Enron.

Second, Plaintiff claims that Defendants failed to disclose adequately the relationship between and intertwined financial interests of Enron and the UBS AG family of companies. Specifically, he points to the exclusive and, for PaineWebber, highly lucrative captive-broker arrangement, at issue in *Lamkin*,[16]

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[16] UBS argues that allowing Plaintiff to establish scienter based on an allegation of trying to avoid an investment loss would "effectively eliminate the state of mind [scienter] requirement as to all corporate officers and defendants." *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994). The Fifth Circuit has held that allegations of motive and opportunity alone are insufficient to meet the scienter requirement. *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 412 (5th Cir. 2001). Nevertheless, this Court notes that the Fifth Circuit also observed that "appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter." *Abrams*, 292 F.3d at 430; *Nathenson*, 267 F.3d at 412.

For a claim of insider trading, however, a plaintiff must show that the insider trading was "in suspicious amounts or at suspicious times," "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information," to satisfy the scienter requirement. *Southland Securities Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 368 (5th Cir. 2004), *quoting Abrams*, 292 F.3d at 435, and *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 987 (9th Cir. 1999). Although he does allege large amounts of stock being sold by insiders at suspicious times, Giancarlo has not provided specific information about the trading practices of each insider who sold his stock.

Nevertheless, as a factor in the picture for purposes of raising a strong inference of scienter, Giancarlo does demonstrate that very large amounts of stock were being sold by the insiders during the relatively short Class Period just before Enron filed for bankruptcy, and the vast majority of these sales were with Defendant PaineWebber acting as broker at the very same time it was urging the putative class members to buy unsecured Enron debt that PaineWebber had purchased from Enron previously. Complaint at ¶¶ 89-90. *See* footnote 20 of this memorandum and order. Moreover, under the Stock Option Plan Agreement between PaineWebber and Enron, PaineWebber was contractually obligated to assist Enron stock option holders with regulatory Section 16 forms

under which PaineWebber was given the first opportunity to develop client relationships with approximately 35,000 Enron employees and Enron affiliate[17] employees relating to their stock option plans and to nourish these employees into permanent clients.[18] Moreover, the complaint asserts that PaineWebber used this exclusive arrangement to claim to investors that PaineWebber "had insight and was in the best position of any broker on Wall Street to know about Enron." #16 at 13-13, citing Complaint at ¶ 206.

Added to the considerable fees for services to and profits from business with Enron, also not disclosed, UBS' financial dependence on Enron was substantial and, in a clear conflict of interest, motivated UBS analysts not only to present Enron in the most favorable light and recommend the purchase of its securities, but to keep it afloat for UBS's continuing personal gain. The complaint at ¶ 19 alleges that UBS sacrificed

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for reporting sales of Enron stock and would have had knowledge of such sales. Complaint at ¶¶ 91-92.

[17] The complaint states that PaineWebber had the same captive broker arrangement with Enron subsidiary EOG Resources, Inc.

[18] The complaint at ¶ 52 represents that about one out of three employees chose to maintain his account after it was opened to execute stock options and that in 2001, new clients generated hundreds of millions of dollars for PaineWebber. Moreover once the employee opened an account he became a retail client, a relationship purportedly independent of the exclusive Enron contract, and was assigned a financial advisor who, with Warburg's research as an objective resource with a reasonable basis, was supposed to analyze the client's individual situation and recommend appropriate investments on an individual basis, free of any influences by any issuer client.

PaineWebber's clients for millions in fees and revenues from UBS' bigger client, Enron.[19]

The core allegation of this suit also supports the pleading: in essence that UBS sacrificed those clients to save its own neck from Enron securities losses. The gravamen of the claim, i.e., the fact that Warburg allegedly discovered how precarious Enron's financial condition is evidenced in UBS' self-serving "dumping" of unsecured Enron debt that UBS owned, i.e., "massive amount" of debt which it had purchased from Enron in a private transaction early in 2001, by misleading, "strong buy" recommendations of the debt's value and by sales of the debt to the putative class of PaineWebber account holders and others. Complaint at ¶¶ 22.

