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 OPPOSITION TO MOTION FOR SUMMARY JUDGMENT FILED BY DEFENDANTS MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND MERRILL LYNCH CO., INC. (DOCKET NO. 4816)

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I. INTRODUCTION

Merrill Lynch Pierce Fenner & Smith Incorporated and Merrill Lynch & Co., Inc. (collectively, "Merrill Lynch" or "Merrill") have filed a Motion for Summary Judgment ("Motion" or "Defs' Mem.") (Docket No. 4816) which simply repeats arguments already rejected by this Court. Merrill continues to argue, not so much that it didn't commit a crime, it did, but that its actions do not form the basis for a finding of primary liability, that reliance under *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), cannot be established and that its role in the fraud that was Enron was so isolated and insignificant that no loss flowed or can be connected to its actions. This is simply not the case.

This Court's recently refined primary liability analysis as applied to Merrill's conduct in structuring and funding LJM2 and engaging in the sham Nigerian Barges sales and bogus mirror image Electricity Trades leads to but one conclusion: Merrill was a primary violator in all three transactions at issue. As to the application of the *Affiliated Ute* presumption, this Court has found that in the scheme context, the duty required is not one of disclosure, but not to engage in a scheme to defraud, and thus reliance has been established under *Affiliated Ute*. As to loss, Merrill's actions were key to the scheme as they allowed Enron to make its year-end 1999 numbers and because those numbers were the spring board for the Broadband fraud. At the time, Merrill noted internally its actions added "great value" to Enron's stock. This, of course, was inflated value. The impact of these transactions on Enron's stock continued well into 2000 and 2001, as later projections were based in part on the year-end 1999 numbers and LJM2 continued to enter into deceptive parking transactions which distorted Enron's reported numbers. As a truer picture of Enron's operations reached the market, this inflation was removed. Thus, Merrill's conduct was a substantial factor in the loss suffered by the Class.

A. Summary of the Facts

In Merrill's Motion there is little discussion of the facts. Why would there be – the facts are terrible for Merrill. Simply put, Merrill was at the center of the Enron scheme to defraud. Merrill structured LJM2, a deceptive entity set up to distort Enron's true financial picture. The Nigerian Barges sale was simply a sham – no real sale at all. The Electricity Trades, in Merrill's own words, were "delta neutral" or "mirror image" transactions, *i.e.*, they were never intended to nor were they a real trade at all. As a result, the principal purpose and effect of the LJM2 structure and the other transactions was to conceal from the public a true picture of Enron's financial strength or lack thereof. In each case, Merrill engaged in its own deceptive conduct subjecting it to primary liability.

LJM2: Merrill attempts to minimize its role in connection with LJM2, suggesting that its role in the formation and launching of LJM2 was *de minimus*. The evidence, however, reveals that is not the case. According to Andrew Fastow, LJM2 was formed to transact earnings management deals with Enron to make Enron's financial statements look the way Enron wanted them to look.[1] Merrill Lynch conceptualized and structured LJM2 in concert with Fastow.[2] Merrill Lynch drafted significant portions of the Private Placement Memorandum and developed and executed the marketing approach for LJM2. Fastow summed up the key role Merrill Lynch played in LJM2 in an April 2000 e-mail: "***LJM2 was a unique and challenging transaction. If it weren't for [Merrill***

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[1] *United States v. Lay, Skilling*, No. H-04-25, Trial Transcript (S.D. Tex. Mar. 7, 2006) ("3/7/06 Lay/Skilling Trial Tr.") at 6440:21-23 (Fastow testimony). All deposition and trial testimony, expert reports and exhibits referenced herein are attached to the Appendix of Exhibits in Support of Lead Plaintiff's Opposition to Motion for Summary Judgment filed by Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Co., Inc. (Docket No. 4816), unless otherwise noted.

[2] Declaration of Andrew S. Fastow ("Fastow Decl.") (Docket No. 5048), ¶41; 10/23/06 Deposition Transcript of Andrew S. Fastow ("10/23/06 Fastow Depo. Tr.") at 259:4-22; 10/24/06 Deposition Transcript of Andrew S. Fastow ("10/24/06 Fastow Depo. Tr.") at 355:6-14, 355:15-18, 358:24-359:9; 10/30/06 Deposition Transcript of Andrew S. Fastow ("10/30/06 Fastow Depo. Tr.") at 1338:19-20.

Lynch's] vision and determination, it wouldn't have happened."[3] Admittedly, Merrill played a far different and much deeper role in LJM2 than Deutsche Bank.

Merrill Lynch actually funded and executed LJM2's early closing in late December 1999, and it knowingly and intentionally "***approved***"[4] and funded several deceptive year-end LJM2/Enron transactions that, along with the sham Nigerian Barges sale and the bogus Electricity Trades, caused Enron to falsely report that it had met Wall Street's earnings expectations for the fourth quarter of 1999.[5] Throughout 2000, Merrill Lynch willingly participated in funding many additional LJM2 transactions – including the infamous Raptors as well as the so-called Backbone transaction with Enron's broadband business ("EBS") – with full knowledge, before funding them, of the purpose and intended effect of those transactions.[6] With the deceptive entity in place, designed and structured by Merrill, Enron had a ready and willing go-to entity to unload unwanted assets. As Fastow has aptly characterized it, LJM2 was a "conduit" through which Merrill (and the other LJM2 partners) participated in the deceptive earnings management transactions. *See infra* §III.A.3.b.

Andersen auditors have testified that they were deceived by side agreements in LJM2 transactions – side agreements of which Merrill was aware when it approved and funded the transactions. So too were investors deceived.

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3 Ex. 1 at MLNBY0052520. Citations and footnotes are omitted and emphasis is added unless otherwise noted.

4 Ex. 2 at ASF_CIV_000001904 ("L.P.'s have approved 5 out of 6 [year-end] deals").

5 Fastow Decl., ¶44.

6 Fastow Decl., ¶46. *See also infra* §III.A.3.b.-c.; Ex. 3 at MLNBY0191091-100; Ex. 4 at MLNBY0169230.

Nigerian Barges: Prior to year-end 1999, Enron had tried to sell electricity generating barges moored off Nigeria but could not find a legitimate buyer.[7] Enron turned to Merrill Lynch because Enron needed a transaction to take the barges off its hands ***just long enough*** for it to book a profit in 1999, at which point it would buy back the barges or "***facilitate [Merrill Lynch's] exit from the transaction***."[8] Merrill's internal documents frequently described the barges scheme as a "'relationship loan.'"[9]

> Enron is viewing this transaction as a bridge to permanent equity ***and they have assured us that we will be taken out of our investment within six months***. The investment would have a maximum 22.5% return.
>
> * * *
>
> Dan Bayly will have a conference call with senior management of Enron ***confirming this commitment to guaranty the ML takeout within six months***.

Merrill's December 23, 1999 "Credit Flash Report" admitted the "***transaction will allow Enron to move assets off-balance sheet and book future cash flows currently as 1999 earnings***."[10]

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7 *See* Ex. 5 at MLNBY0911188-89 (12/23/99 Merrill Lynch Credit Flash Report); Ex. 6 at ETF-BFG-000117 (12/8/99 internal Enron email from James Hughes, "subject: Nigerian Barge Mo[n]etization"); *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Sept. 23, 2004) ("9/23/04 Barges Trial Tr.") at 1046:12-14 (testimony of Merrill employee Tina Trinkle) (Enron wanted Merrill to do the deal "to help them get the sale done by the end of the year and book these earnings.").

8 Ex. 50034 at MLBE0111776. *See also* Fastow Decl., ¶33 (stating that in December 1999, Fastow told Merrill's Tilney why Enron was "asking Merrill, rather than LJM2, to purchase the [b]arges at that time, and I told him of the assurance Mr. Skilling had given me with respect to the barges").

9 *See, e.g.*, Ex. 5 at MLNBY0911188 (Credit Flash Report); Ex. 7 at MLBE0281216-17 (12/29/99 Minutes of ML IBK Positions, Inc. Board of Directors Special Meeting (particularly MLBE0281216) (describing the Nigerian Barge transaction as a "financing")); Ex. 8 at MLBE0176538-81 (8/4/00 Merrill Discussion Materials Prepared for Fixed Income Discussion with Enron (*see also id.* at MLBE0176543) (referencing, under work for Enron, participation in the "Nigerian Barge Loan")); Ex. 9 at MD037396-403; *see also id.* at MD0373402-03.

10 Ex. 5 at MLNBY0911188-89 (Credit Flash Report).

To complete the Nigerian Barges deception, on June 29, 2000, ***exactly six months after the closing of this transaction***, Enron arranged for Merrill's position to be bought out by an SPE controlled by LJM2,[11] which purchased Merrill's $7 million equity interest for $7.525 million[12] – the $7 million put up by Merrill plus a rate of return of 15% per annum and Merrill's upfront fee of $250,000.[13] Counting the $250,000 payment to Merrill for entering into this contrived transaction, ***Merrill received a return of 22.14% on its $7 million advance***[14] – just as secretly promised to Merrill at year-end 1999.

Andersen partners have testified that Andersen was misled by the secret verbal agreement in the Nigerian Barges transaction.[15] Obviously, so was the investing public.

