

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES
LITIGATION

§ Civil Action No. H-01-3624
§ **(Consolidated)**

§
§ CLASS ACTION

This Document Relates To:

MARK NEWBY, et al., Individually and On
Behalf of All Others Similarly Situated,

Plaintiffs,

vs.

ENRON CORP., et al.,

Defendants.

THE REGENTS OF THE UNIVERSITY OF
CALIFORNIA, et al., Individually and On Behalf
of All Others Similarly Situated,

Plaintiffs,

vs.

KENNETH L. LAY, et al.,

Defendants.

**LEAD PLAINTIFF'S RESPONSE TO "SUPPLEMENTAL SUBMISSION" OF
MERRILL LYNCH DEFENDANTS IN SUPPORT OF MOTION FOR
SUMMARY JUDGMENT (DOCKET NO. 4816)**

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I. INTRODUCTION

Confronted with extensive evidence of its deceptive conduct, Merrill continues in its Supplemental Submission (“ML Supp.” or “Supplemental Submission”)¹ to rely on its strategy of distorting the law, the evidence, and Lead Plaintiff’s positions. The Supplemental Submission adds little to the analysis of the issue of primary liability. Most of Merrill’s points have been made before; those which were addressed substantively in Lead Plaintiff’s Opposition to Merrill’s Motion for Summary Judgment (Docket No. 4816) (Docket No. 5197) (“Lead Plaintiff’s Opposition”) are considered only briefly here.

II. ARGUMENT

1. Merrill’s Construction of §10(b) Is Flawed

Merrill asserts that “only a party that makes a misrepresentation or omission (with a duty to disclose) employs a deceptive device as required for primary liability under section 10(b).” ML Supp. at 11. Merrill thus seeks to narrow the class of potential offenders to (a) those who spoke directly to the plaintiff or the market and (b) those who had an independent obligation to do so but did not. This construction would, of course, immunize Merrill (and banks in general) from liability for engaging in phony deals designed to create the false appearance of earnings, but it is not consistent with either the language or the intent of the statute.

Proper construction must begin with the language of §10(b), which broadly prohibits “*any* person, directly or indirectly,” from using or employing “*any* manipulative or deceptive device or contrivance.”²

¹ “ML Supp.” or “Supplemental Submission” refers to the Supplemental Submission of Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch & Co., Inc. in Support of Their Motion for Summary Judgment (INSTR. #4816) (Docket No. 5359).

² Here as elsewhere emphasis has been added and citations and footnotes omitted unless otherwise noted.

The Supreme Court teaches that “where Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.” *Neder v. United States*, 527 U.S. 1, 21 (1999). Deception, or deceit, was such a term; under its settled meaning, “**active concealment**” through words or conduct was a form of actionable misrepresentation:³

The representation which serves as the foundation for an action of deceit may consist of words or conduct. Any active concealment of the truth, by words or conduct creating a false impression or removing an opportunity to discover the facts, is treated as the equivalent of a representation that such facts are not true.

William J. Prosser, *Handbook of the Law of Torts* §86, at 720 (1st ed. 1941). The *Restatement* is to the same effect: “Misrepresentation is used in this Restatement to denote not only words spoken or written but also any other conduct that amounts to an assertion not in accordance with the truth. Thus, words or conduct asserting the existence of a fact constitute a misrepresentation if the fact does not exist.” *Restatement (Second) of Torts* §525, Comment b (1979). “A misrepresentation may be expressed by acts and conduct as well as in words. A falsehood may be expressed by deeds, acts, conduct, or artifice, as well as in words or assertions; deceptive conduct is equivalent to verbal misrepresentation. A misrepresentation may consist of a combination of conduct and concealment or conduct and language or solely of conduct.” 37 C.J.S. *Fraud* §12 (2007)⁴

³ W. Page Keeton defined “active concealment” to mean and include “a situation where the defrauder’s acts or words have produced a false impression: that is, the false impression results from the act done or the words spoken.” W. Page Keeton, *Fraud – Concealment and Non-disclosure*, 15 Tex. L. Rev. 1, 3 (1936). The “false impression” rubric employed by Prosser, Keeton, and other authorities is notably similar to the “false appearance” formulation urged in the SEC’s *Homestore amicus* brief (Ex. 1). All exhibits, deposition transcripts, deposition exhibits, expert reports, and trial transcripts are attached to the Appendix in Support Lead Plaintiff’s Response to “Supplemental Submission” of Merrill Lynch Defendants in Support of Motion for Summary Judgment (Docket No. 4816) filed concurrently herein.

⁴ The Supreme Court has never held that active concealment does not support a securities fraud case. The Court noted in *Neder* that “at the time of the mail fraud statute’s original enactment

The early case of *Leonard v. Springer*, 64 N.E. 299 (Ill. 1902) – cited as authoritative at §525

of the *Restatement* – set out the established rule as follows:

Counsel further contends there is no allegation that the defendant ever knew the plaintiff or ever made any representations of any sort to her. It is true, the representations were not by means of conversations between the parties; but the rule is as stated in the Law of Fraud, by Bigelow (p. 467), that a representation is anything short of a warranty, “proceeding from the action or conduct of the party charged, which is sufficient to create upon the mind a distinct impression of fact, conducive of action. The most usual and obvious example is an oral, written, or printed statement. But statement is by no means necessary. ***Any conduct capable of being turned into a statement of fact is a representation. There is no distinction between misrepresentations effected by words and misrepresentations effected by other acts. It is sufficient that there were acts such as to mislead a reasonably cautious or prudent man in regard to the existence of a fact forming a basis of or contributing an inducement to some change of position by him.***”

Id. at 301.⁵ Thus, the contemporaneous understanding of the language employed by Congress was considerably broader than Merrill suggests: “active concealment” – the creation of a false impression – was (and still is) considered a form of misrepresentation, and a misrepresentation claim could (and still can) be premised upon either words or non-verbal conduct.⁶ Whether “active concealment” is

in 1872, and later when Congress enacted the wire fraud and bank fraud statutes, actionable ‘fraud’ had a well-settled meaning at common law [which] required a misrepresentation ***or concealment*** of ***material*** fact.” 527 U.S. at 22. (some emphasis in original). In view of the comment in *Neder* and the acknowledged “common law roots” of securities fraud actions (*Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 344 (2005)) it seems likely that the Court would conclude that a securities fraud claim ***can*** be founded upon an active concealment, if the other elements of the claim are also met.

⁵ Merrill’s conduct ***is*** “capable of being turned into a statement of fact.” Merrill in effect represented that the Nigerian Barges transaction was a legitimate, arm’s-length purchase and sale transaction. It was not; the representation was false.

⁶ See *Stewart v. Wyoming Cattle Rancho Co.*, 128 U.S. 383, 388 (1888) (“In an action of deceit, it is true that silence as to a material fact is not necessarily, as matter of law, equivalent to a false representation. But mere silence is quite different from concealment; *aliud est tacere, aliud celare*; suppression of the truth may amount to a suggestion of falsehood; and if, with intent to deceive, either party to a contract of sale conceals or suppresses a material fact which he is in good faith bound to disclose, this is evidence of and equivalent to a false representation, because the concealment or suppression is, in effect, a representation that what is disclosed is the whole truth. The gist of the action is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished, it is unimportant whether the means of accomplishing it are words

viewed as a discrete form of deceptive conduct, or (as at common law) as garden-variety misrepresentation, Merrill's conduct as charged in this case is well within the scope of the statutory language.

The Securities and Exchange Commission ("SEC") appreciated the breadth of this statutory language when, in 1942, it promulgated Rule 10b-5.⁷ Each of the rule's three subparts must be understood to prohibit different things.⁸ Their sum is far more expansive than Merrill indicates.

Subpart (a) of Rule 10b-5 prohibits the employment of "any device, scheme, or artifice to defraud." It tracks (and adds to) the "scheme or artifice to defraud" language of the mail and wire fraud statutes, which had been on the books for many years prior to 1942. It has long been recognized that those statutes cover more than just false statements and omissions coupled with a duty to disclose; they also prohibit, among other things, active concealment. *See, e.g., Durland v. United States*, 161 U.S. 306, 312 (1896); *United States v. Colton*, 231 F.3d 890, 898-900 (4th Cir.

or acts of the defendants . . ."). *See also* Thomas M. Cooley, *Cooley on Torts*, 910 (3d ed. 1906): ("In order to make out deception, it is not essential that false assertions should be made in words. A nod, a wink, a shake of the head, or a smile artfully contrived to induce the other party to believe in a non-existent fact . . . may have all the effect of false assertions, and be equally deceptive and fraudulent.").