According to ¶¶ 57-58 of the Complaint Ronald J. Barone throughout the class period was the managing director of the energy group at UBS Warburg Equity Research, which produced research independently of other Warburg and UBS AG groups, had

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[19] Business between Enron and UBS was substantial and enormously profitable to UBS. The complaint addresses the exclusive captive-broker arrangement that PaineWebber had with Enron (see ¶ 95 for graph focusing on Form S-8 registrations filed by Enron that reflect the profit made by PaineWebber under this arrangement from 1996-2000, totaling $7,284,320,971), targeted in *Lamkin* (so that any Enron employee who wished to exercise stock options would have to open a PaineWebber account to do so), the enormous fees PaineWebber collected from Enron, UBS' loans to Enron, Defendants' underwriting of several Enron's public offerings, Warburg's role as co-manager of the Whitewing offshore SPEs, used to conceal Enron's debt, and UBS AG's bundling of Enron debt with Enron securities in credit linked securities. It also presents a graph of the long-term business relationship and numerous lucrative transactions between Warburg and PaineWebber on the one hand and Enron on the other. ¶ 86.

been an analyst since 1971, and specialized in natural gas. Thus he was an experienced analyst, expert in the field. During the class period Barone issued positive research notes on Enron. Despite falling prices of Enron stock during 2001, Enron's announcement in the fall of 2001 that it would perform a massive restatement, Barone persistently rated its stock as a "Strong Buy" until November 28, 2001, on the eve of Enron's bankruptcy, when he downgraded it, but only to "Hold." The complaint at ¶ 59 asserts, "Ron Barone's relentless support of Enron, despite the red flags abound[ing] right before his eyes, provide evidence of Warburg's self dealing. At the very least, Barone's single minded support for Enron calls into question Warburg's allegiance and the 'reasonable basis' upon which it represented that Barone's recommendation was based . . . ." Indeed, he persisted in the "STRONG BUY" recommendations throughout 2001 from a 52-week high price of Enron stock from $85 per share until the day the stock fell to below $1. Complaint at ¶ 149. The complaint at ¶¶ 60-62 charges that from March 2000 on there was a series of warning signs in Enron's public filings with the SEC about "drastic changes in Enron's financial picture and the insider's [*sic*] dumping of their stock," including sharp increases in Enron's total capitalization and of its debt as a percentage of that figure, the enormous financial vulnerability threatened by a drop in Enron stock price or of credit ratings for long-term debt obligations as trigger points structured into the third-party transactions as security, and lack of real increase in net income

despite increased sales. The complaint cites the testimony before the Senate Committee on Governmental Affairs of Howard Schilit, president of an independent research firm, Center for financial Research and Analysis, that Enron's financial statement contained numerous red flags, including phrases like "non-cash sales" and "$1 billion of related party revenue": "for any analyst to say there were no warning signs in the public filings, they could not have read the same public filings that I did." Complaint at ¶ 107. Even after Enron announced Skilling's resignation on August 14, 2001, after it publicly disclosed charges of $1 billion and a reduction of shareholders' equity by $1.2 billion on October 16, 2001, after the SEC began investigating Enron, after a massive restatement of Enron's financial statements from 1997 through the second quarter of 2001 was announced on November 8, 2001, causing a 91% drop in the price of Enron's stock, all examples of objective evidence, Barone persisted in hyping Enron securities as a "strong buy" despite the price of the stock plummeting from $33.84 per share to $12.50 in two weeks before November 1, 2001, and down to $9.91 by November 15, 2001. So did PaineWebber broker Elliott Dufour; the complaint's appendix demonstrates that in November, 2001 Dufour convinced Steve Miller to buy Enron stock because of "PW's special knowledge from its close relationship with Enron as the exclusive broker handling Enron employee stock option accounts." Another PaineWebber broker toeing the company's official "STRONG BUY" line was Tim Kruger. Moreover, Plaintiff claims that while Barone was recommending that clients buy Enron