Bogus Electricity Trades: In December 1999, Enron approached Merrill about a transaction between Enron Power Marketing, Inc. and Merrill Lynch Capital using two electricity derivative contracts.[16] This was another of the three major transactions Merrill and Enron engaged in for the purpose of falsifying Enron's year-end 1999 earnings. Like the Nigerian Barges transaction, Merrill

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11 *See* Ex. 10 at SEC00444604 (6/14/00 email from Bill Fuhs, Merrill, to Geoffrey Wilson, Merrill); *see also* Ex. 11 at MLBE0295112-34 (6/29/00 Share Purchase Agreement between ML IBK Positions, Inc. and LJM2-Ebarge, LLC).

12 Ex. 11 at MLBE0295112-34 (LJM2-Ebarge, LLC Share Purchase Agreement).

13 *See* Ex. 12 at 97 (MLNBY0303177) (4/28/03 Sworn Statement of James A. Brown, Managing Director, Merrill Lynch to Robb Hellwig); *see also* Ex. 11 at MLBE0295112-34 (LJM2-Ebarge, LLC Share Purchase Agreement).

14 *See* Ex. 13 at MLBE0296773 (1/17/02 email from Kira Toone-Meertens, Merrill Lynch, to Joseph Valenti, Merrill Lynch).

15 *See infra* §III.B.4.; 12/7/04 Deposition Transcript of Debra Cash ("12/7/04 Cash Depo. Tr.") at 1608:2-1610:6; Exs. 40327, 40329.

16 *See* Ex. 50006.

and Enron unwound the Electricity Trades ***after*** Enron reported its fourth quarter and year-end 1999 earnings pursuant to a clandestine understanding. As Fastow states in his declaration:

> Based on my conversations with senior Enron and Merrill executives, I understood that, at the time the transaction closed in December 1999, there was a verbal agreement between Mr. Baxter and Mr. Tilney to unwind the transactions in 2000 in exchange for a predetermined fee to be paid by Enron to Merrill. Before the transaction closed I assured Mr. Tilney that Mr. Baxter's verbal agreement would be honored by Enron. I do not believe Merrill would have entered into these transactions absent the agreement to unwind the transactions and to pay the predetermined fee.[17]

And like the Nigerian Barges transaction, Merrill and Enron entered contracts that on their face appeared to be physical and financial trading contracts and appeared to transfer risk, but omitted the true contrary intent of the parties that the transaction was structured to be risk free.

In an email dated December 16, 1999, Merrill explained "a few key points,"[18] the first "key point" was that "$0.20/MWh does not justify doing anything unless it is ***truly risk free*** or the benefits can be clearly articulated."[19] Merrill acknowledged the purpose of the Electricity Trades was not to deliver power, but rather was "for accounting" and emphasized the need for the transaction to have "***no execution risk***," *i.e.*, be risk free:

> ***If Enron is committed to making this transaction for accounting purposes, they should be able to either demonstrate to us that there is no execution risk or give us an actual financial back to back trade independently with ECT*** e.g. we charge them $0.75 for this trade and pay ECT $0.73 for the financial component.[20]

As the year-end 1999 Electricity Trades went to Merrill's Special Transactions Review Committee (the "STRC"), Merrill knew its own deceptive conduct would lead to a false report as to

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17 Fastow Decl., ¶36; *see also id.*, ¶¶37-40.

18 Drott Ex. 44 at MLNBY0270408.

19 *Id.*

20 Drott Ex. 44 at MLNBY0270408.

Enron's fourth quarter and year-end 1999 earnings. The STRC presentation communicated there would be no significant risk that would pass to Merrill in the Electricity Trades:

- "The Global Power Trading Group requests permission to enter into a '***back-to-back***' electricity derivative transaction with Enron Power Marketing, Inc. ('EPMI')."[21]

- "The quantities, pricing points, market locations and term are ***'mirror' image***."[22]

- "The two call options . . . serv[e] to create a ***delta-neutral*** position for both parties . . . ."[23]

- "**<u>Market Risk Management</u>** . . . . ***The proposed transaction is 'back-to-back' and is therefore 'delta-neutral***.'"[24]

Members of the STRC contacted Enron's Chief Accounting Officer, Causey, who confirmed Enron intended to take $50-$60 million in earnings on the transaction and that it would affect bonuses of senior management at Enron.[25]

When Enron sought to unwind the transaction pursuant to the earlier understanding, Enron also sought to renegotiate the $17 million fee promised Merrill. Executives at Merrill were furious. Internally Merrill discussed the "***unwind***," "***at yearend when we did this trade***,"[26] 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***

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21 Ex. 50011 at MLBE0370934.

22 *Id.*

23 Ex. 50011 at MLBE0370935.

24 Ex. 50011 at MLBE0370936.

25 6/17/04 Deposition Transcript of Jeffrey Kronthal ("6/17/04 Kronthal Depo. Tr.") at 316:20-317:6.

26 Ex. 50028 at MLBE0370956 (5/30/00 email from Schuyler Tilney to Dan Gordon and Robert Furst).

compensation)."[27] Merrill's Gordon agreed: "in light of their earnings number (and personal compensation benefits), ***the $17 million does not seem too significant for them***."[28] Acknowledging that the transaction was to service Enron's particular accounting need, Merrill accepted an $8.5 million fee, at least $10 million less than what the purported trading contracts stated Merrill was entitled to.

Auditors for Andersen testified that had they discovered an oral side agreement to unwind the transaction such as the one here, it would have ***negated the accounting treatment*** for the transaction and there would have been ***no profits*** to book from the transaction.[29] Again, as the auditors were deceived by Enron and Merrill, so were investors.

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[27] *Id*.

[28] *Id*. Merrill later agreed to take $8.5 million.

[29] 8/22/06 Deposition Transcript of Thomas Bauer ("8/22/06 Bauer Depo. Tr.") at 405:14-407:15.

FINANCIAL STATEMENT EFFECT OF CERTAIN TRANSACTIONS IN WHICH MERRILL LYNCH ENGAGED
($ millions)

PRE TAX INCOME

	12 mo ended 12/31/99	3 mo ended 3/31/00	6 mo ended 6/30/00	9 mo ended 9/30/00	12 mo ended 12/31/00	3 mo ended 3/31/01	6 mo ended 6/30/01	9 mo ended 9/30/01
Pre Tax Income Overstated/(Understated)	83.1	-	54.1	152.2	776.3	276.6	333.2	600.8
Barges	13.0	-	-	-	-	-	-	-
Electricity Trades	49.0	-	-	-	-	-	-	-
Selected LJM2 transactions (See Note)	21.1	-	54.1	152.2	776.3	276.6	333.2	600.8

EARNINGS BEFORE INTEREST, TAXES AND DEPRECIATION

	12 mo ended 12/31/99	3 mo ended 3/31/00	6 mo ended 6/30/00	9 mo ended 9/30/00	12 mo ended 12/31/00	3 mo ended 3/31/01	6 mo ended 6/30/01	9 mo ended 9/30/01
EBITDA Overstated/(Understated)	83.1	-	54.1	102.7	710.2	260.0	300.0	551.0
Barges	13.0	-	-	-	-	-	-	-
Electricity Trades	49.0	-	-	-	-	-	-	-
Selected LJM2 transactions (See Note)	21.1	-	54.1	102.7	710.2	260.0	300.0	551.0

CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES

	12 mo ended 12/31/99	3 mo ended 3/31/00	6 mo ended 6/30/00	9 mo ended 9/30/00	12 mo ended 12/31/00	3 mo ended 3/31/01	6 mo ended 6/30/01	9 mo ended 9/30/01
Cash Provided by (Used in) Operating Activities Overstated/(Understated)	1,001.0	-	30.0	93.4	875.7	82.9	36.9	69.7
Selected LJM2 transactions (See Note)	1,001.0	-	30.0	93.4	875.7	82.9	36.9	69.7

TOTAL DEBT

	12 mo ended 12/31/99	3 mo ended 3/31/00	6 mo ended 6/30/00	9 mo ended 9/30/00	12 mo ended 12/31/00	3 mo ended 3/31/01	6 mo ended 6/30/01	9 mo ended 9/30/01
Total Debt Overstated/(Understated)	(905.0)	(1,645.0)	(1,645.0)	(4,106.5)	(4,491.3)	(4,125.2)	(4,045.5)	(3,946.8)
Selected LJM2 transactions (See Note)	(905.0)	(1,645.0)	(1,645.0)	(4,106.5)	(4,491.3)	(4,125.2)	(4,045.5)	(3,946.8)

TOTAL EQUITY

	12 mo ended 12/31/99	3 mo ended 3/31/00	6 mo ended 6/30/00	9 mo ended 9/30/00	12 mo ended 12/31/00	3 mo ended 3/31/01	6 mo ended 6/30/01	9 mo ended 9/30/01
Total Equity Overstated/(Understated)	83.1	83.1	309.2	1,357.8	1,965.3	3,053.3	3,093.3	2,344.3
Barges	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0
Electricity Trades	49.0	49.0	49.0	49.0	49.0	49.0	49.0	49.0
Selected LJM2 transactions (See Note)	21.1	21.1	247.2	1,295.8	1,903.3	2,991.3	3,031.3	2,282.3

NOTE: "Selected LJM2 transactions" are Yosemite I, Rawhide, Fishtail/Bacchus, Osprey add-on certificates, Osprey II, Bob West Treasure, Nowa Sarzyna, ENA CLO, MEGS LLC, Backbone, Catalytica, Avici and the Raptors.

