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Enron's Secondary Actors

Another Enron episode aired over the holidays. On December 20, federal District Judge Melinda Harmon ruled on motions to dismiss filed by 12 secondary actors in cases brought on behalf of purchasers of Enron Corporation's publicly traded equity and debt securities[1]. The actors seeking an early exit included nine banking institutions, two law firms and an accounting firm.[2] Two, Deutsche Bank AG and Kirkland & Ellis, were allowed to leave the stage; another two, Bank of America Corporation and Lehman Brothers Holdings, Inc., were successful in reducing their parts. The court denied all other motions.

Judge Harmon's ruling, which will be hard to appeal until the case is over, turned, at the urging of the Securities and Exchange Commission, on an expansive reading of primary securities law liability and generous pleading standards. While breaking little new legal ground in the Fifth Circuit, the opinion stands as a stark sign of the times in reading both facts and law to find sufficient knowledge and participation in securities fraud claims. This reading came even in the face of what the court conceded to be "undifferentiated, boiler-plate allegations repetitively applied to all or many defendants."

A little more than a year ago, Enron declared for what was then the largest U.S. bankruptcy after revealing that it had overstated its profits by close to $600 million since 1997. Its problems stemmed apparently from accounting practices for off-balance sheet financing by special purpose entities. In the shareholder litigation that ensued, complaints included those made against corporate advisors for anti-fraud violations under both federal and state securities laws. The institutions and firms moved to dismiss these claims, noting particularly that the

> allegations that Defendants knew of the Ponzi scheme and yet poured millions of dollars into it or risked their reputations to conceal the scheme merely for fees, payments and profits, and subsequently, once caught in the scheme, shored it up in order to limit their exposure to liability and obtain what payments they could on Enron's debts to them, are inherently irrational, implausible, and/or illogical and the alleged actions are against Defendants' own self-interest.[3]

Judge Harmon's opinion illustrates that perceptions of a current climate of corporate scandal are affecting the ways courts apply pleading requirements. The court found that secondary actors can be found primarily liable for misstatements even if those misstatements are not publicly uttered by or attributed to them. Thus, bankers, lawyers and accountants should have less comfort behind curtains of due diligence, Chinese

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[1] *In re Enron Corporation Securities, Derivative & ERISA Litigation*, MDL-1446, Memorandum and Order Re Secondary Actors' Motion to Dismiss (Dec. 20, 2002 S.D. Tex.)("Opinion"). http://www.txs.uscourts.gov/newby52.pdf (Note: This is a 310 page document that may take up to 10 minutes to download.)

[2] Canadian Imperial Bank of Commerce, CitiGroup, Inc., J.P. Morgan Chase & Co., Barclays, PLC, Credit Suisse First Boston, Bank of America Corporation, Merrill Lynch & Co., Lehman Brothers Holdings Inc., Deutsche Bank AG, Kirkland & Ellis, Vinson & Elkins LLP and Arthur Andersen LLP.

[3] Opinion at 259.

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walls and anonymity, particularly if acting with knowledge, intent and third party reliance. The court's opinion is notable for certain broad themes.

1. SEC's View of Primary Liability for Secondary Actors

The court adopted the view urged in a friend-of-the-court brief filed by the SEC concerning the interpretation of *Central Bank of Denver N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). In *Central Bank*, the U.S. Supreme Court held that to be a primary violator under Section 10(b) of the Securities Exchange Act of 1934 a defendant must "make" a material misstatement or omission. The case is widely understood to mean that there is no private right of action for aiding and abetting under Section 10(b) and that secondary actors, such as lawyers, accountants or banks, can only be liable if all requirements for primary liability are met.[4]

To state a valid claim for primary liability under Section 10(b) and Rule 10b-5, a plaintiff must show that the defendant (1) made a misstatement or an omission of a material fact (2) with scienter[5] (3) in connection with the purchase or the sale of a security (4) upon which the plaintiff reasonably relied and (5) that the plaintiff's reliance was the proximate cause of his or her injury.[6] As to the first element -- the making of a false statement or omission of a material fact -- the SEC argued in its brief that an investment bank or other secondary actor can be liable as a primary violator for *Central Bank* purposes for "making" a misstatement or omission if it has a substantial role in "creating" the misstatement or omission. This would be so whether or not the secondary actor signed or has been identified in the relevant document issued to the investing public.

The view adopted by Judge Harmon -- the so-called "substantial participation" test -- has previously been followed by the Ninth Circuit and district courts in Texas, Illinois and California. On the other hand, the Second, Tenth and Eleventh Circuits, as well as district courts in New Jersey, Massachusetts and Pennsylvania have rejected the substantial participation test as eviscerating the core holding of *Central Bank*'s repudiation of aiding and abetting liability under the federal securities laws. This split in the views of the various federal courts may yet be resolved by the United Stated Supreme Court.