stock, he was "helping Enron insiders dump millions of dollars of their own Enron shares." #16 at 11, citing Appendix A attached to the Original Complaint and ¶¶ 89-92 of the complaint. Only on November 1, 2001 did Barone issue a Research Note that finally discussed ongoing insider selling,[20] Enron's efforts to work with rating agencies to maintain investment grade status, its cooperation with the SEC's newly launched investigation and a warning of a possible SEC penalty, acknowledgment of the "questionable nature" of Enron's partnerships, the need to address such issues as the "evolving state of [Enron's] balance sheet, management credibility, and the ultimate outcome of shareholder lawsuits," and he finally characterized Enron stock as "a high risk investment vehicle, not appropriate for risk-averse individuals." Complaint at ¶¶ 71-72. Yet he still recommended Enron stock as "STRONG BUY." *Id.* at ¶72.

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[20] The complaint asserts that in one year the insiders' sales of their Enron stock exceeded half of Enron's net income for the year 2000, and that $415 million worth of insider stock was sold between July 2000 and March 1, 2001. For instance, at ¶ 77, the complaint notes that Enron's head of Human Resources, Cindy Olson, urged employees to invest all of their 401(k) money in Enron stock while she sold 83,183 of her own shares of Enron stock for $6,505,870, largely during the latter part of 2000 and early 2001. The Emery Financial Group, part of PaineWebber before its merger with UBS AG and remaining with it, was led by Rocky Emery, who handled accounts for some of Enron's top officers, including Ken Lay, Jeffrey Skilling, Ken Rice,, Cliff Baxter, and Lou Pai. Complaint at ¶ 48. The complaint asserts that from December 2000 through March 2001 the Emery Group sold more that $65,000,000 of Enron stock for Ken Lay ($20,604,300), Jeffrey Skilling ($12,382,100), Ken Rice ($1,096,465), and Lou Pai ($45,833,700). In June and July of 2001, Emery Group additionally helped Ken Lay sell another $6,808,155, Jeff Skilling, $1,034,200, Ken Rice, $18,993,991, and Lou Pai, $3,215,605. *Id.* at ¶ 78.

The complaint additionally charges that PaineWebber had a "gentleman's agreement," also not disclosed, with Enron: as long as PaineWebber managed the Enron Employee Stock Benefit Plan, it would not provide any information adverse to Enron or that its financial advisors would not advise clients to buy or sell Enron securities, regardless of the clients' individual needs, without Enron's approval. Moreover, UBS mandated that Barone's "STRONG BUY" recommendation had to be included in any investment advice to PaineWebber clients, even though PaineWebber was supposed to be providing "disinterested advice." Complaint at ¶ 25.

Plaintiff also alleges that UBS analysts were not "independent"; they not only received incentive compensation to endorse a positive picture of Enron's performance, but were also threatened with termination if Enron learned that they had urged anything but a "buy" recommendation for Enron securities. Barone's compensation was also related to how much investment banking business he could generate, including at Enron. Complaint at ¶¶ 136-143. The complaint alleges that PaineWebber "finessed" disclosures to its retail clients about Enron so as not to lose the exclusive contract to manage the stock option plans.

As a specific example of this treatment of PaineWebber brokers, the complaint points to Chung Wu.[21] In sharp contrast to

[21] The complaint at ¶¶ 173-74 asserts that in the summer of 2000 Wu, who was hired by PaineWebber as a "second tier" member of the Emery Financial Group in 1999, was first warned of and reprimanded for providing clients with adverse information about Enron by Ken Logson of the Emery Group after Wu discussed with a client that it might be a negative sign that Enron was selling off international assets. Logson allegedly told Wu that Enron had a

the allegations about Barone, who persistently hyped Enron securities as a "strong buy," despite knowing from his own research and from personal contacts with Enron's top management, even at the time of Jeffrey Skilling's resignation, that all was not well with the company, Plaintiff alleges that PaineWebber broker Chung Wu recognized and on August 21, 2001 by e-mail tried to inform his clients that Enron had problems and to advise that they diversify their holdings, which were over concentrated in Enron stock. For contents of e-mail see ¶ 180. When the managers of Enron's stock option plan learned the same day from one of Wu's clients that Wu had e-mailed such warnings to his clients, they reported Wu to PaineWebber and urged that Wu be fired. Barone, who was called back from vacation early, seconded the recommendation that Wu be fired. PaineWebber not only fired Wu, but called each of Wu's clients, reiterated Barone's "strong buy"