⁷ "If Congress has 'explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837, 843-44 (1984), and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001).

⁸ *Cf., United States v. Naftalin*, 441 U.S. 768, 774 (1979) (Construing very similar language contained in §17(a) of the 1933 Act, the Court observed: "As is indicated by the use of an infinitive to introduce each of the three subsections, and the use of the conjunction 'or' at the end of the first two, each subsection proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities – not to narrow the reach of the prior sections.").

2000).⁹ The SEC should be presumed to have understood, and intended, the breadth of the language it used in subpart (a) of the rule.

Subpart (b) prohibits the making of false or misleading statements. The other subparts thus must be understood as prohibiting something other than, and in addition to, the making of false or misleading statements.

Subpart (c), prohibiting engagement “in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,” speaks directly to deceit by conduct. The law has long recognized that a person’s non-verbal conduct can “operate[] as a fraud or deceit upon third persons.”¹⁰ It is striking that the SEC chose words that track almost exactly the

⁹ In *Colton*, the Fourth Circuit rejected a bank fraud defendant’s assertion that “because he had no fiduciary, statutory, or other independent legal duty to disclose to the RTC any of the information he . . . withheld, he [could not] be guilty of ‘a scheme or artifice to defraud.’” 231 F.3d at 897. The court held that defendant’s conduct, involving deceptive real estate transactions, could and in that case did constitute a scheme or artifice to defraud: “[T]he common-law principle that, in the absence of an independent disclosure duty, ‘nondisclosure is not fraudulent, presupposes mere silence, and is not applicable where, by words or conduct, a false representation is intimated or any deceit practiced.’” *Id.* “[T]he distinction between simple nondisclosure and concealment is in accord with traditional principles of common law fraud.” *Id.* “Concealment often is accompanied by an affirmative misrepresentation or a violation of an independent statutory or fiduciary disclosure duty, but neither is ‘essential’ for actionable fraud. What is essential is proof of a ‘scheme or artifice to defraud,’ which can be shown by deceptive acts or contrivances intended to hide information, mislead, avoid suspicion, or avert further inquiry into a material matter. . . . Here . . . the ‘very structure of the transaction would allow a reasonable inference of an intent to defraud.’” *Id.* at 901. The Court rejected defendant’s argument that the Supreme Court’s *Chiarella* decision was to the contrary. Noting (incorrectly, we suggest) that the securities laws might not be a good analogy because they might be subject to different principles of statutory construction, the Court held that *Chiarella* was not on point because it “involved mere silence, or nondisclosure, and in that context, the Court unexceptionally noted that ‘[a]t common law . . . one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.’ It does not appear that any allegation of active concealment was lodged against *Chiarella*.” *Id.* at 902.

¹⁰ See *Meehan v. Valentine*, 145 U.S. 611, 621 (1892) (citing to and quoting Justice Story’s *Commentaries of the Law of Partnership*: “Mr. Justice Story, at the beginning of his *Commentaries on Partnership*, first published in 1841, said: . . . ‘The true rule, *ex oequo et bono*, would seem to be that the agreement and intention of the parties themselves should govern all the cases. If they

words Justice Story used 100 years earlier to describe how the creation, through conduct, of the false appearance of a partnership could operate as a deceit upon “third persons.”

The language of §10(b) and of Rule 10b-5, and the “accumulated settled meaning” of that language at common law, strongly supports the conclusion that *active concealment* – conduct creating a false impression of material fact – is unlawful, and that one who engages in this conduct commits a violation of §10(b) and Rule 10b-5.

The question becomes whether Merrill “engaged” in active concealment, or merely assisted Enron in doing so. Merrill’s position is that the only actionable deception was in Enron’s *reporting* of false financial results impregnated by the Nigerian Barges deal, the phony power trades, and the LJM2 transactions. In other words, Merrill argues that only the person who *directly speaks* to the plaintiff or the market can be liable for the fraud. But that ignores the fact that deception can be (and here was) accomplished by acts as well as words and that the Merrill transactions were intended to deceive the market – their *raison d’être* was to manipulate Enron’s financial reporting.¹¹ Because it intended, or at least had substantial reason to expect, that the financial effects of its deceptive conduct would be reported to and relied upon by the market, Merrill is subject to liability. This is consistent with traditional tort principles:

The maker of a fraudulent misrepresentation is subject to liability for pecuniary loss to another who acts in justifiable reliance upon it if the misrepresentation, although

intended a partnership in the capital stock, or in the profits, or in both, then that the same rule should apply in favor of third persons, even if the agreement were unknown to them. And on the other hand, if no such partnership were intended between the parties, then that there should be none as to third persons, unless where the parties had held themselves out as partners to the public, or *their conduct operated as a fraud or deceit upon third persons.*” *Id.* (citing Story on Partnership §§1, 38, 49).

¹¹ That the transactions themselves were deceptive – that the deception inhered in and originated with the transactions – is further demonstrated by the fact that *they were accounted for and reported precisely as Merrill and Andrew Fastow (“Fastow”) anticipated and intended.* This is *not* a case in which the accountants misreported the documented deal structure.

not made directly to the other, is made to a third person and the maker intends or has reason to expect that its terms will be repeated or its substance communicated to the other, and that it will influence his conduct in the transaction or type of transaction involved.

*Restatement (Second) of Torts §533.*¹²

Merrill engaged in transactions that were deceptive in the sense that they gave the false appearance of being something other than what they were. Merrill was not only aware of the deception – it actively engaged in and thereby committed an active concealment. Thus, in effect, Merrill made a false representation. And, because its deception was aimed squarely at the market, Merrill may be found directly and primarily liable to market participants, even though the deception was communicated to the market through Enron.

This is exactly the situation and argument Judge Kaplan dealt with in *Parmalat*:

In this case, the complaint alleges that the banks' actions in connection with the relevant transactions actually and foreseeably caused losses in the securities markets. The banks made no relevant misrepresentations to those markets, but they knew that the very purpose of certain of their transactions was to allow Parmalat to make such misrepresentations. In these circumstances, both the banks and Parmalat are alleged causes of the losses in question. So long as both committed acts in violation of statute and rule, both may be liable.

¹² Comments d-g to §533 strengthen the conclusion that Merrill's intent that the financial results be communicated through Enron to the market, and/or the fact that Merrill had reason to expect that result, render Merrill liable to those who directly or indirectly relied upon Enron's financial reporting. Thus Comment d makes clear that "liability, however, extends beyond those whom the maker of the misrepresentation intends to reach or to influence. It includes those whom he has reason to expect it to reach and influence, although he does not make the misrepresentation with that intention or purpose. If he is aware of the intention of the third person to make use of the misrepresentation by communicating it to others, he has a special reason to expect that it will be so communicated and will be relied on." See also Comment f: "One of the situations to which the rule stated in this Section is frequently applied is where misrepresentations are made to a credit-rating company for the purpose of obtaining a credit rating based on them. In this case the maker is subject to liability to any person who may be expected to and does extend credit to him in reliance upon the erroneous rating so procured. ***The fact that the rating company does not communicate the figures misstated by the maker of the misrepresentations is immaterial. It is enough that their substance is summarized with reasonable accuracy or that the rating given expresses the effect of the misstatements made.***"

This analysis is not an end run around *Central Bank*. If a defendant has committed no act within the scope of Section 10(b) and Rule 10b-5 – as in fact was the case in *Central Bank* – then liability will not arise on the theory that that defendant assisted another in violating the statute and rule. But where, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5.

In re Parmalat Sec. Litig., 376 F. Supp. 2d 476, 509-10 (S.D.N.Y. 2005).

2. Lead Plaintiff Does *Not* Assert that Primary Liability Springs from Knowledge Alone – Merrill Itself Engaged in Deceptive Conduct

Merrill states “knowledge of the purpose of the transactions does not convert aiding and abetting into primary liability.” ML Supp. at 7. While this may be true, the evidence in this case demonstrates more than knowledge. Merrill knowingly (apparently knowledge is not an issue) engaged in deceptive conduct.