Merrill Lynch Executives Take the Fifth: Every one of the executives at Merrill Lynch involved in the above-referenced transactions has taken the Fifth Amendment rather than describe Merrill's engagement in the scheme to defraud.[30] The assertion of the Fifth Amendment by Merrill's former executives – those involved in these transactions – entitles Lead Plaintiff to an adverse inference from the evidence and questions put to these executives. *See, e.g., Baxter v. Palmigliano*, 425 U.S. 308 (1976). *See infra* §§III.A.3.b., III.B.1.-2., III.B.6., III.D.2., III.D.4., IV.A.

B. Summary of the Legal Arguments

The recent legal standards articulated by the Court demonstrate that indeed Merrill's conduct rises to the level of a primary violator. Merrill engaged in transactions, undertaking its own deceptive conduct, for the principal purpose and effect of distorting Enron's operations and financials. And Merrill garnered significant fees for engaging in such actions. Merrill continues to argue against the application of the *Affiliated Ute* presumption of reliance, but this issue has been addressed numerous times by this Court and other recent authority fully supports the Court's interpretation here. As to loss, Merrill at the time of the transactions commented on the fact that its actions had added "great value" to Enron's stock – albeit inflated value. Merrill's contrary position today – simply lawyer driven – does not change the reality. Merrill's actions were a substantial factor in the loss suffered by the Class subjecting Merrill to liability for that loss.

Primary Liability: Merrill continues to argue that the most it can be liable for is its participation "in a rimless hub-and-spoke conspiracy, with Enron at the hub and Merrill Lynch constituting a spoke not having knowledge that other spokes and a broader conspiracy existed." Defs' Mem. at 44. Merrill argues its participation in such a conspiracy is a form of secondary

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[30] The only exception is Schuyler Tilney's recent (August 17, 2006) recantation of his Fifth Amendment assertion as to certain transactions, but not to the Nigerian Barges.

liability, asserting as such it cannot be held accountable for the massive fraud in which it engaged. Merrill is simply wrong as to the characterization of its own actions and the test to be applied in determining primary versus secondary liability.

As this Court recently held, "the allegations against Merrill Lynch relating to the Nigerian barge 'sales,' . . . satisfy the requirements for pleading primary violations of the statutes." *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *170 (S.D. Tex. June 5, 2006) ("6/5/06 Order"). The Court had repeatedly recognized, for pleading purposes, that Merrill committed primary violations of Rule 10b-5(a) and (c) by engaging in the Electricity Trades and the Nigerian Barges shams. *See In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 703 (S.D. Tex. 2002) (the Nigerian Barges sham and bogus Electricity Trades deal "fit the patterns of the scheme alleged by Lead Plaintiff throughout the complaint"); *In re Enron Corp. Sec. Litig.*, 310 F. Supp. 2d 819, 830 (S.D. Tex. 2004) (same). This Court further recognized that Lead Plaintiff properly alleged "an ongoing scheme in which Merrill Lynch participated in a substantial way over years," including "early in the Class Period when it participated in establishing and funding LJM2 at a critical accounting time, despite red flags identified in the complaint and known to Merrill Lynch." *Id.* The evidence now fully developed supports the Court's earlier articulations of the law and a finding that Merrill was a primary violator in the Enron fraud.

Under this Court's recently refined scheme (Rule 10b-5(a)-(c)) liability rulings, which adopted the SEC's test: "'Where a wrongdoer, intending to deceive investors, ***engages in a deceptive act*** as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the market regardless of whether he designed the scheme.'" *Enron*, 2006 U.S. Dist. LEXIS 43146, at *164-*165. As this Court explained further, it is not necessary that Merrill actually structured or designed the transactions at issue, although it did in many instances, such as LJM2, as long as Merrill itself committed a deceptive act. "'Wrongdoers could studiously avoid engaging in any design activity, and effectively immunize their conduct. . . . Liability should be available against any person ***who engages in a deceptive act*** within the meaning of Section 10(b) as part of a scheme to defraud, regardless of who designed the scheme.'" *Id.*[31] And while Merrill continues to argue that absent "manipulation" a defendant can only be liable if it "made a statement or omission" (Defs' Mem. at 50), this Court recently reiterated that it was not just representational conduct that subjects a primary actor to liability under the securities laws – "'deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words.'"[32] *Enron*, 2006 U.S. Dist. LEXIS 43146, at *165. This Court noted several examples: If an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. "'***If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available***.'" *Id.*[33] This is exactly what Merrill did in structuring and selling LJM2.

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31 The "use or employ" statutory language in §10(b) does not require that a defendant be the originator or mastermind of the scheme – even though Merrill was in many of the transactions at issue. *See Simpson v. AOL Time Warner Inc. ("Homestore")*, 452 F.3d 1040, 1051 (9th Cir. 2006); Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions that Favor Appellant (submitted on appeal of *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), *aff'd*, 452 F.3d 1040 (9th Cir. 2006)) ("SEC Brief") (Ex. 14) at 2.

32 Observing that "'[i]t has long been accepted that Section 10(b), and Rule 10b-5(a) and (c) thereunder, cover conduct beyond the making of false statements and misleading omissions, which are covered by Rule 10b-5(b),' the SEC quotes the conclusion of the Supreme Court in *Zandford*, "'Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit' that <u>conduct, 'without more</u>,' was a fraud."'" *Enron*, 2006 U.S. Dist. LEXIS 43146, at *165 (quoting *SEC v. Zandford*, 535 U.S. 813, 815 (2002)) (emphasis added by SEC); *Affiliated Ute*, 406 U.S. at 152 (noting that while Rule 10b-5(b) targets false statements or omissions, paragraphs (a) and (c) "are not so restricted").

33 As this Court has held, the fact that Enron ultimately published the misleading numbers arising from the deceptive transactions does not break the causal chain as to secondary actors. *Enron*, 310 F. Supp. 2d at 830. The SEC agrees, noting "[C]ertainly where the making of the false

As to Nigerian Barges, this was simply a sham sale. In *In re Parmalat Sec. Litig.* ("*Parmalat I*"), 376 F. Supp. 2d 472 (S.D.N.Y. 2005), the court recognized that a sham transaction where in effect there is a guarantee versus the risk associated with a normal business transaction, the actors are subject to primary liability.[34] The mirror image Electricity Trades also subject Merrill to primary liability. In *SEC v. Hopper*, No. H-04-1054, 2006 U.S. Dist. LEXIS 17772 (S.D. Tex. Mar. 24, 2006), the SEC alleged the defendants participated in "certain 'round-trip' energy trades" that "were sham transactions, bogus trades portrayed as legitimate sales, that were improperly accounted for and reported." *Id*. at *3. Like the Merrill Electricity Trades here, the SEC alleged the defendants had engaged in risk-less trades "with no contemplation of delivery." *Id*. at *5. Judge Werlein held:

> [I]t could be inferred that the round-trip trading scheme was fraudulent apart from the manner in which the trades were characterized in the SEC filings, given that the trades themselves were sham transactions . . . . ***Because the round-trip trades were sham transactions, and therefore had an inherent tendency to deceive, it cannot be said that the alleged fraud or deception only occurred when the trades were misreported in the companies' SEC filings***. Thus, the SEC has adequately alleged that [the defendant's] round-trip trading scheme was a "device" or "scheme" to

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statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation." SEC Brief (Ex. 14) at 22.

[34] In its 7/20/06 Order (*In re Enron Corp. Sec. Litig.*, 439 F. Supp. 2d 692 (S.D. Tex. 2006)) ("7/20/06 Order"), the Court relied extensively on the scheme liability analysis employed by Judge Kaplan in *Parmalat I*. *See, e.g.*, *In re Enron Corp. Sec. Litig.*, 439 F. Supp. 2d 692, 721-24 (S.D. Tex. 2006). At the same time, though, this Court made clear its understanding that ***the SEC's position*** "***appears to be in accord with Judge Kaplan's analysis in Parmalat***." *Id*. at 715. In *Parmalat I*, the plaintiffs alleged that defendant Citigroup violated Rule 10b-5(a) and (c) when it securitized certain of Parmalat's invoices that were known to the bank to be worthless. 376 F. Supp. 2d at 481-82. The plaintiffs also claimed that defendant Banca Nazionale del Lavoro ("BNL") violated Rule 10b-5(a) and (c) by factoring Parmalat's invoices which BNL knew to be without value. In the scheme, BNL paid Parmalat cash for the assignment of the bad invoices. But unlike a legitimate factoring, where "one party purchases, at a discount, receivables from the party that issued them and then attempts to collect the face amount of the invoices" (*id.* at 488), "Parmalat had ***guaranteed*** to BNL . . . and the other banks, payment of the full face value of the invoices." *Id.* As such, the so-called "factoring" and "securitization" arrangements were simply loans to Parmalat; the invoices "played ***no economic role*** in the transaction; they were simply ***a device or excuse*** that ***permitted Parmalat*** to record the revenue and to ***conceal*** the liability on the guarantees." *Id*.

> defraud, or at least a "practice" or "course of business" which operated as a fraud or deceit upon the investing public, that encompassed conduct beyond mere misstatements.