"list of brokers who will be sanctioned" for saying detrimental things about Enron" and that Logson, himself, was on it. Moreover UBS Houston Branch Manager Patrick Mendenhall, Rocky Emery, and Willie Finnegan, sales manager at PaineWebber's downtown office, also admonished Wu and other brokers numerous times that if they provided adverse information about Enron to Enron employees with accounts, the brokers would be sanctioned, taken off the account and even terminated. *Id.* at ¶ 175. The brokers were warned of such consequences every time any one of them made such a mistake.

Nevertheless, Plaintiff asserts, Wu continued to provide his clients with updated information about Enron's financial condition, frequently by e-mail. On May 14, 2001 he e-mailed a detailed report of Enron's P/E ratio and problems with its plant in India, about which Enron remained silent, and observed that EBS continued to lose money and its market value had decreased. ¶ 178. On June 15, 2001 he e-mailed a new P/E chart comparing Enron with other energy companies. On July 17, 2001 he sent his clients Barone's newest analysis of Enron stock. On August 15, 2001 he e-mailed them a discussion of Enron's institutional selling. His August 20, 2001 e-mail to his clients resulted in his termination, discussed in the text.

recommendations, of which Paine Webber claimed it was absolutely sure, and told the clients that PaineWebber had fired Wu for improperly sending out erroneous information about Enron.[22]

Reliance

Plaintiff, belatedly according to Defendants, relies on the fraud-on-the-market theory to demonstrate reliance, the necessary element that provides the "causal connection between a defendant's misrepresentation and a plaintiff's injury," for his § 10(b) claims. *Basic v. Levinson*, 485 U.S. 224, 243 (1088). Under that doctrine, established by the Supreme Court because proving actual reliance for every individual class member in class actions is unduly burdensome, a rebuttable presumption of reliance on the alleged misstatement or omission arises if the plaintiff can demonstrate that "(1) the defendant made public material misrepresentations, (2) the defendant's shares were traded in an efficient market, and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed." *Greenberg v. Crossroad Systems, Inc.*, 364 F.3d 657,

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[22] UBS insists that Wu was terminated because Wu violated NASD and NYSE rules and UBS' policies. UBS also charges that Plaintiff has not alleged that he received or relied on Wu's message or UBS Houston Branch Manager Patrick Mendenhall's follow-up communication with Wu's clients. Nevertheless, the allegations about Wu serve to demonstrate the relationship between Enron and UBS, the improper pressures placed on brokers by Enron and UBS that knowingly violated industry standards, UBS' motivation to participate in the scheme, and the conflicts of interests, all serving to give rise to a strong inference of scienter.

Moreover, Plaintiff has alleged reliance not on Wu's e-mails, but on the fraud-on-the-market doctrine and the fact that the UBS analysts' research notes and recommendations, including Barone's, were publicly disseminated and thus likely to have influenced that market.