When a secret side agreement fundamentally changes the true nature of a transaction, it is deceptive to present the transaction as though the side agreement does not exist. Merrill asserts that “[b]oth this Court and *Parmalat* squarely hold that receipt of such assurances [like the oral side agreements in this case] is not sufficient to constitute a deceptive act on the part of a financial institution.” ML Supp. at 9. That broad assertion is inaccurate in what it suggests and concludes. A side agreement – in and of itself – may or may not be deceptive in nature. More important is whether a secret side agreement transforms the nature of a transaction such that the transaction, *as presented*, creates a false impression, *i.e.*, a false appearance of earnings, cash flow, or some other financial metric. ***It is the creation of the false impression – through side agreements or otherwise – that defines the deception and gives rise to primary liability.*** That is what the evidence shows here: Merrill engaged in transactions structured and presented to look like one thing, but in fact because of secret side agreements they were something else altogether. In other words, the side

agreements changed the true underlying economics of the transactions such that they were not in fact what they appeared to have been.

This Court has consistently recognized the principle that where a “secondary actor created an appearance of substance where it is lacking or created a fiction or false appearance of revenues intended to deceive investors in Enron securities or . . . engaged in acts, practices, or course of business that operated as a fraud or deceit upon any person in connection with the purchase or sale of an Enron security, that defendant may be liable under Rule 10b-5(a) and (c).” *See In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2006 U.S. Dist LEXIS 88121, at *19 n.11 (S.D. Tex. Dec. 4, 2006). That oral assurances or side agreements have a role in creating the deceptive appearance does not change this principle. Any person who creates a deceptive appearance of substance, or of earnings or other financial metrics, incurs primary liability whether the deception stems from side agreements or from some other source.

3. Merrill’s Constrained View of What Constitutes a “Sham” or “Deceptive Device or Contrivance” Is Flawed

Merrill asserts that “all that was ‘improper’ about” the barges and electricity trades transactions “was oral assurances from Enron that should have precluded Enron from reporting of profit” (ML Supp. at 14-15), and thus that it did not use or employ a deceptive device or contrivance. According to Merrill, the only deceptive contrivance or device was in Enron’s financial reporting. *See id.* at 12. We have already addressed this argument. Where a secret side agreement transforms the nature of a transaction such that the transaction, *as presented*, creates a false impression, *i.e.*, a false appearance of substance where there is none, or a false appearance of earnings, cash flow, or some other financial metric, the transaction as a whole is deceptive. A person who engages in such a deception – in effect representing that the transaction, *as presented*, is legitimate – commits a primary violation of §10(b).

Merrill asserts that the district court's reasoning in *Parmalat* supports its contention that the receipt of assurances, such as those given by Enron and requested, accepted and acted upon by Merrill, are not sufficient to constitute a deceptive act on the part of a secondary actor. *See* ML Supp. at 9. This is simply not so. As to the two transactions held inactionable by Judge Kaplan, he found that "there is no suggestion that the transactions were something other than what they appeared to be." *Parmalat*, 376 F. Supp. 2d at 505. By contrast, the side agreements at issue in the barges and electricity trades transactions completely changed the nature and appearance of the transactions from a true sale that provided cash flow and income to a simple loan providing neither.

Merrill next attempts to escape liability based on a statement by Judge DeMoss from *United States v. Brown*, 459 F.3d 509 (5th Cir. 2006), with respect to the deprivation-of-honest services doctrine not securities fraud. *See* ML Supp. at 13.¹³ The reasoning and applicability of the law, in the honest-services context, is entirely different than in the securities fraud context and the majority in *Brown* recognized this.

The majority in *Brown* found "[w]e hold only that the alleged conduct is not a federal crime *under the honest-services theory of fraud specifically.*" 459 F.3d at 523. "***This opinion should not be read to suggest that no dishonest, fraudulent, wrongful, or criminal act has occurred.***" *Id.*

The majority in *Brown* actually expressed a view of the evidence consistent with Lead Plaintiff's allegations regarding Merrill. "Bayly asked for a written assurance to support Enron's

¹³ In his concurring and dissenting opinion, Judge DeMoss wrote that any "wrong arising from [the transaction] . . . would be in Enron's employees' reporting of the transaction . . . not in the manner in which Merrill's employees negotiated the deal." *See Brown*, 459 F.3d at 536. Judge DeMoss dismissed the oral side agreement because it was not in the final contract and would not have been legally binding on Enron. Oral side agreements to commit fraud rarely, if ever, are legally enforceable, but that does not change the fact that they occur and can change the very nature of certain transactions. As the SEC has stated, "oral guarantees, even if legally unenforceable, may have the same financial reporting significance as written guarantees." Ex. Drott 48 at 3 ("FRR-23," republished at 1985 SEC LEXIS 130).

promise, and someone responded that a writing was not possible because such an assurance would prevent Enron from receiving the accounting treatment it sought with the deal.” *Brown*, 459 F.3d at

515. The majority explained:

According to Government witness Eric Boyt, an accountant for [Enron], both Fastow and Boyle said that during the conference call, Fastow promised that Merrill would not own the barges for longer than six months and that if Enron could not facilitate a buyer, it would “guarantee a 15 percent buyback within six months.”

Id. And, of course:

Merrill and LJM2 closed the deal for the resale on June 29, 2000, when LJM2 paid Merrill \$7,525,000 for its interest in the barges. That figure represented *exactly* six-months’ return at a rate of 15% annually.

Id. at 516.

Tellingly, the Court stated that applying the “honest-services fraud” charge would be inappropriate because “*accounting fraud and securities fraud . . . are heavily regulated under other statutes*” (*id.* at 523 n.13), indicating the Court’s belief that the conduct of the Merrill executives is cognizable under both accounting fraud and securities fraud statutes, the types of violations alleged in this civil case but which the government failed to pursue as a separate claim to verdict in the criminal case.¹⁴

The concurring and dissenting opinion of Judge Reavley is also relevant to Lead Plaintiff’s claims against Merrill. *Id.* at 531-34. Judge Reavley stated, “[T]he evidence at trial proved that Fastow, Glisan, Boyle, and McMahon, and other Enron personnel temporarily ‘parked’ the barges

¹⁴ As the court in *Brown* noted: “We do not presume that it is in a corporation’s legitimate interests ever to misstate earnings – it is not. However, where an employer intentionally aligns the interests of the employee with a specified corporate goal, where the employee perceives his pursuit of that goal as mutually benefiting him and his employer, and where the employee’s conduct is consistent with that perception of the mutual interest, such conduct is beyond the reach of the honest-services theory of fraud as it has hitherto been applied. Therefore, the Government must turn to other statutes, or even the wire fraud statutes absent the component of honest services, to punish this character of wrongdoing.” *Id.* at 522-23.

with Merrill Lynch so that Enron could meet its earnings.” *Brown*, 459 F.3d at 533. “*In sum, the government proved that [Bayly, Brown and Furst’s] scheme involved withholding material information from Enron and its shareholders and caused a detriment to Enron and its shareholders.*” *Id.* Finally, Judge Reavley stated: “Most important . . . *falsifying Enron’s books does not serve a legitimate corporate purpose, even if it temporarily made Enron’s finances appear more attractive to the investing public in the short term.*” *Id.*

4. Merrill Ignores the Evidence Demonstrating Its Deceptive Conduct in Connection with LJM2

Lead Plaintiff’s Opposition made, and supported with evidence, the following points:

1. Merrill and Fastow structured and launched LJM2 for the express purpose of engaging with Enron in earnings and balance sheet management transactions – *i.e.*, transactions designed to deceive investors.¹⁵ LJM2 was designed and operated as a “conduit” through which Merrill and others indirectly engaged in these deceptive transactions.¹⁶

2. Merrill “approved” and indirectly engaged in the year-end 1999 LJM2 transactions, which created at least \$22 million of phony fourth quarter 1999 earnings for Enron,¹⁷ and it indirectly engaged in each subsequent LJM2 project, each time with advance knowledge of the structure, purpose and effect of each deal, including the Raptor deals.¹⁸

This Court previously approved Lead Plaintiff’s allegations that Merrill “actively engaged in the scheme to defraud . . . from early in the Class Period when it participated in establishing and

¹⁵ See Lead Plaintiff’s Opposition at 47-58.

