

March 22, 2007

ENRON APPELLATE RULING REJECTS CLASS CERTIFICATION:

Fifth Circuit Holds Secondary Actors Cannot Be Primarily Liable Under Securities Laws For Conduct Alone

On March 19, 2007, the United States Court of Appeals for the Fifth Circuit ruled that Credit Suisse First Boston, Inc., Merrill Lynch & Co., Inc. and Barclays PLC (collectively, the “banks”) could not be held liable as primary violators of Section 10(b) of the 1934 Securities and Exchange Act (the “1934 Act”) for involvement in challenged partnerships and transactions of Enron Corporation (“Enron”). Plaintiffs, shareholders of Enron, filed suits beginning in 2001 alleging that the banks and others participated in partnerships and transactions that allowed Enron to misstate its financial results. Plaintiffs sought to hold the banks liable as primary violators under Section 10(b). The United States District Court for the Southern District of Texas (Harmon, J.) issued an order certifying the suit as class action on June 5, 2006.

Haynes and Boone, LLP, acted as Texas litigation counsel in this matter on behalf of Credit Suisse First Boston (USA), Inc. and Credit Suisse First Boston LLC, together with the New York law firm of Cravath Swaine & Moore LLP.

Threshold Issues

Before the Fifth Circuit, plaintiffs argued that the banks were not entitled to appeal the lower court’s order granting class certification because, among other things, certification issues were enmeshed with underlying merits and a complete factual record had yet to be developed. The Court rejected this position and noted that the case gave rise to novel questions of law underlying the district court’s findings supporting certification. The Court found that “we may address arguments that implicate the merits of plaintiffs’ cause of action insofar as those arguments also implicate the merits of the class certification decision.” In exercising its discretion to review the order, the Court noted that “class certification may be the backbreaking decision that places ‘insurmountable pressure’ on a defendant to settle, even where the defendant has a good chance of succeeding on the merits.”

No Presumption of Reliance on Alleged “Omissions”

The Fifth Circuit held that the district court had improperly applied a “presumption of reliance” to alleged omissions by the banks on the rationale of the Supreme Court decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 1238 (1972). The Fifth Circuit noted that under *Affiliated Ute*, in a case primarily concerned with alleged omissions, a securities plaintiff may be presumed to rely on the non-disclosure of information where the defendant owed a duty to disclose such information. In rejecting the district court’s application of the *Affiliated Ute* presumption, the Court held that the banks did not owe Enron’s shareholders any duty to disclose the nature of the alleged transactions. Accordingly, the Fifth Circuit found that to the extent plaintiffs alleged primarily omissions, “it is only sensible to put plaintiffs to their proof that they *individually* relied on the banks’ omissions.”

No Fraud-on-the-Market Presumption

Plaintiffs brought suit under a theory of “scheme liability” and alleged “deceptive acts.” The Fifth Circuit addressed whether the so-called “fraud-on-the-market” presumption of reliance could be applied for purposes of class certification to the conduct alleged by plaintiffs. In *Basic v. Levinson*, 485 U.S. 224 (1988), the Supreme Court held that reliance on misrepresentations may be presumed where those trading securities did so in reliance on the integrity of the market. The Fifth Circuit held that the district court in this case employed an overbroad definition of “deceptive acts” in concluding that the banks’ alleged actions constituted a primary violation of Section 10(b). The Court of Appeals found the district court’s ruling inconsistent with another Supreme Court decision, *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), which prohibited “aiding and abetting” liability in Section 10(b) cases.

The Court reviewed two conflicting decisions from other Circuits addressing secondary actor liability. It agreed that the Eighth Circuit’s definition of “deceptive” conduct – conduct that involves either a misstatement or a failure to disclose by one who has a duty to do so – was correct. The Court rejected the Ninth Circuit’s broader definition that an act may be “deceptive” even where the actor has no duty to disclose. Because the Fifth Circuit found the banks had no duty to Enron’s shareholders, their alleged actions were not “misrepresentations” on which an efficient market might be presumed to rely and, thus, the fraud-on-the-market theory of reliance was inapplicable.

The Fifth Circuit held that “[b]ecause no class may be certified in a Section 10(b) case without a classwide presumption of reliance, our analysis of reliance disposes of this appeal.”

The Court concluded that its decision was consistent with the scope of Section 10(b) liability articulated in *Central Bank*. It noted the potential consequences of permitting the broad rule advocated by plaintiffs that would impose securities fraud liability on a party to an arm’s-length business transaction based on a public company’s potential to use the transaction to mislead investors. Such an expanded notion of liability, it ruled, “would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.”

Concurring Opinion

Judge James Dennis issued a concurring opinion, agreeing with the decision to reverse class certification, but on different grounds. Judge Dennis wrote that in determining whether the plaintiffs had satisfied the prerequisites of maintaining a class action under Federal Rule of Civil Procedure 23, it was unnecessary for the Court to consider whether secondary actors generally may be liable as primary violators under Section 10(b) or Rule 10b-5. The concurring Judge determined that the lower court had erred when it concluded that any defendant found to have knowingly violated the securities laws could be held jointly and severally liable for *all* of the plaintiffs’ losses under the Private Securities Litigation Reform Act of 1995 (the “PSLRA”). Rather than reaching the majority’s conclusion barring class certification against the defendant banks, Judge Dennis would have remanded the case to the district court for a further determination whether common damages issues still predominated over individual issues.

A copy of the Fifth Circuit’s opinion is available at <http://www.ca5.uscourts.gov/opinions/pub/06/06-20856-CV0.wpd.pdf>.

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