661 (5th Cir. 2004), *citing Basic v. Levinson*, 485 U.S. 224, 247 n.27 (1088). This presumption of reliance

> rested on two assumptions. First that "the market price of shares traded on well-developed markets reflects all publicly available information," or as *Basic* put it in an appended footnote, "we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices." . . . . And, second, that "the reliance of individual plaintiffs on the integrity of the market price may be presumed." [citations omitted]

Nathenson, 267 F.3d at 413-14. The Fifth Circuit insists that "a fraud-on-the-market theory may not be the basis for recovery in respect to an alleged misrepresentation that does *not* affect the market price of the security in question." *Id.* at 414. In *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001), the Fifth Circuit made clear that "'in cases depending on fraud-on-the market theory, [] the complained of misrepresentation or omission [must] have actually affected the market price of the stock[.]'" *Id.* at 662, quoting *Nathenson*, 267 F.3d at 414-15. *See also In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991)(In fraud-on-the-market cases, "causation is not premised on any specific transaction between plaintiff and defendant. . . . Causation lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the

market, causation is presumed."), *cert. denied sub nom. KPMG Peat Marwick v. Abbey*, 502 U.S. 967 (1991).[23]

There is currently no serious dispute that there was a well developed and efficient market for trading Enron securities, but if a dispute should arise, proof ultimately would be required. Moreover, the analyst reports and persistent "Strong Buy" recommendations from a highly regarded firm like Warburg,[24] indeed from UBS Defendants as a group, would necessarily be within the "publicly available information" and would be known by market professionals and thus affect the price of the securities, as would purchases by a sufficiently large putative class as well as other investors. Thus the Court finds that Giancarlo has adequately alleged reliance here.

Scienter

Scienter is "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The Court considers the totality of alleged facts and circumstances in determining if the complaint raises a strong inference of scienter. *Goldstein v. MCI WorldCom*, 340 F.3d 238, 246 (5th Cir. 2003); *Abrams*, 292 F.3d at 430; *Nathenson*, 267 F.3d at 340 (must consider allegations of scienter cumulatively).

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[23] Defendants have argued that for its fraud-on-the market theory of reliance, Plaintiff cannot "plead and prove that UBS's alleged fraud *caused* the collapse of Enron securities." #18 at 2. As noted above, that is not the test.

[24] Indeed the complaint at ¶ 44 notes that "[i]n December 2001, *Institutional Investor* magazine ranked Warburg as the No. 1 global research firm in the world."

The complaint must particularize both false statements or fraudulent omissions and intent allegations. *Goldstein*, 340 F.3d at 249.

As for scienter[25] of corporate entities like Defendants here, the Fifth Circuit has concluded that the court should" look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of the corporation's officers and employees acquired in the course of their employment." *Southland*, 365 F.3d at 366 (and cases cited therein). Thus "'[t]he knowledge necessary to form the requisite fraudulent intent must be possessed by at least one agent and cannot be inferred and imputed to a corporation based on disconnected facts known by different agents.'" *Id.* at 366-67, *quoting Gutter v. E.I. Dupont De Nemours*, 124 F. Supp. 2d 1291, 1311 (S.D. Fla. 2000); *see also First Equity Corp. v. Standard & Poor's Corp.*, 690 F. Supp. 256, 260 (S.D.N.Y. 1988)("While it is not disputed that a corporation may be charged with the collective knowledge of its employees, it does not follow that the corporation may be deemed to have a culpable state of mind when that state of mind is possessed by no

[25] Scienter "mean[s] an 'intent to deceive, manipulate or defraud' or that 'severe recklessness' in which the 'danger of misleading buyers or sellers . . . is either known to the defendant or is so obvious that the defendant must have been aware of it.'" *Southland*, 365 F.3d at 366, *quoting Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981)(*en banc*).

single employee. A corporation can be held to have a particular state of mind only when that state of mind is possessed by a single individual.") (*quoted by Southland*, 365 F.3d at 367), *aff'd*, 869 F.2d 175 (2d Cir. 1989). In the case of Defendants here, the central Warburg individual would be Ron Barone, who, according to the complaint, for reasons discussed knew or was severely reckless in not knowing[26] that the research analysts' public statements about Enron were false and misleading. Similarly, the allegations of particular statements by UBS Houston Branch Manager Patrick Mendenhall (Complaint, e.g., at ¶¶ 183, 192 evidencing the brokerage firm's fraudulent misrepresentation to clients, not to mention communications between UBS and Enron over Wu's dismissal, are sufficient to raise and strong inference of and attribute scienter to UBS.