¹⁶ 10/24/06 Deposition Transcript of Andrew S. Fastow (“10/24/06 Fastow Depo. Tr.”) at 417:6-11.

¹⁷ See Lead Plaintiff’s Opposition at 25-45.

¹⁸ See Lead Plaintiff’s Opposition at 40-45 nn.133-154.

funding LJM2 at a critical accounting time, despite red flags identified in the complaint and known to Merrill Lynch.” *In re Enron Corp. Sec. Litig.*, 310 F. Supp. 2d 819, 830 (S.D. Tex. 2004). The evidence now supports these allegations and even shows much more involvement and knowledge by Merrill. *See* Lead Plaintiff’s Opposition at §III.A.

Merrill ignores this evidence, opting instead for a sanitized fantasy version of the story in which it had little to do with LJM2 or any LJM2 transactions.¹⁹ Thus, Merrill asserts that “[f]unding and structuring an Enron-related SPE that *Enron* uses for deceptive purposes is, at most, aiding and abetting.” ML Supp. at 24. This ignores the fact that LJM2’s independence was crucial to the manner in which Enron could report transactions. Merrill structured (“Merrill Lynch and I structured – came up with the structure together”)²⁰ and launched LJM2 for the express purpose of engaging in deceptive and manipulative transactions “to manage Enron’s earnings and balance sheet” to make Enron’s financial statements “what Enron desired them to be.”²¹ Merrill knew Fastow and Enron were secretly arranging the timing of transactions and LJM2’s return of (and on) assets for which LJM2 would act as a “buyer,” and this was before Merrill even closed LJM2 and the first round of LJM2-Enron transactions in late December 1999. *See* Lead Plaintiff’s Opposition at 47-54; Fastow Decl., ¶33; 10/24/06 Fastow Depo. Tr. at 514:21-515:17. Merrill, in other words, intended the deceptive consequences. Merrill also suggests – incorrectly – that only Enron engaged in deception. Most if not all of the LJM2 transactions had the purpose and effect of creating the false appearance of earnings, cash flow, or some other financial metric. They involved “active

¹⁹ Merrill is free, of course, to try to spin that tale to the jury, but it is not entitled to summary judgment in the face of substantial evidence upon which a jury could (and we believe will) find that it did commit primary violations.

²⁰ 10/30/06 Deposition Transcript of Andrew S. Fastow (“10/30/06 Fastow Depo. Tr.”) at 1338:18-23. *See also* Declaration of Andrew S. Fastow (“Fastow Decl.”) (Docket No. 5048), ¶41.

²¹ Fastow Decl., ¶¶41-42.

concealment” which, as discussed above, has long been viewed as the legal equivalent of misrepresentation. Here, the representation-by-conduct was that these were legitimate, arm’s-length transactions. They were not; the representations were false. The question is whether Merrill is chargeable, or only LJM2 itself.

Fastow testified that LJM2 was a “conduit” through which Merrill and others engaged in these transactions.²² Merrill was merely one step removed from LJM2, and it was just as culpable and in many ways more so. Without Merrill selling LJM2 it is not clear LJM2 would have been as successful as it was in deceiving Enron investors.²³

Merrill’s argument, ultimately, is that a party can shield itself from Rule 10b-5 liability by inserting a limited partnership or some other entity as an intermediary in deceptive transactions. But that kind of form-over-substance dodge is blocked by the “directly or indirectly” language contained in §10(b) and Rule 10b-5.

Merrill insists that it had no involvement in the day-to-day operation of LJM2 or in the selection of the transactions, and that these factors preclude a finding of liability. But those factors only go to the question of whether Merrill may lose its status as a limited partner and thus be subject to vicarious liability for LJM2’s wrongdoing; it does not address Merrill’s direct liability for its own wrongdoing. “[L]imited partner status does not protect a limited partner from fraud liability if the

²² 10/24/06 Fastow Depo. Tr. at 417:6-11. This testimony is corroborated by numerous other facts, including the contemporaneous documents showing that Merrill “approved” the year-end 1999 transactions – before it became a limited partner – and that it was given detailed information as to each transaction before it was asked to fund it. Moreover, Merrill understood the deceptive purpose of the transactions and – without any legitimate business purpose of its own – went forward anyway.

²³ As one investor noted: “My whole emphasis was, if Merrill Lynch is selling it, it has to be good because they’re the biggest brokerage firm in the world.” said Joe Marsh, a Merrill client. Paula Dwyer, Laura Cohn, Emily Thornton, & Wendy Zellner, *Merrill Lynch: See No Evil*, Business Week, Sept. 16, 2002, at 3-4 (Ex. 2).

limited partner participates in the fraud.”²⁴ The evidence here is sufficient to permit the jury to decide if Merrill did in fact engage in the fraud.²⁵

Merrill embraces Bankruptcy Examiner Neal Batson’s (“Batson”) statement that he had not found evidence “to date” that Merrill “had any role in the day-to-day operations of LJM2 or in the selection or approval of the transactions entered into by LJM2.” Ex. 3 (Third Interim Report of Neal Batson (“Batson III”), Appendix I (“App. I”)) at 46. Batson’s conclusion was reached without the benefit of Fastow’s testimony that “Merrill Lynch and I structured – came up with the structure [LJM2] together.”²⁶ According to Fastow, without Merrill there would be no LJM2: “LJM2 was a unique and challenging transaction. If it weren’t for [Merrill’s] vision and determination, it wouldn’t have happened.”²⁷ Fastow further testified that LJM2 was designed to be and was a “conduit” through which Merrill and others invested in the LJM2/Enron deals.²⁸ LJM2 was not, in other words, a blind pool, and Merrill was not simply a passive investor. Fastow also produced, very late in discovery, a document he personally prepared in the Spring of 2000, which said that Merrill and the others who closed in December 1999 had “approved” the year-end deals – and did so before they became limited partners. Having conceptualized, designed and structured LJM2 for the deceptive purpose, according to Fastow, of “managing [Enron’s] earnings,” Merrill cannot sit back and assert

²⁴ J. William Callison & Maureen A. Sullivan, *Partnership Law and Practice: General and Limited Partnerships* §23.1 (Thompson/West 2006).

²⁵ The evidence concerning Merrill’s involvement in the structuring and launching of LJM2, and in connection with the LJM2 transactions, cited in Lead Plaintiff’s Opposition, is more extensive and detailed than the evidence concerning Deutsche Bank. Moreover, the evidence shows Merrill’s own deceptive acts, *including acts taken before it became a limited partner*, for which it can be held directly liable.

²⁶ 10/30/06 Fastow Depo. Tr. at 1338:18-23. *See also* Fastow Decl., ¶41.

²⁷ Ex. 4 at MLNBY0052520.

²⁸ 10/24/06 Fastow Depo. Tr. at 417:6-11, 515:18-25.

once it provided a vehicle for the fraud to take place that all it did was fund the transactions and that it should be sheltered from primary liability. Nor is there any question Merrill knew throughout the remainder of the Class Period that the vehicle it structured and continued to fund was having its intended effect, as an examination of just a couple transactions illustrates.

In the Nowa Sarzyna transaction – the largest of the 1999 year-end earnings manipulation transactions – the transaction involved the “warehousing” of an unfinished power plant being built in Poland by an Enron European subsidiary. Enron had planned to sell the power plan into a new structure called “Project Margaux.” That transaction was supposed to have created significant “earnings” for Enron in the fourth quarter of 1999, but the power plant was behind schedule and could not become operational by year-end. The Margaux structure was also behind schedule and could not be in place in time to transact the much-needed year-end earnings deal. Enter LJM2. Problem solved.

Fastow confirmed the deceptive nature of the Nowa Sarzyna transaction:

A. *[L]JM was basically, what we called, warehousing the asset, just owning it for a short period of time with no intention of being the permanent owner of the asset.*

This allowed Enron to record the sale at year-end for financial reporting purposes, even though we knew LJM wasn't going to be the real owner of it in the future.