Id. at *37-*38.

Although there should be no question here, certainly there is a material issue of fact as to whether Merrill's conduct in the Electricity Trades at issue was deceptive.

Reliance: Merrill continues to argue that application of the *Affiliated Ute* presumption of reliance is barred because Merrill was under no duty to disclose. The duty in this instance, as carefully analyzed by the Court, is not a duty to disclose, but a duty not to engage in the scheme to defraud. Thus, plaintiffs have satisfied what Merrill argues is a second leg of *Affiliated Ute* in the scheme context to the extent a duty is required. Specifically, this Court found the duty to be, "the duty not to engage in a fraudulent 'scheme' or 'course of conduct' [that] could be based primarily on an omission." *Smith v. Ayres*, 845 F.2d 1360, 1363 & n.8 (5th Cir. 1988); *in accord Heller v. Am. Indus. Props. Reit,* No. SA-97-CA-131-5EP, 1998 U.S. Dist. LEXIS 23286 (W.D. Tex. Sept. 28, 1998); *Enron*, 2006 U.S. Dist. LEXIS 43146, at *102. Nor is there a loop hole in the securities laws casting too wide a net if the duty owed is not one of disclosure as Merrill argues in its Motion. As the Court in *Parmalat I* found, there is more than one way to prove transaction causation. 376 F. Supp. 2d at 509. In the Rule 10b-5 context, reliance often refers to representational conduct, *i.e.*, violations of Rule 10b-5(b). *Id*. However, in the scheme context (Rule 10b-5(a) and (c)) transaction causation can be shown if the actions engaged in by the defendant actually and foreseeably caused losses in the securities markets. *Id*. In *Parmalat I*, the Court noted:

> 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.

Id. The Court in *Parmalat I* went on to note that this was not an end run around *Central Bank*. Specifically,

> 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.

Id. at 509-10.

As this Court has already recognized, to the extent a duty to disclose is required, it arises as to one that engages in a scheme. *Enron*, 2006 U.S. Dist. LEXIS 43146, at *273-*274. *See In re Initial Pub. Offering Sec. Litig*. ("*IPO*"), 241 F. Supp. 2d 281, 381-82 (S.D.N.Y. 2003) ("Where a defendant has engaged in conduct that amounts to 'market manipulation' under Rule 10b-5(a) or (c), that misconduct creates an independent duty to disclose. . . . [P]articipants in the securities market are entitled to presume that all of the actors are behaving legally; silence that conceals illegal activity is therefore intrinsically misleading and (presuming the illegality is also material) is always violative of Rule 10b-5(b)."); *SEC v. Santos*, 355 F. Supp. 2d 917, 920 (N.D. Ill. 2003) (relying on *IPO* and holding that violations of subsections (a) and (c) of Rule 10b-5 create an independent duty to disclose that is not limited to market manipulation).

Having pled and now supplied the evidence supporting the scheme and Merrill's involvement in it, Lead Plaintiff is entitled to the *Affiliated Ute* presumption of reliance.[35]

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[35] To the extent a duty to disclose is ultimately necessary, as Merrill asserts, this Court has noted that in *Santos* that court found that violations of subsections (a) and (c) of Rule 10b-5 "create an independent duty to disclose." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *274. Failure to do so thus gives rise to a violation of Rule 10b-5(b). *See also IPO*, 241 F. Supp. 2d at 381-82. Defendants' attempt to distinguish this case by arguing *IPO* is limited to market manipulation is unpersuasive. Although the defendant's violation in that case was related to market manipulation, the district court's reasoning supports the conclusions that the rule is not so limited. The court

Loss Causation: Merrill's own investment bankers recognized in contemporaneous admissions that Merrill's year-end 1999 transactions gave Enron's stock price an artificial boost: "we were clearly helping them make earnings for the quarter and year (***which had great value in their stock, not to mention personal compensation***)."[36] In fact, the Electricity Trades were the precise cause of Enron making its earnings as they were likely the last transaction booked – close to midnight on the last day of the year. For Merrill to now argue against its own admission, made years earlier, simply highlights that issues of fact exist as to loss and its causes in this case.

As Enron's former CFO Fastow states in his declaration, the Electricity Trade

> ***had the effect of increasing Enron's reported income by $40 million or more and contributed to causing Enron to report higher income at year end than it would otherwise have been able to report***.[37]

Fastow also states with respect to the Nigerian Barges transaction:

> ***[T]he guarantee from me reduced the risk to Merrill in a manner sufficient so that Arthur Andersen, had it known of the guarantee, would not have treated the transaction as a true sale. As a result of the true sale treatment, Enron recorded higher income and funds flow at year-end than it otherwise would have***.[38]

As to the year-end 1999 LJM2 transactions, Fastow declares:

> ***Based 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***.[39]

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reasons, "participants in the securities market are entitled to presume that all of the actors are behaving legally; silence that conceals ***illegal activity*** is therefore intrinsically misleading and (presuming the illegality is also material) is always violative of Rule 10b-5(b)." *Id.* at 382.

36 Ex. 50028 at MLBE0370956.

37 Fastow Decl., ¶36.

38 Fastow Decl., ¶34.

39 Fastow Decl., ¶41.

First, if Merrill had not engaged in the falsification of Enron's reported financial results at year-end 1999 via either the Nigerian Barges transactions, the Electricity Trades, or the LJM2 transactions, there "would almost certainly have precipitated a dramatic drop in Enron's stock price."[40] As noted above, Merrill recognized the value added to the stock price.

Second, by falsifying Enron's 1999 financial results Merrill contributed substantially to the inflation in Enron's stock price which moved from $36.25 in mid-December 1999 to $56.56 in January 2000. After Enron hit its 1999 numbers and held a very successful analyst conference, Enron's stock continued to climb, based in part on the fact that Enron had hit, albeit falsely, its year-end numbers. In the month of January alone, Enron's stock price jumped from $44.375 to $67.875 – an increase of 38.8% versus industry indices.[41]

Third, Merrill contributed – substantially – to the concealment of Enron's true financial condition from the rating agencies, causing investors to misperceive Enron's true creditworthiness. As discussed in plaintiffs' expert reports, "[m]aintaining an investment-grade credit rating was essential to Enron," primarily to allow the Company's Wholesale segment to maintain credit with, and the confidence of, its trading counterparties.[42]

This Court has ruled that "Plaintiff's economic loss may occur as 'relevant truth begins to leak out' or 'after the truth makes its way into the market place.'" *Enron*, 439 F. Supp. 2d at 701.

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[40] *See* Declaration of Scott Hakala in Support of Lead Plaintiff's Response to Merrill Lynch's Supplemental Memoranda filed in Support of Motion for Judgment on the Pleadings ("Hakala Decl.") (Docket No. 4976-5), ¶2; 1/17/06 Expert Report of Blaine F. Nye, Ph.D. ("Nye Report"), ¶43. *See also* Arthur Levitt, The "Numbers Game," N.Y.U. Center for Law and Business, September 28, 1998, (Ex. 15) at 3; Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio,* July 1999, (Ex. 16) at 2; Jennifer Conrad, Bradford Cornell & Wayne Landsman, *When Is Bad News Really Bad News?* (June 1999) (Ex. 17) at 2-3, 20.

[41] Hakala Decl., ¶5.

[42] Nye Report, ¶51.

This truth may emerge partially and over time, and may come through different types of revelations and disclosures. *See id.* at 719-24.; *id.* at 701; *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2005 U.S. Dist. LEXIS 41240, at *63-*64 (S.D. Tex. Dec. 22, 2005) ("12/22/05 Order"). This Court also stated that under *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), and in the context of this case, these revelations of Enron's true condition need not specifically identify Merrill's conduct. *Enron*, 439 F. Supp. 2d at 720. Because, as this Court has held, Merrill is alleged, and now plaintiffs have established, to have engaged in the larger Enron Ponzi scheme, it is sufficient that the leakage of information and partial disclosures revealed Enron's true conditions concealed by the scheme and some of the wrongful conduct engaged in by co-schemers.

Beginning in the Spring of 2001, there were numerous partial disclosures and leaks of negative information (among others), which gradually revealed Enron's true financial condition and the reality that Enron's reported financial condition was the product of fraud – the very "risk" "concealed" by Merrill's conduct. *Lentell*, 396 F.3d at 173. As this Court held, "Plaintiff's economic loss may occur as 'relevant truth begins to leak out' or 'after the truth makes its way into the market place.'" *Enron*, 439 F. Supp. 2d at 701 (quoting *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005)). Merrill does not address these disclosures in its Motion, and indeed cannot do so without conceding there is a triable issue.

Merrill continues to claim that *Dura* requires a corrective disclosure preceding a significant drop in stock price. Defs' Mem. at 30-31. This is simply not so and this Court has already noted that *Dura* imposes no such requirement. *See Enron*, 439 F. Supp. 2d at 701 ("The Supreme Court did not affirmatively adopt *Dura Pharmaceuticals*' argument that a plaintiff must allege and ultimately prove that the defendant made a corrective disclosure of the fraud that was followed by a related price drop.").