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[4] That is, the court concluded that a person who merely gives aid to those who commit fraud is covered neither by the language nor the intent of the statute.

[5] Scienter, or knowledge, for purposes of securities fraud requires a showing of "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976). At the pleading stage, Fed. R. Civ. P. 9(b) requires that allegations of fraud be pled with specificity. This specificity is established by alleging facts that give rise to "a strong inference of fraudulent intent" (*Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994)), for example by alleging facts to show that defendants had both motive and opportunity to commit fraud or by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness (*In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993)). Recklessness is a more exacting threshold than negligence, which does not suffice for purposes of liability for fraud. *See Ernst & Ernst*, 425 U.S. at 197; *see also SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001) (recklessness is "highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it") (citing *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979)).

[6] *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 69 (2d Cir.), *cert. denied*, *sub nom.*, *Scholastic Corp. v. Truncellito*, 122 S.Ct. 678 (2001).

Until then, however, under Judge Harmon's decision, corporate advisors may have more exposure. With no ability to predict where their clients may be sued and with the SEC now encouraged to press for a liberal reading of *Central Bank*, corporate advisors for public companies must consider a zone of risk that is close to aiding and abetting.[7]

2. Corporate Scandal Begets Judicial Skepticism

The court's decision also shows a more critical judicial attitude toward corporate advisors in the light of recent high exposure corporate scandals, investigations and settlements. In evaluating the defendants' motions, the court noted that

> what may have been implausible two or three years ago is hardly so today, in light of a plethora of revelations, investigations, evidence, indictments, guilty pleas, and confessions of widespread corporate corruption and fraud by companies, auditors, brokerage houses, and banks. Lining one's pockets with gold, at the expense of investors, employees, and the public, appears too often to be a dominating ambition, and public scepticism [sic] about the market is very prevalent.[8]

Thus, the court rejected arguments relying on "common, legitimate business actions or practices (e.g., loans, commodity swaps, passive investments, underwriting securities offerings, regular working relationships with a company's executives, issuance of analyst reports, and desire to earn profits) that are not inherently improper or fraudulent" because such "*activities must be viewed in context*, i.e., within the totality of surrounding circumstances." Opinion at 259-60 (emphasis added).

Similarly, taking notice of recent investigations into securities analysts' practices, the court was skeptical of the effectiveness of Chinese walls in maintaining necessary separation between subdivisions with conflicting business objectives. Addressing the sufficiency of the claims regarding such walls, Judge Harmon said that although the plaintiffs make only conclusory allegations in this area, "the Chinese wall issue is another allegation *that must be viewed in the total context*, including facts unearthed in current investigations by the SEC and by prosecutors like Eliot Spitzer, the attorney general of New York." Opinion at 262 (emphasis added). The court went on to quote from articles in *The Wall Street Journal* and *Business Week* that were critical of the financial services industry.

3. Increased Knowledge of and Profit from a Fraud Enhances the Risk of Primary Liability

In the usual case, plaintiffs' securities lawyers sue financial institutions because they have "deep pockets." The lawyers hope that some of the taint of alleged issuer malfeasance will attach to the investment bank or broker-dealer. Such claims often fail. Enron and other recent cases may be different, not because the law has changed, but

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[7] The court's interpretation will have no impact on secondary actors involved with registration statements. The complaint asserts claims under the Securities Act of 1933 against three of the investment banking defendants with respect to the registered offering and sale of Enron notes. Scienter is not required to sustain such a claim. Citing allegations of various "red flags and warnings at least some of which should have alerted an underwriter doing a due diligence investigation that greater scrutiny was appropriate," the Court found that the complaint adequately stated Section 11 claims grounded in negligence and/or fraud against those firms.

[8] Opinion at 259.

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because of allegations that the financial institutions went beyond providing their ordinary, typical services and did so seeking economic rewards outside the scope of such services. In effect, the role of the financial services industry is caught in a new and less favorable light.

The Enron plaintiffs alleged that the use of special purpose entities had no economic purpose other than as contrivances or deceptive devices to misrepresent Enron's financial condition. "Moreover, the purchase of Enron securities by unknowing investors was an integral part of the scheme, necessary to keep the house of cards out of bankruptcy and to further a scheme so lucrative for Defendants." Opinion at 273-74.

The court found that the pleading requirement for a Section 10b-5 violation had been satisfied by allegations of a regular pattern of related and repeated conduct involving the creation of unlawful, Enron-controlled special purpose entities and the sale of unwanted Enron assets to these entities in clearly non-arm's length transactions. In many cases, these transactions were undone as soon as the reports were made. Notable to the court was the further allegation that "[t]hese transactions were not isolated, one-of-a-kind instances of violations of the statutes, but deliberate, repeated actions with shared characteristics that were part of an alleged common scheme through with Defendants all profited handsomely, many exorbitantly." Opinion at 274-75.

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