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[26] While the complaint concedes that Enron was notorious for concealing how it arrived at its numbers, i.e., its "'black box' quality," independent analysts were reading the same financial statements and numbers and "coming up with huge red flags." Complaint at ¶ 105. As an example, ¶ 106, it notes that six of eight independent newsletters recommended selling Enron stock before November 2001, three as early as March or April of that year. Discussing the Senate Committee on Governmental Affairs report, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, in part addressing the failure of analysts to provide accurate and unbiased analyses of Enron (¶¶ 97-105), the complaint charges that Barone "simply did not ask the hard questions because he did not want to antagonize Enron's management or jeopardize the investment banking business derived from Enron. . . . If Barone did not understand Enron's financials or how it made its money, he should not be recommending the Enron stock as a 'STRONG BUY.'" *Id.* at ¶ 105. His financial incentives to look the other way were enormous and his undisclosed conflicts of interest controlling.

UBS O'Connor

The Court agrees with Defendants that Plaintiff fails to allege any specific facts to support his conclusory allegation that UBS O'Connor, which was not named as a defendant in *Lamkin*, had "financial motivation to commit fraud" which "caused it to be strictly liable to Plaintiffs." Complaint at ¶ 93. About the only allegation against this entity is that it purchased some of the unsecured Enron debt, along with UBS Warburg and UBS AG. Clearly the pleading is inadequate to sustain a fraud claim and to raise a strong inference of scienter about that entity's involvement in any scheme, contrivance, deceptive device or course of business that would operate as a fraud or deceit upon PaineWebber account holders in connection with the sale or purchase of the debt securities for purposes of a claim under § 10(b) and Rule 10b-5.

IV. Warburg's Earlier Settlements with the SEC, the NASD, and the NYSE:

Finally UBS insists that allegations about research analysts' settlements with the SEC, the NASD, and the New York Stock Exchange about analysts' practices[27] should be stricken from

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[27] According to Plaintiff, in 2002 the SEC's Enforcement Division, New York Attorney General Eliot Spitzer, the Criminal Division of the Department of Justice, the NYSE, and the NASD, along with some state securities regulators investigated a number of Wall Street brokerage firms, including Warburg, for conflicts of interest. That investigation was resolved by a global settlement, pursuant to which ten securities brokerage firms, including Warburg, agreed to pay hundreds of millions of dollars in penalties and change their business practices to comply with a permanent injunction obtained by the SEC. #16 at 4-5. Specifically with respect to Warburg, Giancarlo claims that

the complaint because they do not relate to Enron or any of the alleged wrongdoing here and because a consent judgment voluntarily entered into between a private litigant and a federal agency that is not the result of adjudication should not be used as evidence in subsequent litigation. *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893 (2d Cir. 1976)(holding that "a consent judgment between a federal agency and a private corporation which is not the result of actual adjudication of any of the issues . . . can not be used as evidence in subsequent litigation between that corporation and another party")(*citing* Fed. Rule of Evidence 410).

The courts appear to follow *Lipsky*. *See, e.g., Leford v. Rapid-American Corp.*, No. 86 Civ. 9116 (JFK), 1988 WL 3428, *1 (S.D.N.Y. Jan. 8, 1988)("references in a complaint to proceedings which do not adjudicate underlying issues may be stricken")(*citing Lipsky*); *In re Prudential Securities Inc. Ltd. Partnership Litig. v. Prudential Securities Inc.*, 107 F.3d 3 (Table), 1996 WL 739258,

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Warburg did investment business with many companies on which it wrote research reports, encouraged its analysts to participate in and aid in generating investment banking business, and told that their participation would be a factor in calculating the amount of their compensation, including bonuses. *Id., citing SEC v. UBS Warburg, L.L.C.*, Cause No. 03-CV-2943 (S.D.N.Y.). According to Plaintiff, the SEC concluded that such financial incentives to the Warburg analysts subjected them to improper influences by the investment bank and conflicts of interest that lured them to public nonobjective research reports and violate both federal and state securities laws and NYSE & NASD rules of conduct. *Id.* Warburg was fined $80,000,000 and agreed "'not to take any action or make or permit any public statement, including in regulatory filings or otherwise, denying directly or indirectly in this AWC (Letter of acceptance, Waiver, and Consent) or creating the impression that the AWC is without factual basis' in order to avoid any further regulatory investigation or scrutiny by the NASD, NYSE, and SEC. *Id.*