Merrill also contends that Lead Plaintiff purportedly "cannot rely on a 'scheme' theory of loss causation." Defs' Mem. at §II.C. That is, Merrill argues that Lead Plaintiff should not be able to rely on disclosures of manipulations caused by the acts of other scheme defendants, to demonstrate loss causation. Defs' Mem. at 32. But again, this is not the law, as this Court found that Lead Plaintiff may indeed use disclosures concerning the conduct of other scheme participants to demonstrate loss causation for later-revealed acts of a subject defendant:

> [That] ***the identity of a particular participant/ defendant's primary [violation] need not have been revealed*** if the same type of primary violations by other defendants with the same purpose . . . is leaked or disclosed to the market and causes a steep decline in the price of Enron's stock . . . .
>
> . . . Disclosure of the roles of some primary violators in a multi-defendant scheme to defraud investors . . . ***should be viewed as sufficient to show loss causation for later-disclosed actions*** . . . .

Enron, 439 F. Supp. 2d at 724. This Court's previous ruling disposes of Merrill's contention.

Joint and Several Liability: This argument by Merrill, as with many of the above, has been rejected by this Court numerous times. The Court phrased the issue thusly: "[I]s a defendant liable only for the loss suffered by plaintiff that was caused by that defendant's own primary violation or is a defendant liable for the loss caused by all primary violators participating in the scheme as a whole?" *Enron*, 2006 U.S. Dist. LEXIS 43146, at *222. The Court chose the latter. Defendants may be held "jointly and severally liable for the loss caused by the entire overarching scheme, ***including conduct of other scheme participants about which it knew nothing***." *Id*. Merrill refuses to acknowledge that the Court already decided this issue. *See* Defs' Mem. at 43-53.

The Private Securities Litigation Reform Act of 1995 ("PSLRA") is unequivocal in providing that knowing violators of Rule 10b-5 are jointly and severally liable for all of a plaintiff's damages regardless of the violator's degree of fault as compared with others in the scheme. The PSLRA states: "Any covered person against whom a final judgment is entered in a private action ***shall be liable for damages jointly and severally*** only if the trier of fact specifically determines that such covered person ***knowingly committed a violation*** of the securities laws." 15 U.S.C. §78u-4(f)(2)(A). There need only be "a" violation by the defendant; one is enough. The statute plainly states there "shall be" joint and several liability for damages under the final judgment if the trier of fact finds one "knowingly committed a violation." *Id*. There is no exception, or reduction, or apportionment of liability for knowing violators who claim lack of responsibility for all the damages found. There simply is no ambiguity as to the clear text of the statute or to congressional intent that knowing violators should bear the entire brunt of plaintiffs' damages.

II. STATEMENT OF CLAIMS

Lead Plaintiff's claims proceed against Merrill under §10(b) of the Securities Exchange Act of 1934 ("§10(b)"), 15 U.S.C. §78j(b), and SEC Rule 10b-5, 17 C.F.R. §240.10b-5, promulgated thereunder ("Rule 10b-5"). Specifically, Lead Plaintiff seeks to hold Merrill liable under subsections (a) and (c) of Rule 10b-5, which render it actionable to "'employ any device, scheme, or artifice to defraud'" and/or to "'engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,'" respectively. *Enron*, 2006 U.S. Dist. LEXIS 43146, at *97. This Court has ruled that, to recover under Rule 10b-5(a) and (c),

> plaintiff must assert that the defendant (1) committed a deceptive or manipulative act, (2) with scienter, that (3) the act affected the market for securities or was otherwise in connection with their purchase of sale, and (4) that the defendant's actions caused the plaintiff's injuries.

Id. at *88 n.45. Lead Plaintiff possesses more than sufficient evidence to establish all of these elements concerning Merrill.

III. STATEMENT OF FACTS

In December 1999, Enron was coming up short on its earnings targets and the pressure was on "[t]o generate earnings to help meet the budgeted target for the quarter."[43] Enter Merrill, which would play a major role in several deceitful and manipulative deals at year-end 1999 with Enron to create millions of dollars in phony income and hide millions in debt. Merrill Lynch engaged in these deceptive transactions and others to enhance its long-term relationship with Enron to reap further profits from the ongoing scheme. Merrill was a Tier Three bank at Enron, but it communicated to Andrew Fastow its constant desire to be viewed as a Tier One bank.[44] As Merrill Lynch manipulated its equity analyst reporting and engaged in deceptive transactions, the business Merrill received from Enron increased considerably, escalating from approximately $3 million in revenues in 1998 to approximately $40 million in 1999. Merrill's business with Enron continued to thrive into 2000 and 2001, as Merrill engaged in LJM2 transactions and continued to sell Enron securities in various offerings and loan Enron money, earning $18 million in fees and millions in interest.[45] Indeed, after Merrill's performance associated with the Nigerian Barges, Electricity Trades and LJM2, Fastow came to view Merrill Lynch as a Tier One bank.[46]

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[43] *See United States v. Lay*, *Skilling*, No. H-04-25, Trial Transcript (S.D. Tex. Mar. 22, 2006) ("3/22/06 Lay/Skilling Trial Tr.") at 9409:13-21 (Glisan testimony). *See also* 9/23/04 Barges Trial Tr. at 980:16-19 (Garrett testimony) (testifying: "there was a shortfall in Enron's earnings targets, and there was a bucket that needed to be filled, and this was part of the effort to fill that bucket of earnings shortfall").

[44] 10/24/06 Fastow Depo. Tr. at 517:11-17, 518:11-22.

[45] *See* Ex. 135; Ex. 18 (Third Interim Report of Neal Batson, Appendix I) at 14, 16.

[46] 10/24/06 Fastow Depo. Tr. at 520:24-521:10.

A. Merrill Lynch Committed Acts of Deception and Manipulation in Connection with LJM2

The explicit purpose for forming LJM2 was to transact "earnings management" deals with Enron – phony last-minute deals that caused Enron to "***make its numbers, . . . meaning, [to] make the financial statements look the way [Enron] wanted [them] to look***."[47] Because LJM2 was created for the express purpose of transacting these manipulative "earnings management" deals, LJM2 itself was a fraudulent device, artifice or contrivance. 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***.[48]

Indeed, Merrill Lynch internally admitted that "[s]ham deals with partnerships [such as LJM2] distorted Enron's true financial picture – inflated earnings and understated on balance sheet debt."[49] Most if not all of the individual transactions between LJM2 and Enron were designed and executed for the purpose and with the effect of creating the "false appearance of earnings and funds flow, and lower debt, thereby obfuscating the true underlying economic performance and health of the Company."[50]

Merrill Lynch was centrally involved in the deception and distortion achieved through LJM2, both in the formation and launching of the fund and in the approval and funding of the deceptive transactions. Merrill Lynch conceptualized and structured LJM2 in concert with Fastow beginning in the summer of 1999.[51] As Fastow testified, "Merrill Lynch and I structured – came up

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47 3/7/06 Lay/Skilling Trial Tr. at 6440:21-23 (Fastow testimony).

48 10/24/06 Fastow Depo. Tr. at 359:18-20.

49 Ex.19 at MLNBY0919625.

50 Fastow Decl., ¶42.

51 10/24/06 Fastow Depo. Tr. at 352:22-353:24. *See also* Fastow Decl., ¶41.

with the structure together."[52] Fastow further testified the purpose of the LJM2 structure was to provide Enron a counterparty for transactions that would be used to "manage [Enron's] balance sheet" and "manage [Enron's] income statement."[53] In fact, according to Fastow's testimony, this was the "main focus" of Fastow's discussions with Merrill Lynch in the summer of 1999 when the two were conceptualizing LJM2.[54] Fastow described this as an "iterative process" where Merrill was "involved so that they could tell me what was necessary, in terms of structure."[55]

Merrill Lynch also drafted significant portions of the Private Placement Memorandum and developed and executed the marketing approach for LJM2. For example, Fastow testified that Merrill Lynch participated in drafting "the pitch book, the slide presentation that [Fastow] gave to potential investors, as well as the private placement memorandum."[56] Merrill Lynch then proceeded to make the LJM2 deception possible by raising most of the money for LJM2.[57] Fastow summed up the key role Merrill Lynch played in forming LJM2 in an April 2000 e-mail: "***LJM2 was a unique and challenging transaction. If it weren't for [Merrill Lynch's] vision and determination, it wouldn't have happened***."[58]

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52 10/30/06 Fastow Depo. Tr. at 1338:15-23. *See also* Fastow Decl., ¶41.

53 10/24/06 Fastow Depo. Tr. at 355:6-14.

54 10/24/06 Fastow Depo. Tr. at 355:15-18.

55 10/24/06 Fastow Depo. Tr. at 358:24-359:7.

56 10/24/06 Fastow Depo. Tr. at 359:21-360:13. *See also id.* at 356:1-4 ("Merrill Lynch helped – helped create the pitch book. . . . [I]n its various stages, we exchanged – versions and comments of the pitch book.").