* * *

A. *It allowed Enron to report the numbers it wanted to report.*²⁹

Merrill engaged and funded, before the LJM2 structure was fully in place, the Nowa Sarzyna transaction knowing it was a warehousing deal,³⁰ not a real purchase. *An internal Merrill*

²⁹ *United States v. Lay, Skilling*, No. H-04-25, Trial Transcript (S.D. Tex. Mar. 7, 2006) at 6449:4-14 (Fastow Testimony).

*document noted: “LJM2 to hold [the Nowa Sarzyna facility] until Enron finds a long term investor.”*³¹ Nor was Merrill a “passive investor” in LJM2. Having prepared the private placement memo for LJM2, Merrill “sold” LJM2 and thus the Nowa Sarzyna facility to investors. Specifically, in a sales presentation prepared by Merrill for a February 7, 2000 meeting with an investor, it showed that Nowa Sarzyna was still to be transferred to Margaux – even though LJM2 then “owned” it. Ex. 8 at ASF_CIV_000000799-807. Finally, by no later than March 20, 2000, Merrill knew that LJM2 was going to complete the phony deal by purchasing 40% of the equity in the new Margaux structure and that Margaux would acquire – largely from LJM2 – Nowa Sarzyna. Ex. 9 at MLNBY0226448.³²

An example of Merrill’s continuing role in the scheme is the deceptive Raptor transactions. These transactions involved hedges that, due to secret guarantees from Enron about which Merrill knew, were riskless transactions for LJM2. Fastow testified: “I and others at Enron, including Enron’s Chief Accounting Officer, had an unwritten agreement that LJM2 would be paid the return of its investment, plus a profit, prior to Talon [Raptor SPE] engaging in any hedging.”³³ In other words, not only was LJM2 not at risk in the Raptor transactions – a requirement if Enron were to book revenue – but it had already received a profit guarantee before the first transaction. *Fastow*

³⁰ See also Ex. 5 at MLNBY0190119. See, e.g., Ex. 6 at MLNBY0226741. Merrill was familiar with the Margaux structure – Robert Furst, who by December 1999 was Merrill’s Relationship Manager with respect to Enron, had worked on the Margaux structure while employed at CSFB.

³¹ Ex. 7 at MLNBY0247673.

³² And of course to top off the LJM2 transactions, Merrill sold the barges to LJM2 for further holding until an ultimate buyer could be found by Enron.

³³ Ex. 13448, Ex. A at 2.

*was explicit*³⁴ *about the side agreement, whose purpose was to eliminate LJM2's risk, on a conference call with Merrill and some of its clients on March 21, 2000.*³⁵ Through the Raptors, Enron's pretax income for the year ended December 31, 2000, was overstated \$532 million and for the nine months ended September 30, 2001, \$545 million. Enron's total equity for the year ended December 31, 2000, was overstated \$704 million and for the nine months ended September 30, 2001, \$1.077 billion due to the Raptors. 2/22/06 Supplemental Expert Report of Saul Solomon at Schedules 3, 8.

Thus, in the Raptor's transactions Merrill's funding was a fiction and Merrill had a guaranteed return before the first transaction was completed. As Fastow testified: "*My opinion is that many of the transactions that LJM2 did with Enron caused Enron's financials to be misleading and deceptive.*"³⁶ Further, Fastow confirmed that "*[b]ased on my conversations with its executives, Merrill understood that LJM2 would be used to manage Enron's earnings and balance sheet, and that the transactions undertaken by LJM2 with Enron in December 1999 resulted in Enron reporting higher earnings than it would have otherwise absent those transactions with LJM2.*"³⁷

³⁴ While acknowledging Merrill's important role in setting up LJM2, *i.e.*, raising \$390 million in capital commitments, investing directly, enabling 97 senior Merrill executives to invest and receipt of investor information regarding capital calls, distributions, valuations and updates summarizing the transactions in which LJM2 participated (Ex. 3 (Batson III, App. I at 45-46)), Enron's Bankruptcy Examiner Batson could not determine if Merrill was more than a private placement agent or passive investor because Batson did not have the benefit of Fastow's recent testimony that it was he and Merrill that initially structured LJM2 and without Merrill's vision there would be no LJM2.

³⁵ Ex. 9 at MLNBY0226436.

³⁶ 10/24/06 Fastow Depo. Tr. at 359:14-20.

³⁷ Fastow Decl., ¶41.

Finally, LJM2 was the entity that took the barges off Merrill's hands at the end of the agreed upon six months. Obviously, Merrill committed yet another deceptive act in "selling" the barges to LJM2. As the Court in *Brown* noted:

In turn, the plan was for LJM2 to also flip the interest in the barges after the end of 2000 so that Enron would not have to show that the profits earned in 1999 were "unwound." In return for Enron's use of LJM2's balance sheet in this manner, Enron was to pay LJM2 a flat \$ 350,000 fee and a 15% annual rate of return for the period it held the barges, and ensure that LJM2 would be taken out of the investment by January 15, 2001. An industry buyer, an energy company, ultimately bought the barges during the period LJM2 held the barges; tellingly, this ultimate buyer conducted purchase negotiations with APACHI, not with LJM2 which held the barges in name.

459 F.3d 516 n3.

Merrill suggests it was forced to fund LJM2 transactions under the LJM2 partnership agreement. That ignores, however, the fact that Merrill was not a partner, and so was not bound by the partnership agreement (or anything else) when it "approved" the year-end 1999 transactions. It also ignores other provisions of the partnership agreement and Fastow's testimony that Merrill was "free to object" and by vote could "prohibit" Fastow "from making the investment." Lead Plaintiff's Opposition at 46-47. In any event, this is not a defense on which summary judgment may be grounded. Merrill should be required to take its devil-made-me-do-it defense to the jury.

B. Whether Merrill Is Subject to Joint-and-Several Liability for Its Ongoing Engagement in the Scheme Is Properly a Jury Question

1. The Court Correctly Decided This Issue in Lead Plaintiff's Favor

Merrill again advances its position that, as a matter of law, it cannot be subject to joint-and-several liability, asserting that it should not be "liable for losses caused by transactions in which it did *not* participate" (ML Supp. at 47), that it acted in "simply a hub and spoke conspiracy, which is not actionable under 10(b)" (ML Supp. at 50), and that the Court should "clarify" it is off "the hook" for joint-and-several liability (ML Supp. at 53-54). While Merrill admits that the Court "has

previously ruled that a ‘reasonable argument’ could be made for such [joint-and-several] liability” (ML Supp. at 46), it essentially asks, again, for reconsideration of the Court’s prior rulings on this issue. There is no basis for reconsideration at this point. Nor has Merrill brought forward summary judgment evidence which would require a different result. The issue of joint-and-several liability is one that should be tried to the jury.

2. The PSLRA Left Intact Traditional Joint-and-Severall Liability Jurisprudence in Connection with Knowing Violations of the Law

This Court recently observed that “the PSLRA replaced the common law’s scheme of joint and several liability and contribution rights with proportionate share liability where a defendant lacks ‘actual knowledge’ of fraud.”³⁸ But, the “common law’s scheme of joint and several liability” still applies to knowing violators and supports the statute, and under the common law Merrill would be held jointly and severally liable.

In an article published in 1937, William J. Prosser identified no fewer than eight different alternative bases for the imposition of joint-and-several tort liability.³⁹ Several may be applicable here, depending upon the jury’s view of the evidence at trial.

“It is settled definitely that all who act in concert will be liable for the entire result.” Prosser, 25 Cal. L. Rev. at 429. The concerted action that sufficed at common law to impose joint-and-several liability was consistent with scheme liability under §10(b). As one court explained:

If parties, although acting independently, know, or have reasonable ground to believe, that their independent acts, combining with the independent acts of others, will create a result that will become a nuisance and they do so causing damage, they become as it were joint wrongdoers *ab initio*, and are liable as joint tort-feasors. Where all have knowledge of the independent acts that create the result and continue

³⁸ *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2007 U.S. Dist. LEXIS 5111, at *89 (S.D. Tex. Jan. 24, 2007).

³⁹ William J. Prosser, *Joint Torts and Several Liability*, 25 Cal. L. Rev. 413 (1937).

the independent acts with knowledge, this *ipso facto* creates a concert of action and makes a common design or purpose.

