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NEWSLETTER

Judge Harmon Rules on Secondary Actors' Motions to Dismiss in Enron Litigation

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A federal court in Houston, Texas recently ruled on the motions to dismiss by the banks, law firms and accountants that were sued in *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, No. H-01-3624 (S.D. Tex. Dec. 19, 2002) (*In re Enron Litigation*). Judge Melinda Harmon granted the motions of Deutsche Bank AG and Kirkland & Ellis altogether and dismissed the claims against Lehman Brothers and Bank of America Corporation based on Section 10(b) of the Exchange Act of 1934 (Section 10(b)) and Securities Exchange Commission (SEC) Rule 10b-5 (Rule 10b-5). It denied the motions of the other secondary actors. In ruling on the motions to dismiss, the court, among other holdings, made several rulings regarding the contours of liability for secondary actors under Section 10(b) and Rule 10b-5.

The court initially acknowledged that, under the U.S. Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1993), there is no liability for aiding and abetting or conspiracy under Section 10(b), and secondary actors therefore can only be liable under Section 10(b) as a primary violator. Because the U.S. Supreme Court's *Central Bank of Denver* decision did not determine what conduct of a secondary actor would constitute a primary violation, the court observed that the lower federal courts have adopted two divergent approaches – the "bright-line" test and the "substantial participation" test.

The U.S. Court of Appeals for the 2nd Circuit has adopted the "bright-line" test to determine what conduct constitutes a primary violation of Section 10(b) and Rule 10b-5. *See Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998). For a secondary actor to be liable as a primary violator under this standard, the plaintiff must present evidence that the secondary actor: (1) made a material misrepresentation *and* (2) "the misrepresentation must be attributed to [the] specific actor at the time of public dissemination." According to the 2nd Circuit, requiring that the plaintiff prove the misrepresentation was attributable to the secondary actor "in advance of the investment decision" ensures that the element of reliance is not "undermined."

In contrast, the U.S. Court of Appeals for the 10th Circuit has adopted the "substantial participation" test. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996). Under this test, there is no requirement that the alleged misrepresentation be specifically attributable to the secondary actor at the time of dissemination. Instead, the plaintiff need only prove that the secondary actor: (1) made a material misrepresentation and (2) "knew or should have known that his representation would be communicated to investors." Stated differently, a secondary actor is liable under the "substantial participation" test where "there

is 'substantial participation or intricate involvement' of the secondary party in the preparation of fraudulent statements even though that participation might not lead to the actor's actual making of the statements."

In the *In re Enron Litigation*, the SEC, as *amicus curiae*, criticized both the "bright-line" and the "substantial participation" tests and advocated a third test in its briefing. The SEC's proposed test would make a secondary actor a "primary violator" of Section 10(b) if the actor, "acting alone or with others" with the requisite scienter, "creates" a misrepresentation on which investors relied. Under this view, to be liable as a primary violator, it is not necessary for the secondary actor "to be the initiator of a misrepresentation." Rather, an actor "can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else."

After reviewing all three tests, the court adopted the SEC's test for primary liability for a material misrepresentation or omission under Section 10(b) because the court found it most accurately reflected the holding of *Central Bank of Denver* and most reasonably balanced the interests of "victimized investors" and "harassed defendants." The opinion also reasoned that the SEC's construction of a statute for which it has been given rulemaking authority is entitled to deference. Because there is no clear and narrow definition of "substantial participation or intricate involvement," according to the court, the "substantial participation" test "may fail to differentiate between primary liability and aiding and abetting." The court also found that the "bright-line" test would provide a "safe harbor" for all secondary actors except those that signed the document containing the misrepresentation or that were otherwise identified to the public as the maker of the representation, which would allow the creators of misrepresentations to escape liability "as long as they concealed their identities." Furthermore, the opinion found that a secondary actor could be liable under Rule 10b-5(a) and (c) if it "actively employed a significant material device, contrivance, scheme, or artifice to defraud or actively engaged in a significant, material act, practice, or course of business that operated as a fraud or deceit upon any person in connection with the purchase or sale of any security" with the requisite scienter.

Additionally, the court observed that to survive a motion to dismiss, the plaintiff must meet the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (PSLRA). The PSLRA provides that a plaintiff asserting a claim under Section 10(b) for making material misrepresentations or omissions must "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading." In the U.S. Court of Appeals for the 5th Circuit, the pleading standards of the PSLRA "at a minimum, incorporate the standard for pleading fraud under" Rule 9(b) of the Federal Rules of Civil Procedure. *ABC Arbitrage Plaintiffs Group v. Tchurak*, 291 F.3d 336, 349-50 (5th Cir. 2002). The court noted that the PSLRA also mandates that a plaintiff asserting a claim that has a scienter requirement must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In the 5th Circuit, the requisite level of scienter for Section 10(b) claims is "severe recklessness." *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 (5th Cir. 2001). According to the court, "severe recklessness" is "an extreme departure from the standard of ordinary care, and that present[s] a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

In early January 2003, the secondary actors filed Motions For Section 1292(b) Certification for Immediate Appeal of the court's decision. On January 23, 2003, the court denied the motions, finding that immediate appeals were not warranted.

For more information, please contact one of WRF's Professional Liability Attorneys at 202.719.7130.