57 Ex. 20 at MLBE0117792 (4/6/00 email from David Sullivan). *See also* Ex. 18 at 16 n.51.

58 Ex. 1 at MLNBY0052520.

In addition, Merrill Lynch participated in LJM2's early closing in late December 1999, and it knowingly and intentionally "***approved***"[59] and funded several deceptive year-end LJM2/Enron transactions that, along with the sham Nigerian Barges sale and the bogus Electricity Trades, caused Enron to falsely report that it had met Wall Street's earnings expectations for the fourth quarter of 1999.[60] And as to Merrill Lynch's role as a limited partner in LJM2, Fastow testified, "***I think Merrill Lynch played the – the most active role of any of the limited partners***."[61] Throughout 2000, Merrill Lynch, through LJM2, engaged in many additional LJM2 transactions – including the infamous Raptors as well as the so-called Backbone transaction with EBS – with full knowledge, before funding them, of the purpose and intended effect of those transactions.[62] As Fastow aptly described it to Merrill, LJM2 was a "conduit" through which Merrill engaged in LJM2 transactions.[63]

Like the other deceptive transactions in which Merrill engaged, Merrill viewed LJM2 as an opportunity to profit and advance its status within Enron. For example, Merrill Lynch's internal Appropriation Request form for LJM2 focused heavily on the investment as an opportunity to "***enhance its strong relationship with Enron***."[64] The form further stated that "IBK [Investment

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59 Ex. 2 at ASF_CIV_000001904 ("L.P.'s have approved 5 out of 6 [year-end] deals.").

60 Fastow Decl., ¶44.

61 10/24/06 Fastow Depo. Tr. at 360:23-25.

62 Fastow Decl., ¶46. *See also* Ex. 3 at MLNBY0191091-100; Ex. 4 at MLNBY0169230.

63 10/24/06 Fastow Depo. Tr. at 417:2-11, 515:18-516:8.

64 Ex. 21 at MLNBY0257141.

Banking] ***views ML's investment in the Fund as an opportunity to continue, and further advance, ML's client relationship with Enron over the long term***."[65]

1. Merrill Lynch Was Instrumental in the Formation and Launching of LJM2, Which Was Expressly Designed to Be an Earnings Management Device

The formation of LJM2 dates back to mid-summer 1999, when Fastow and Merrill began to discuss the formation of a new private equity fund with Fastow as the general partner,[66] and Fastow retained Merrill Lynch to help him structure and syndicate the fund. From the very beginning, Merrill understood and agreed that the primary purpose of the LJM2 fund would be ***to manage Enron's earnings and balance sheet***.[67]

In early August 1999, Fastow prepared and provided to Merrill Lynch (as well as to CSFB, Deutsche, and other banks who might be persuaded to invest in LJM2) a sales presentation describing the "Opportunity" as follows:[68]

Companies sell assets with superior return potential to:

- ***Manage balance sheet***
- ***Manage income statement***

Managing Enron's earnings and balance sheet "was understood to mean making the numbers what Enron desired them to be . . . to create the false appearance of earnings and funds flow, and lower debt, thereby obfuscating the true underlying economic performance and health of the Company."[69]

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65 Ex. 21 at MLNBY0257145.

66 Ex. 22 at MLNBY0187387-90.

67 Ex. 22 at MLNBY0187389. *See also* 10/24/06 Fastow Depo. Tr. at 355:6-18.

68 Ex. 23 at MLNBY0074344-50; Fastow Decl., ¶42.

69 Fastow Decl., ¶42.

As Fastow testified, when he "talked about . . . manipulating or managing earnings" with Enron's banks who were limited partners in LJM2 (including Merrill), he specifically discussed ***how*** LJM2 would manipulate Enron's earnings, including "the timing of earnings, the actual creation of earnings, and changing the nature of earnings that Enron was recording."[70]

Chris Loehr, a former Enron employee, worked closely with LJM2. He testified at the Lay/Skilling trial that LJM2 and Enron did basically two kinds of transactions: "One I would refer to as a parking transaction where Enron needed to sell an asset temporarily with the intention of taking it back at some point in the future. The second . . . was LJM investing in the equity of an off-balance-sheet vehicle that Enron was putting together."[71] This testimony is consistent with what Merrill Lynch knew no later than August 18, 1999, as reflected in handwritten notes of a Merrill employee taken during a meeting concerning LJM2.[72]

Merrill's internal documents confirm that it understood the earnings management purpose of LJM2. A copy of Fastow's sales presentation, produced from Merrill Lynch's files, bears handwritten notes (apparently made by Merrill's David Sullivan) on the page entitled "Overview," reflecting Merrill's understanding that LJM2 deals would allow Enron to "***deconsolidate [to avoid reporting debt or losses] or book income***."[73] The notes observe that "***ENE [stock] trades off of earnings***," and confirm that LJM2 was designed to respond to Enron's "***need to book income***."[74]

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[70] 10/24/06 Fastow Depo. Tr. at 356:19-358:23.

[71] *United States v. Lay, Skilling*, No. H-04-25, Trial Transcript (S.D. Tex. Mar. 14, 2006) ("3/14/06 Lay/Skilling Trial Tr.") at 7708:17-7709:2 (Loehr testimony).

[72] Ex. 24 at MLNBY0189584.

[73] Ex. 23 at MLNBY007344-50.

[74] Ex. 23 at MLNBY007344-50. Later Merrill Lynch documents noted that a primary "exit route[]" for some of LJM2's "[i]nvestments" would be in the form of an "***[e]ffective put***" of the asset back to Enron. *See, e.g.*, Ex. 25 at MLNBY0257763. This concept was discussed internally by J.P.

Subsequently, Merrill took over the drafting of the LJM2 sales presentation or "flip book." A draft of the flip book prepared by Merrill in early September 1999 contained the following explicit earnings management language noted above that Enron's rationale for selling assets was to "[m]anage its balance sheet" and "[m]anage its income statement."[75]

Notably, this explicit earnings management language was removed from the LJM2 flip book before it was circulated outside of Merrill Lynch and the other banks.

> When I met with the banks who invested as limited partners, I believe my presentation still had the phrases "managing balance sheet" and "managing income statement" in it. And we talked explicitly about that. That was a big part of my presentation.
>
> When I – after the initial close, and when I met with other limited partners, I believe I used the phrase "financial flexibility." I still talked about what that meant with them, but it had the different slide in it.[76]

As Fastow testified, somebody pointed out to him that the use of the terms "managing income statement" and "managing balance sheet" was "too blatant" – "earnings management" was being

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Morgan executives in similar terms: "Where a 'put' back to Enron has been negotiated with anticipated returns of 15%-20%, LJM2 anticipates leveraging investments to create more attractive returns." Ex. 51102 at JPMNBY200221386.

75 Ex. 26 at MLNBY0074291.

76 10/24/06 Fastow Depo. Tr. at 391:1-10.

publicly targeted by the SEC.[77] As a result, Fastow removed that language from the written materials shown to non-bank investors.[78]

There should be no doubt that Merrill Lynch understood the purpose of LJM2. In fact, Merrill worked with Fastow to structure LJM2. *See supra* at 23-24. Moreover, Merrill was centrally involved in preparing the Private Placement Memorandum ("PPM") and the marketing approach and materials, as well as in the marketing activities that produced most of the $385 million that was raised for the fund. Of course, in so doing, Merrill acted with full awareness and in full support of the core earnings management purpose of LJM2.

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[77] 10/24/06 Fastow Depo. Tr. at 390:8-16. "Take your pick of ***fraudulent financial reporting schemes***. One of these gimmicks, manipulating reported income through '***earnings management***' techniques, draws its share of attention in the financial press. A company can effect earnings management practices in a variety of ways." So began an article entitled "Earnings Management and the Abuse of Materiality" published in the September 2000 edition of the *Journal of Accountancy*. *See* Ex. 27. The topic of "earnings management" had been well up on the radar screen for many months before then. Former SEC Chairman Arthur Levitt highlighted the issue in a major address delivered at New York University on September 28, 1998. *See* Ex. 15. Richard H. Walker, then the Director of the SEC's Division of Enforcement, said in a December 1999 speech that the SEC was closely scrutinizing "intentional misstatements by senior management, even if small in amount, and particularly if designed to manage earnings. We brought 18 actions last year specifically alleging that the ***purpose of the fraud was to engage in earnings management for the purpose of meeting projections and compensation benchmarks***. Many, if not most, of the remaining actions involved schemes to manipulate earnings for similar purposes. These actions shared a common blueprint: companies either recorded non-GAAP or fictitious sales, or, as we alleged in the case of W.R. Grace, created cookie-jar reserves." *See* Ex. 28 (speech by SEC Staff: "Behind the Numbers of the SEC's Recent Financial Fraud Cases" by Richard H. Walker, Director, Division of Enforcement, U.S. Securities & Exchange Commission, 27th Annual National AICPA Conference on Current SEC Developments, December 7, 1999). Merrill Lynch simply cannot advance the position that it thought earnings management was anything other than earnings manipulation – in other words, fraud.

[78] 10/24/06 Fastow Depo. Tr. at 390:8-16.