Moses v. Morganton, 133 S.E. 421, 423 (N.C. 1926). Here, at a minimum, each bank defendant knew that it was engaging in transactions that had the purpose and effect of creating a false appearance of earnings, cash flow, or other financial reporting metrics, thus hiding Enron's true financial condition and prospects, and knew that other banks were similarly engaged in other transactions with similar purpose and effects. A finding of joint-and-several liability thus would be appropriate on this ground.

But joint or concerted action is not a necessary prerequisite for joint-and-several liability.

“The universal common-law rule is that each of two or more persons whose tortious conduct causes harm is liable to the injured party for the entire harm and each may, therefore, be sued separately and held liable for all of the damage.” *MacMillan Bloedel, Ltd v. The Flintkote Co.*, 760 F.2d 580, 584-85 (5th Cir. 1985). *See also Restatement (Second) of Torts* §875; Prosser, 25 Cal. L. Rev. at 432-35. Thus, as Justice Calvert wrote for the Texas Supreme Court, “[w]here the tortious acts of two or more wrongdoers join to produce an indivisible injury . . . all of the wrongdoers will be held jointly and severally liable for the entire damages” – even where there is “no concert of action or unity of design” between or among the wrongdoers. *Landers v. East Texas Salt Water Disposal Co.*, 248 S.W.2d 731, 732-34 (Tex. 1952). The focus is properly on the indivisible injury, not on the fact that two or more wrongdoers each caused that injury.⁴⁰

⁴⁰ The *Landers* rule also answers Merrill's objection that Lead Plaintiff is impermissibly pursuing a “hub and spoke” conspiracy. As noted, joint-and-several liability *can* flow from concerted action or unity of design, but concerted action or unity of design is not necessary where, as here, plaintiffs allege and can prove an indivisible injury.

In this regard, it is important to focus on the nature of the indivisible injury.⁴¹ From and after January 18, 2000, Merrill caused the truth about Enron’s financial condition and prospects – its true underlying, continuing weakness – to be hidden from investors by creating the false appearance of earnings and other financial metrics. Others similarly created the false appearance of earnings, operating cash flow, or other financial metrics and thereby caused the truth to be hidden. Investors were damaged when the risks that were hidden by these transactions materialized.⁴² While different defendants engaged in different transactions, it would be virtually impossible to “apportion with reasonable certainty” the injury caused by the different actors whose conduct caused the truth about Enron to remain hidden. Hence, the injury should be viewed as indivisible.

In the context of a summary judgment motion, it is important to consider burden of proof issues. “Where the tortious conduct of two or more actors has combined to bring about harm to the plaintiff, and one or more of the actors seeks to limit his liability on the ground that the harm is capable of apportionment among them, the burden of proof as to the apportionment is upon each such actor.” *Restatement (Second) of Torts* §433B(2). This is the rule in the Fifth Circuit. In *Borel v. Fibreboard Paper Products Corp.*, 493 F.2d 1076 (5th Cir. 1974), the Fifth Circuit explained that the *Landers* opinion (cited above) in effect creates a rebuttable presumption favoring the imposition

⁴¹ Merrill’s brief uses the term “indivisible loss” rather than indivisible injury or harm. *See, e.g.*, ML Supp. at 46 n.13. This is not only the wrong terminology, it is the wrong concept. *See Primrose Operating Co. v. National American Ins. Co.*, 382 F.3d 546, 556-57 (5th Cir. 2004) (Defendant “fails to distinguish among the alleged negligent acts, the resulting ‘pollution incidents,’ and the injury arising from the pollution incidents. The allegations state that the ‘acts of negligence have produced an indivisible *injury*,’ not that the negligent acts or the pollution incidents themselves are indivisible.”).

⁴² As discussed above, Merrill’s continued insistence that Lead Plaintiff must show that it was a substantial cause of Enron’s *collapse* is an irrelevant diversion. Lead Plaintiff will prove causation by showing that Merrill caused the truth about Enron’s true financial condition and prospects to be hidden, and that investors were damaged when the risks that were hidden by these transactions materialized in 2001.

of joint-and-several liability “[w]here the tortious acts of two or more wrongdoers join to produce an indivisible injury, that is, an injury which from its nature cannot be apportioned with reasonable certainty to the individual wrongdoers.” *Id.* at 1095. Thus the Court held (in an opinion written by Judge Wisdom): “The effect of the *Landers* case may be stated as follows: Where several defendants are shown to have each caused some harm, the burden of proof (or burden of going forward) shifts to each defendant to show what portion of the harm he caused. If the defendants are unable to show any reasonable basis for division, they are jointly and severally liable for the total damages.” *Id.*

In this case, Merrill will have the opportunity at trial to bring forward evidence to demonstrate “what portion of the harm [it] caused.” But Merrill, as the party with the burden on the issue, is not entitled to summary judgment based on its assertion that Lead Plaintiff has not demonstrated “what portion of the harm [Merrill] caused.”

The fact that Lead Plaintiff will not seek damages from Merrill in connection with purchases of securities made before January 18, 2000, in no way undermines the indivisible injury analysis. “If the tortious conduct of each of two or more persons is a legal cause of harm that cannot be apportioned, each is subject to liability for the entire harm, irrespective of whether their conduct is concurring or consecutive.” *Restatement (Second) of Torts* §879. But a person is not made jointly and severally liable, under the rules concerning indivisible injury, for harm caused prior to his or her wrongful act. *Id.*, Comment b.⁴³

Lead Plaintiff believes the evidence will sustain the claim that Merrill’s conduct was a substantial cause of indivisible injury from January 18, 2000 to the end of the Class Period. Merrill

⁴³ See also Prosser, 25 Cal. L. Rev. at 420-21, 435 (“[T]here are cases where the first tort-feasor may be liable for the damages caused by the second, since he created the risk, but the converse does not follow.”).

no doubt will attempt to show that at some point its conduct ceased to be sufficient for causation. That is a determination for the jury. Lead Plaintiff's experts will be able to testify as to price inflation on a daily basis during the Class Period. So it will not be difficult to assess damages against Merrill for whatever period the jury determines is appropriate under the evidence.

C. Loss Causation

Exchange Act §21D(b)(4) provides: "In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant[s]⁴⁴ alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4); *see Dura*, 544 U.S. at 345-46. "The statute thereby makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." *Id.* at 346. This imposes a "requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." *Id.* Neither Lead Plaintiff nor this Court has ever suggested that it is not necessary to establish loss causation as to each defendant.

Merrill argues that the above-cited provision radically *changed* "the traditional elements of causation and loss" and the traditional understanding of proximate cause and joint-and-several liability, imposing in their stead a requirement of proof of a separate loss attributable to each defendant. ML Supp. at 36. First, the cases cited by Merrill do not support its assertion. To prove loss causation or proximate cause, plaintiff need only prove that a defendant's conduct was a *substantial or significant factor* in the loss caused – not the sole or only factor. Secondly, at page

⁴⁴ Under 1 U.S.C. §1, the singular includes the plural. Complex securities frauds often involve multiple actors. As the Court in *Central Bank* noted "there are likely to be multiple violators." And secondary actors like accountants, bankers and lawyers are liable if found to be primary violators. *Central Bank N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994).

36 of its brief Merrill focuses on the singular “defendant” in 15 U.S.C. §78u-4(b)(4) but ignores the fundamental federal statutory construction rule that “*words importing the singular include and apply to several persons, parties or things.*” 1 U.S.C. §1. Thus, Merrill would have this Court change the wording of the PSLRA’s loss-causation provision to say plaintiff has the burden of proving the act or omission of “*each*” defendant caused a *separate* loss, rather than that plaintiff’s loss was caused by the “act or omission of the defendant[s],” which is what it actually says. 15 U.S.C. §78u-4(b)(4).⁴⁵

Merrill also transmogrifies Lead Plaintiff’s theory of loss causation discussed in §VI.C. of Lead Plaintiff’s Opposition. According to Merrill, “plaintiff seeks to hold Merrill Lynch liable for all shareholder losses resulting from Enron’s collapse.” ML Supp. at 32. But that is not the case. ML Supp. at 3-4 (acknowledging plaintiffs do not seek from Merrill “losses suffered by the class . . . during the first fifteen months of the class period”).