*7 (2d Cir. Dec. 27, 1996), *cert. denied*, 521 U.S. 1119 (1997); *Adams v. Bell*, 711 F.2d 161, 195 (D.C. Cir. 1983)(*en banc*)(*citing Lipsky* for rule that "collateral estoppel not appropriate because consent decree 'not true adjudication[] of the underlying issues,'"), *cert. denied*, 465 U.S. 1021 (1984). *Adams* also cites, as *in accord*, *United States v. Rexach*, 482 F.2d 10, 18-19 (1st Cir.),[28] *cert. denied*, 414 U.S. 1039 (1973)(same), and *Standard Oil Co. v. Ill. Central R. Co.*, 421 F.2d 201, 205 (5th Cir. 1969)(same).[29] The District of Columbia Circuit Court of Appeals proclaimed that "preclusion of parties is *never* appropriate. *Adams*, 711 F.2d at 195, *citing United States v. State of La.*, 90 F.R.D. 358, 362-63 (E.D. La. 1981)("persons not party to Title VI consent proceeding can challenge judgment in separate proceeding"), and *Restatement (Second) of Judgments* § 68 (1970). As explained in 18A Charles Alan Wright, Arthur R. Miller and Edward H. Cooper, *Fed. Practice & Proc.* § 4443

> To support preclusion at all, there must be a judgment in some form; a settlement agreement by itself is effective only as a contract. If there is a judgment in some form, the central characteristic of a consent judgment is that the court has not actually resolved the substance of the issues presented. To be sure, in various

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[28] In *Rexach*, the First Circuit Court of Appeals wrote, "[T]he most basic premise for utilizing the concept of collateral estoppel--that there be a prior judgment on the merits--is absent in this case." 482 F.2d at 18-19.

[29] The Fifth Circuit observed, "The settlement was no more and no less than 'a non-litigated, court-approved compromise effectuated to avoid the risk of litigation,' and as such it did not serve as an estoppel by judgment on the parties or those in privity with them." 421 F.2d at 205.

> circumstances judicial approval of a consent judgment may require careful scrutiny of its fairness in light of the probable outcome on the merits. . . . However close the examination may be, the fact remains that it does not involve contest or decision on the merits. Any findings made as part of the approval process go to the reasonableness of the settlement, not the merits of the dispute. The judgment results not from adjudication but from a basically contractual agreement of the parties. It can be entered only if the parties have in fact agreed to entry, it is to be enforced in accord with the intent of the parties, and it can be vacated according to basically contractual principles of fraud, ignorance, mistake, mutual breach, or special protection of favored parties.

Thus the Court grants UBS' request to strike the references in the complaint to the research analysts' settlements with the SEC, the NASD, and the New York Stock Exchange about analysts' practices.

Accordingly, for the reasons stated in this memorandum and order, the Court

ORDERS that UBS' motion to strike references in the complaint to the research analysts' settlements with the SEC, the NASD, and the New York Stock Exchange about analysts' practices is GRANTED. The Court further

ORDERS that UBS' motion to dismiss claims under the 1933 Act as time-barred is GRANTED with prejudice. The Court further

ORDERS that UBS' motion to dismiss the 1934 Act claims as to UBS O'Connor only is GRANTED, and that entity is DISMISSED from this action without prejudice. Finally, the Court

ORDERS that UBS' motion to dismiss the 1934 Act claims against all other Defendants is DENIED.

SIGNED at Houston, Texas, this 17th day of February, 2005.

MELINDA HARMON
UNITED STATES DISTRICT JUDGE