By late August 1999, Merrill had started drafting the PPM to raise the money from investors to fund LJM2.[79] An August 31, 1999 draft reflected Merrill's understanding of the purpose of LJM2 (and of Enron's prior off-balance-sheet activities):

> The Partnership is similar to other funding vehicles either set-up or utilized by Enron in the past. Enron benefits from such off-balance-sheet vehicles in two primary ways: ***keeping its balance sheet strong and maximizing earnings. . . . Enron's need to both maintain a strong balance sheet and maximize earnings motivate Enron to sell existing assets . . . with superior return potential to outside financial investors***.[80]

On September 16, 1999, Fastow and Kopper made an LJM2 presentation in New York to a small group of Merrill private equity sales executives. A Merrill Lynch memo outlined the LJM2 plan, stating that "***The primary source of investment opportunities will be existing assets owned by Enron***."[81] Fastow reinforced this message at the September 16th presentation, observing that "[t]he prime hunting ground [for LJM2 deals] is gonna be highly complex structured deals that have to be moved in a short time."[82]

An email string dated September 24, 1999, between Mark Murphy (Merrill Lynch private equity sales) and David Sullivan (Merrill Lynch private equity syndication), confirms Merrill's understanding of and enthusiasm for the earnings-management-for-hire concept that was LJM2. Murphy posed questions about Fastow's obvious conflict of interest and about whether there would be any real competing bids for the assets LJM2 would "purchase" from Enron. Sullivan (after explaining that "***Andy can make a hell of a lot more money with LJM2 than Enron***"), pointed out

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79 Merrill personnel participated with Fastow and his staff, and the lawyers from Kirkland & Ellis, throughout the PPM drafting process. *See, e.g.*, Ex. 29 at MLNBY0157520-64; Ex. 30 at MLNBY0060880; Ex. 31 at MLNBY0050782.

80 Ex. 32 at MLNBY0074261.

81 Ex. 33 at MLNBY0226615 (emphasis in original).

82 Ex. 50200 at 48.

that "***real and qualified purchasers [to compete with LJM2 for deals] will be few and far between as most of LJM2's investments will be the ones that Enron needs to be made quickly***. . . . All of this opportunity emanates from Enron's need to keep recycling capital (***and need to dump assets***)."[83] Indicating he understood, Murphy emailed back: "Don't get me wrong ***I LOVE THIS DEAL!!!!!!!!!!!!!!!!!!!!!!!!***"[84]

A September 27, 1999 draft of the PPM noted that "Enron has $34 billion of assets on its balance sheet, ***but has in excess of $51 billion of assets under management (the difference between these numbers represents the amount of assets financed off-balance sheet***)."[85] The significance of the off-balance-sheet financing was not lost on Merrill Lynch; deals like those contemplated for LJM2 had to be done to create cash for Enron ***but not show more debt on its financial statements***. The same section of the draft PPM (entitled "Rationale for Enron Deal Flow") noted that "***[a]dditional debt may place [Enron's] investment grade credit rating in jeopardy***."[86]

Merrill Lynch embraced the earnings and balance sheet management story – Enron's need to "***dump assets***" to make its financial statements look the way they wanted them to look – and indeed made it a central theme of its marketing strategy for LJM2. It was the explanation for why Enron could be expected time and again to enter into deals providing "***superior returns***" to LJM2, selling it "***mispriced assets***" and thereby creating a "***can't lose***" investment opportunity.[87] "Sophisticated"

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83 Ex. 34 at MLNBY0074444-45.

84 Ex. 34 at MLNBY0074444 (emphasis in original).

85 *See* Ex. 35 at MLNBY0074666 (Draft PPM Executive Summary).

86 *Id*.

87 *See* Ex. 36 at MLNBY0189548-53. Another element of the "can't lose" value proposition was Enron's willingness to buy assets back from LJM2 at a profit to LJM2. This investment "exit" strategy, termed an "***[e]ffective put***" in internal LJM2/Merrill Lynch documents (Ex. 37 at MLNBY0170278), is explained in an internal memorandum describing the deal to upper

private equity investors pitched by Merrill Lynch "got it," as illustrated by a comment about an investment manager who, after hearing the pitch, "***understands the economics of the deal favor LJM2 investors***."[88] A comment by another (apparently honest) investment manager further illustrates how clear it was to those "in the know" that LJM2 was a vehicle to falsify Enron's finances – he reacted negatively to the pitch because he "***does not like companies that 'massage' earnings***."[89]

This marketing strategy proved effective. The original goal was to raise $200 million in capital for LJM2. Ultimately, ***Merrill almost doubled that figure, as it raised most of the total of $394 million committed to LJM2***.[90] And Merrill was well paid for its efforts – its fee was approximately $5 million.[91]

2. Merrill Lynch Approved and Funded, and Thereby Engaged in, the Deceptive LJM2 Transactions

Merrill Lynch not only structured and marketed the LJM2 vehicle to others – ***it also put its own money into LJM2 and thus funded the deceptive transactions through the LJM2 conduit***.[92] It is important to note that those who participated in LJM2, like Merrill Lynch, did not simply passively invest a stated amount of cash and then depend upon the general partner (Fastow, through

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management at J.P. Morgan Chase (one of Merrill Lynch's co-investors). Ex. 51102 at JPMNBY200221386.

88 Ex. 38 at MLNBY0302367.

89 Ex. 39 at MLNBY0302370.

90 Ex. 20 at MLBE0117792.

91 Ex. 40 at MLNBY0050806.

92 In addition, Merrill created and sponsored a "feeder fund" through which senior Merrill bankers were encouraged to invest their personal funds in LJM2. This Merrill "feeder fund" was one of the largest LJM2 investors, with over $17 million in invested capital.

a shell entity) to re-invest or deploy their capital as he saw fit. Rather, LJM2 was a "flow-through" entity; ***the LJM2 investors were informed in advance what transactions they were being asked to fund, and then responded to capital calls to fund those transactions***.[93] So, LJM2 investors – including Merrill Lynch – were not mere passive, uninformed investors. They did, in fact, know – ***before they funded transactions – "where and how [the] monies were being used by Enron and Fastow***." *Cf. Enron*, 2006 U.S. Dist. LEXIS 43146, at *388.

With respect to the critical year-end 1999 LJM2 transactions – transactions that, along with the Nigerian Barges deal and the bogus power trades, created the false impression that Enron had met earnings expectations for the fourth quarter of 1999 – Merrill Lynch was even more involved. According to a set of contemporaneous notes prepared by Fastow in early 2000, ***Merrill Lynch (as well as CSFB, Deutsche Bank, and the other early-closing LJM2 partners) in fact "approved 5 out of 6" of these year-end deals***.[94]

The first, early closing of the LJM2 partnership took place on December 20, 1999. Prior to closing, Merrill Lynch and the other participants in this closing (primarily Enron's other top banks) were provided with the "Supplement Number One to Private Placement Memorandum" (PPM Supplement), dated December 15, 1999.[95] The PPM Supplement identified five Enron deals that would be transacted by year-end, and contained a capital call to fund these specific transactions.[96]

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[93] 10/24/06 Fastow Depo. Tr. at 367:19-370:1.

[94] Ex. 2 at ASF_CIV_000001904. *See also* 10/24/06 Fastow Depo. Tr. at 367:19-370:1.

[95] Ex. 44.

[96] Ex. 44 (Merrill Lynch knew by mid-December 1999 that Enron needed to close at least five to seven year-end transactions with LJM2, and of the "***obvious benefit***" to Enron of these year-end transactions.). Ex. 42 at MLNBY0083153 (Merrill bankers participated in conference calls with Michael Kopper in which the particulars of the deals were discussed well in advance). *See e.g.*, Ex. 41; Ex. 43.

The transactions included the purchase from Enron Europe of an interest in the Nowa Sarzyna power plant in Poland; investment in both equity and debt in ENA CLO 1 Trust (also known as Project Merlin); purchase of an interest in an Enron SPV known as MEGS, LLC; and an investment in an Enron SPV known as Bob West Treasure LLC.[97] These were all, in one way or another, phony deals, the principal purpose and effect of which was to create a false appearance of earnings or funds flow, as confirmed by the following testimony given by Fastow in the recent trial of Ken Lay and Jeff Skilling:

> Q. Let's focus first on the end of 1999. Were there a number of deals that you were asked to do at the end of 1999?
>
> A. Yes.
>
> Q. Do you remember roughly how many?
>
> A. I think LJM2 did six trans – LJM2 did six deals with Enron in December of '99.
>
> * * *
>
> Q. And, in general, what was the purpose of these six or so transactions?
>
> A. ***To help Enron meet its income target for the year***.[98]

Merrill Lynch knew that these were illegitimate transactions, designed to artificially increase Enron's reported earnings and operating cash flow and reduce its reported debt. Fastow states: "Merrill understood . . . that the transactions undertaken by LJM2 with Enron in December 1999 resulted in Enron reporting higher earnings than it would have otherwise absent these transactions with LJM2. . . . Merrill understood that in conjunction with some of these transactions, LJM2 received certain assurances from Enron management or structural features attendant to the

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97 *Id.*

98 3/7/06 Lay/Skilling Trial Tr. at 6440:24-6441-13. *See also* Fastow Decl., ¶¶41, 44.

transactions that caused the equity holders – LJM2 – to have less risk in their investment than a true arms-length third party would have."[99] In other words, these transactions were prototypical earnings management deals – just the kind of deals Merrill was told LJM2 was being formed to engage in.