From one false premise Merrill leaps to another, namely that Lead Plaintiff must “prove at trial that Merrill Lynch was a substantial cause of Enron’s collapse.” ML Supp. at 32. Lead Plaintiff does not claim that Merrill’s actions alone caused the collapse or bankruptcy of Enron, nor need we prove that.

Rather, Lead Plaintiff expects to prove at trial that Merrill engaged in deceptive transactions that created the false appearance of higher earnings, higher funds flow, and/or lower debt, and that the false impressions Merrill and the other banks created hid the truth about Enron’s financial condition and prospects. The truth was that Enron’s earnings were weak, and were neither growing

⁴⁵ Congress knew how to use the word “each” in the statute when it was necessary to accomplish what it intended. The word “each” appears 22 times in the PSLRA, including many references to defendants, *i.e.*, a defendant has the right to have the jury answer a written interrogatory “on the issue of *each* such defendant’s state of mind.” 15 U.S.C. §78u-4(d).

nor dependable; that its debt load was large and growing, and in fact was unsustainable; and that its funds flow from operations was weak. These, of course, are interrelated factors, and it was the risks inherent in these factors which Merrill and the other banks hid, and which began to materialize in 2001 with huge economic losses to class members.

D. Merrill Has Not Rebutted the Presumption of Reliance to Which Lead Plaintiff Is Entitled

This Court has previously concluded that the Class is entitled to the presumption of reliance established by *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), that the market for relevant Enron securities was efficient, and that *Greenberg* does not preclude a presumption of reliance here. *In re Enron Corp. Sec. Litig.*, 236 F.R.D. 316, 317 (S.D. Tex. 2006). These conclusions are correct and, absent contrary guidance from the Fifth Circuit, should not be revisited at this stage of the litigation.

1. Greenberg Has No Application Here

Merrill nevertheless continues to insist that the decision in *Greenberg* defeats class-wide reliance because, it says, the stock price was not impacted by its conduct. This is wrong legally and factually. *Greenberg* says 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.” *Greenberg v. Crossroads Sys.*, 364 F.3d 657, 662 (5th Cir. 2004) (quoting *Nathenson v. Zonagen*, 267 F.3d 400, 414 (5th Cir. 2001)). There is no doubt that conduct by Merrill and the other banks in hiding Enron’s debt, and in fabricating the false appearance of earnings and funds flow, substantially affected Enron’s stock price. As Merrill recognized at the time, its year-end transactions had added “*great value*” – *real inflation* – to Enron’s stock price.⁴⁶

⁴⁶ When Enron sought to unwind the power trade transaction pursuant to the earlier understanding, Enron also sought to renegotiate the \$17 million fee it promised Merrill. Executives

There are, moreover, critical differences between this case and *Greenberg*. This is a scheme case under Rule 10b-5(a) and (c), while *Greenberg* was a garden-variety Rule 10b-5(b) statements case.⁴⁷ *Greenberg* involved allegedly false statements that, according to plaintiffs, contained new misleading information that should have moved the stock price – but that did not do so. This case primarily involves allegations of deceptive **conduct hidden from the market**. “A person cannot rely upon what he is not told,” and the market generally does not move in response to information unknown to it. *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *288 (S.D. Tex. June 5, 2006).

Here, as in *Basic*, the very purpose of the deception was to **prevent** price movement – to **hide** from the market a truth that, if known, would very likely have moved the market. The focus should not be on whether or when the stock price **actually moved**, but on whether it **would have moved** absent the fraud. This what-would-have-happened inquiry is distinct in ways both practical and theoretical from the what-did-happen inquiry in *Greenberg*.

Where, as in *Greenberg*, plaintiffs’ contention is that the fraud **changed** the market’s prior expectations as to discounted future cash flows,⁴⁸ it is reasonable to inquire whether the stock price

at Merrill were furious. Internally Merrill discussed the “**unwind**” “**at yearend when we did this trade.**” (Ex. 50028 at MLBE0370956 (5/30/00 email from Schuyler Tilney to Dan Gordon and Robert Furst), emphasizing that circumstances had not changed to justify a lower fee, for “**they knew what we were making at . . . the quarter and year (which had great value in their stock price, not to mention personal compensation).**” *Id.* Merrill’s Gordon agreed: “[I]n light of their earnings number (and personal compensation benefits), **the \$17 million does not seem too significant for them.**” *Id.* Merrill later agreed to take \$8.5 million.

⁴⁷ The banks say *Greenberg* was a scheme case. But the Fifth Circuit’s opening paragraph specifies: “The action is based on several statements made by defendants.” 364 F.3d at 659. The opinion then identifies sub-section (b) as the “pertinent part” of Rule 10b-5. *Id.* at 661 n.5.

⁴⁸ Stock prices are largely a function of the market’s understanding of the current (discounted) value of the company’s future cash flows. See Burton G. Malkiel, *Is The Stock Market Efficient?*, 243 Science 1313, 1316 (1989); Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth*

in fact moved. But where – as here and in *Basic* – the purpose of the deception is to artificially *maintain* market expectations – that is, to *hide* facts that if disclosed would materially change expectations – it makes no sense to look for price movement. Simply put, there is no reason for the price to change if the fraud succeeds and the market’s expectations do not change. In *Nathenson*, this Court recognized as much:

We also realize that in certain special circumstances public statements falsely stating information which is important to the value of a company’s stock traded on an efficient market may affect the price of the stock even though the stock’s market price does not soon thereafter change. For example, if the market believes the company will earn \$1.00 per share and this belief is reflected in the share price, then the share price may well not change when the company reports that it has indeed earned \$1.00 a share even though the report is false in that the company has actually lost money (presumably when that loss is disclosed the share price will fall).

Nathenson, 267 F.3d at 419. In the “special circumstances” identified by *Nathenson*, the market is led to believe either explicitly (*Basic*) or implicitly (*Enron*) that X has not happened or is not going to happen, *i.e.*, that there is no “new news” and thus nothing new to react to. *Greenberg*’s “actual movement” test, fashioned in a case grounded in allegations that new information moved the stock price, should not apply in this different setting.⁴⁹

Even Merrill grudgingly recognizes that the kind of deception involved in this case – deception designed to hide risks – is dynamically different from deception designed to raise market expectations in connection with product announcements or the like:

A concealed risk can lead to a decline in stock price either because a corrective disclosure reveals the falsity of the misrepresentations or omissions, or because the

and the Valuation of Shares, 34 J. Bus. 411, 415-16 (1961); Richard A. Brealey & Stewart C. Myers, *Capital Investment and Valuation* 77 (2003); Eugene F. Fama & Merton H. Miller, *The Theory of Finance* 87-89 (1972).

⁴⁹ For similar reasons, *Greenberg*’s “non-confirmatory test” should not be imported into this different setting. The deceptive scheme in this case, intended to *maintain* market expectations, was generally hidden from view. It is not possible to “confirm” a fact that has not come to light in the first place.

risk which was concealed materializes and causes the price to decline. [Citation omitted.] Thus, where the alleged misstatement is an intentionally false opinion or statement, it is the revelation of falsity through a corrective disclosure that causes the loss, but where the alleged misstatement conceals a risk, it is the materialization of the undisclosed condition that causes the loss.

* * *

When loss causation is based on a materialization of a risk allegedly concealed by multiple defendants, it might in some circumstances make sense to hold all of the defendants liable for substantially engaging in similar conduct, even if previously unknown to the market, because it is the concealed condition that causes the loss.

ML Supp. at 40. Thus Merrill admits that in concealed risk cases, the stock price may only move when the “undisclosed condition that causes the loss” materializes. There is no indication that the *Greenberg* panel had concealed risk cases in mind, or intended to fashion a rule which would make little if any sense in this different factual setting.

The differences between this case and *Greenberg* are critical; this Court properly recognized that *Greenberg* does not control here.

2. Merrill Misallocates the Burdens of Proof

The Court’s decision in *Basic* and a line of Fifth Circuit precedents hold that a material fraud presumptively affects the price of securities traded in an efficient market. *Basic Inc. v. Levinson*, 485 U.S. 224, 246-48 (1988); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 298-99 (5th Cir. 1990); *Nathenson*, 267 F.3d at 413-14; *Unger v. Amedisys, Inc.*, 401 F.3d 316, 322-23 (5th Cir. 2005). As noted in *Nathenson*, the fraud-on-the-market presumption has two parts: “First, that ‘the market price of shares traded on well-developed markets reflects all publicly available information,’ . . . [a]nd, second, that ‘the reliance of individual plaintiffs on the integrity of the market price may be presumed.’” 267 F.3d at 413-14 (quoting *Basic*, 485 U.S. at 247 & n.24).

The presumption may be rebutted by a “showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price.” *Basic*, 485 U.S. at 248; *see also Fine*, 919 F.2d at 299. The Fifth Circuit

observed in *Nathenson* that the link may be severed by, among other things, “a showing that ‘the market price would not have been affected by’ the alleged ‘misrepresentations,’ as in such a case ‘the basis for finding that the fraud had been transmitted through market price would be gone.’” 267 F.3d at 414 (quoting *Basic*, 485 U.S. at 248).

Defendants say *Greenberg* reversed the *Basic* presumption, shifting to Lead Plaintiff the burden of proof. In other words, defendants assert that to benefit from presumed reliance, Lead Plaintiff now must affirmatively show that the fraud in fact distorted the price of Enron stock.

This is wrong. Under *Basic*, once Lead Plaintiff identified a material fraud and demonstrated market efficiency, defendants had the burden, on rebuttal, of “showing that the market price would not have been affected” by the fraud. *Nathenson*, 267 F.3d at 414. *Basic* explicitly allocated ***to the defendant*** this burden, emphasizing that presumptions are “useful devices for ***allocating the burdens of proof between parties.***” *Basic*, 485 U.S. at 245. Fifth Circuit precedent holds that the defendant bears the burden of proof here. *See, e.g., Fine*, 919 F.2d at 299 (holding that the defendant “could rebut the presumption of reliance . . . by showing: (1) that the nondisclosures did not affect the market price; or (2) that the Plaintiffs would have purchased the stock at the same price had they known the information that was not disclosed; or (3) that the Plaintiffs actually knew the information that was not disclosed to the market” and placing on the defendant “the burden of showing that the Plaintiffs knew of the omitted or misstated facts, or that they would have traded at the same price had they known”).

Greenberg specifies how, in certain cases, rebuttal (*i.e.*, severing the link between the fraud and the price paid for the stock) may be proved. But there is no indication that the *Greenberg* panel intended to overturn the presumption, or the allocation of burdens of proof, announced in *Basic*. To the contrary, *Greenberg* explicitly recognizes *Basic*’s holding, including its allocation of burdens of proof. 364 F.3d at 661. Moreover, this Court observed in *Unger* – decided after *Greenberg* – that

only the Supreme Court could *fundamentally change* the presumption by requiring a plaintiff to prove “not the efficiency of the relevant market but rather whether a misstatement distorted the price of the affected security.” *Unger*, 401 F.3d at 323 n.4.

Greenberg says, in *dictum*, that “*Nathenson* makes it clear that to establish this nexus the plaintiffs must be able to show that the stock price was actually affected.” 364 F.3d at 665. But *Nathenson* did not purport to change the Supreme Court’s careful allocation of the burdens of proof in connection with establishing or rebutting the fraud-on-the-market presumption. Reading *Greenberg* in tandem with *Basic* and Fifth Circuit precedent such as *Am. Solar King* and *Nathenson*, it appears that plaintiff makes this showing by proving the criteria necessary for the first prong of the presumption, *i.e.*, that the securities traded in an efficient market which would be presumed to reflect all publicly available information.

Were *Greenberg* read, as defendants urge, to fundamentally change the presumption or reverse the allocation of burdens of proof set out in *Basic*, 485 U.S. 248, *Fine*, 919 F.2d 299, and numerous other authorities, it would not be binding. “When panel decisions are in conflict, the earlier one controls.” *Meditrust Fin. Servs. Corp. v. Sterling Chems., Inc.*, 168 F.3d 211, 214 n.4 (5th Cir. 1999); *see also Latham v. Shalala*, 36 F.3d 482, 483 n.1 (5th Cir. 1994) (“Where decisions conflict, the earlier decision should be followed.”).

Clear Supreme Court and Fifth Circuit precedents allocate to defendants the burden of showing that the Enron fraud did not distort the price of the stock. Merrill has not carried this burden and is therefore not entitled to summary judgment.

3. The Court Properly Held the *Affiliated Ute* Presumption of Reliance Applies in This Case

The Court has correctly found the *Affiliated Ute* presumption of reliance applies in this case. *Enron*, 2006 U.S. Dist. LEXIS 43146, at *272-*274. Merrill disputes that holding but offers no new justification to disagree with the Court’s thorough analysis.

The *Affiliated Ute* presumption addresses the fact that “[r]equiring a plaintiff to show a speculative state of facts, *i.e.*, how he would have acted if omitted material information had been disclosed,” should not be required. *Basic*, 485 U.S. at 245. The Fifth Circuit has observed that the *Affiliated Ute* presumption “responds to the reality that a person cannot rely upon what he is not told.” *Smith v. Ayres*, 845 F.2d 1360, 1363 (5th Cir. 1988). Thus, in assessing the applicability of the *Affiliated Ute* presumption, a major focus should be on whether the market had the opportunity directly to analyze and digest the information at the core of the fraud.

In this case, Merrill’s deceptive conduct and its pernicious effects on Enron’s reported financial statements were hidden from public view. Because they were hidden, neither the market nor individual investors could have known, or directly relied upon, information concerning the fact or effects of this conduct. And, because the purpose and effect of the deceptive conduct and scheme was to distort Enron’s financial statements, it is reasonable to apply the presumption here; “the facts withheld [were] material in the sense that a reasonable investor might have considered them important in the making of [an investment] decision.” *Affiliated Ute*, 406 U.S. at 153-54.

4. Merrill’s Claim There Are Not Sufficient Omissions Present to Trigger *Affiliated Ute* Is Incorrect

Merrill asserts “*Affiliated Ute* does not apply because this is not an omissions case.” ML Supp. at 57. According to Merrill, because Enron made financial disclosures, there can be no case of omission. ML Supp. at 57-58. That is nonsense.

In *Affiliated Ute* the individual defendants talked with the plaintiffs about their stock sales, but did not disclose that they “were in a position to gain financially from their sales and that their shares were selling for a higher price in that market.” 406 U.S. at 153. The Supreme Court described these facts as “involving *primarily* a failure to disclose.” *Id.* Under Merrill’s theory, the fact that the *Affiliated Ute* defendants communicated at all with the plaintiffs concerning their stock

sales would preclude application of the presumption, even though the critical fact – defendants’ personal interest in the stock sales – was hidden.

As this Court has recognized, the Fifth Circuit has held that the presumption may be applied in cases primarily – but not purely – involving omissions:

Issuers of securities are under a continuing obligation to make disclosure. Because of the continuing obligation to make disclosure, “it is difficult to envision a pure case of nondisclosure when the issuer is a publicly reporting company” The presence of disclosure documents may prevent this from being a case of pure nondisclosure; it does not, however, prevent this case from being primarily one of nondisclosure, as in *Affiliated Ute*.

Finkel v. Docutel/Olivetti, 817 F.2d 356, 363 (5th Cir. 1987).

That Enron made financial disclosures fails to address the pertinent issue. The case against Merrill is not based on Enron’s fraudulent acts – Merrill is subject to primary liability because *it engaged* in deceptive conduct. The facts concerning Merrill’s deceptive conduct, and its effect on Enron’s financial results, were *not* disclosed. These were material facts “whose very existence plaintiffs [had] no reason to consider.” *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1119 (5th Cir. 1988), *vacated, remanded, Fryar v. Abell*, 492 U.S. 914 (1989).

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing **LEAD PLAINTIFF'S RESPONSE TO "SUPPLEMENTAL SUBMISSION" OF MERRILL LYNCH DEFENDANTS IN SUPPORT OF MOTION FOR SUMMARY JUDGMENT (DOCKET NO. 4816)** document has been served by sending a copy via electronic mail to serve@ESL3624.com on **March 2, 2007**.

I further certify that a copy of the foregoing document has been served via overnight mail on the following parties, who do not accept service by electronic mail on **March 2, 2007**.

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