Of course, that these were phony earnings management deals could not have been a tremendous surprise to Merrill Lynch, as it was actually doing the fictitious Nigerian Barges sale and bogus Electricity Trades ***at the same time for the same purpose***. Moreover, at this time Merrill Lynch knew that if no legitimate buyer could be found within six months, LJM2 would "purchase" the barges from Merrill with the same no-lose "bear-hug" guarantee from Enron.[100]

So, with full knowledge of what it was doing, Merrill Lynch executed and funded LJM2's early closing on December 20, 1999, and it "approved" then funded the bogus, year-end transactions on December 22, 1999.[101] These deals (Bob West Treasure, MEGS, Nowa Sarzyna, ENA CLO, Yosemite) generated a huge amount of fictitious income for Enron at year-end 1999.[102]

Nowa Sarzyna

The Nowa Sarzyna transaction, the largest of the year-end transactions in terms of earnings manipulation, illustrates the deceptive, fictitious nature of the LJM2 year-end deals. It involved the

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99 Fastow Decl., ¶¶41, 44.

100 Fastow Decl., ¶33 ("in December 1999 . . . . I told [Tilney] of the assurance Mr. Skilling had given to me"); 10/23/06 Fastow Depo. Tr. at 258:23-259:22; 10/24/06 Fastow Depo. Tr. at 375:5-20.

101 Ex. 45 at MLNBY0254765; Ex. 46 at MLNBY0170035. *See also* 10/24/06 Fastow Depo. Tr. at 372:24-373:6.

102 *See supra* at 9; Ex. A (all references to Ex. A or Ex. B are to the Appendix of Charts in Support of Lead Plaintiff's Opposition to Motion for Summary Judgment filed by Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Co., Inc. (Docket No. 4816), filed concurrently herewith); 1/17/06 Expert Report of Saul Solomon ("Solomon Report") at 101-09; 2/22/06 Supplemental Expert Report of Saul Solomon ("Solomon Supp. Report"), Schedules 3-6, 8. Yosemite was not "known and approved" before year-end 1999, but was in fact done in February 2000 and backdated to year-end 1999.

"warehousing" of an Enron asset, meaning the temporary "sale" of the asset in a transaction in which neither the downside risk or upside potential of the asset was really transferred to the "buyer" and in which Enron maintained significant actual control of the asset.[103] Nowa Sarzyna was an unfinished power plant being built in Poland by an Enron Europe subsidiary. Enron had planned to sell Nowa Sarzyna into a new structure called "Project Margaux." That transaction was supposed to have created significant "earnings" for Enron Europe in the fourth quarter of 1999. But there were problems. The power plant was behind schedule and would not become operational by year-end. And the Margaux structure was also behind schedule and would not be in place in time to transact the much-needed year-end earnings deal. These were serious problems, for Enron needed the "earnings" from this "sale" to make its 1999 numbers. Enter LJM2. Problem solved.

LJM2 "acquired" a 75% equity interest in Nowa Sarzyna in late December 1999, allowing Enron to (fraudulently) book almost $16 million in earnings. LJM2 agreed to serve as a short-term "parking lot" for the asset – nothing more, nothing less. Internal emails from Enron confirm that LJM2's holding period would be three months or less, after which it would be transferred to the Margaux structure or, pursuant to "an 'informal' agreement among senior management"[104] Enron would "provide liquidity" (*i.e.*, buy it back).[105] Enron paid LJM2 an up-front fee of $750,000[106] and agreed to pay LJM2 a 25% return on its "investment."[107] Enron performed as agreed; in late March

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[103] A contemporaneous Enron email illustrates the point: "Most of our share of Poland will be sold to a friendly third party, and then bought back some time next year. . . . The third party is basically a thinly-capitalized SPV . . . but we will still have complete operational control . . . ." Ex. 47 at ECTe001195985-86. *See also* 10/24/06 Fastow Depo. Tr. at 371:3-22.

[104] Ex. 48 at ECTe000859182.

[105] *Id.*

[106] Ex. 49 at E232311.

[107] Ex. 50 at ECTe000861256.

2000, an Enron subsidiary repurchased 33% of the interest LJM2 had acquired, and Condor purchased the other 67%, at the agreed rate of return. Nowa Sarzyna was subsequently placed in the newly finished Margaux structure.

Fastow confirmed the deceptive nature of the Nowa Sarzyna transaction in his trial testimony:

Q. What's the deal name here?

A. Nowa Sarzyna.

Q. What was that?

A. A Poland power project.

Q. A Polish power plant[.]

* * *

Q. What does it say under "Other Benefits to Enron?"

A. "Acted as a bridge to the closing of Margaux."

Q. What did that mean?

A. ***Well, it meant that LJM 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***.

Q. So that was a benefit to Enron; is that right sir?

A. ***It allowed Enron to report the numbers it wanted to report***.[108]

Merrill Lynch knew about the Nowa Sarzyna fiction – that it was an asset-parking or warehousing transaction – yet it "approved" the deal and helped fund it through the early closing. Merrill Lynch knew that Nowa Sarzyna was supposed to have been placed into the Margaux

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108 3/7/06 Lay/Skilling Trial Tr. at 6448:15-6449:14.

structure.[109] Then, through the PPM Supplement, Merrill Lynch learned that LJM2 was to buy what, on paper, appeared to be the majority interest in the project.[110] But, Merrill Lynch knew that the transaction was a warehousing deal, not a real purchase and sale; ***an internal Merrill Lynch document noted: "LJM2 to hold [the Nowa Sarzyna facility] until Enron finds a long term investor***."[111] Further confirming Merrill's knowledge was a sales presentation prepared by Merrill for a February 7, 2000 meeting with an investor, which plainly showed that Nowa Sarzyna was still to be transferred to Margaux – even though LJM2 then "owned" it.[112] Finally, by no later than March 20, 2000, Merrill Lynch knew that LJM2 was going to purchase 40% of the equity in the new Margaux structure and that Margaux would acquire – largely from LJM2 – Nowa Sarzyna.[113] The year-end Nowa Sarzyna deal was a deceptive asset warehousing deal that permitted Enron to book millions of dollars of income it had not yet earned. Merrill Lynch knew about and knowingly engaged in this deception.

Bob West Treasure, LLC

Bob West Treasure, LLC ("Bob West"), was an SPE formed by Enron North America ("ENA") in December 1999, capitalized with $3 million in equity and $105 million in debt, for the purpose of entering into a Gas Inventory Forward Sale Contract with EEX E&P Company

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109 *See, e.g.*, Ex. 51 at MLNBY0226741. Merrill Lynch was well familiar with the Margaux structure – Robert Furst, who by December 1999 was Merrill Lynch's Relationship Manager with respect to Enron, had worked on the Margaux structure while employed at CSFB.

110 *See also* Ex. 52 at MLNBY0190119.

111 Ex. 53 at MLNBY0247673.

112 Ex. 54 at ASF_CIV_000000799-827.

113 Ex. 55 at MLNBY0226448.

("EEX").[114] On December 28, 1999, Enron sold 90% of its membership interest in Bob West to LJM2 for $2.7 million.[115] Enron retained the sole and exclusive right to market LJM2's interest in Bob West.[116] While no gain was recorded on the equity sale to LJM2, ENA was able to record a gain of approximately $900,000 related to the mark-to-market value of the commodity and interest rate swaps previously entered into with Bob West,[117] and the deal allowed Enron to deconsolidate Bob West and thereby avoid reflecting $105 million in debt on its balance sheet.[118]

ENA CLO Trust

In December 1999, Enron was attempting to offload some of its merchant investments, primarily debt and investments in energy related investments, through the ENA CLO (Credit Linked Obligation) Trust structure.[119] ENA CLO, otherwise known as Project Merlin, was to be capitalized with $311.3 million in notes and $12.9 million in equity.[120] Enron had been unable to find a buyer for the riskiest positions in the structure – the equity and riskiest debt tranche. So, at year-end LJM2 stepped forward as the buyer for the equity and the last $19.6 million of the debt.[121] As LJM2 explained, "LJM was 'the plug' for the BB notes that couldn't be sold."[122] This allowed the entire

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114 Solomon Report at 102-03, 109.

115 *Id.*

116 Ex. 56 at AASDTEX000623794, AASDTEX000623798-99 (draft of SEC Responses to the LJM Transactions).

117 Solomon Report at 103.

118 *Id.*

119 *Id.* at 104.

120 *Id.*

121 *Id.*

122 Ex. 57 at ASF_CIV_000014974.

CLO structure to close. Enron repurchased the notes and equity at par, plus accrued interest in May and July 2001.[123] Because it was able, with the assistance of LJM2, to close the CLO structure, Enron was able to record $178.4 million in funds flow from operations for the fourth quarter of 1999.[124] This purported "investment" was subject to a side agreement just like the other side agreements of which Merrill Lynch was aware.[125] Andersen auditors testified they were deceived by the side agreement, which falsified the accounting.[126]

MEGS LLC

In September 1999, MEGS, a wholly owned subsidiary of ENA, entered into an agreement to purchase an offshore natural gas gathering contract with Burlington Resources and Mariner.[127] In December 1999, ENA sold 90% of its equity interest to LJM2.[128] Enron retained the sole and exclusive right to market LJM's interest in MEGS.[129] Enron repurchased the MEGS equity from LJM2 in March 2000.[130] According to LJM2, "[n]o 3rd parties (i.e., banks) would buy this Mariner

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123 Solomon Report at 104.

124 *Id.*

125 Ex. 32041 at 2, 4 ("Enron agrees to repurchase [notes]on or before September 30, 2000 at an amount equal to the invested amount . . . plus accrued and unpaid interest."); *id.* at 1, 3 ("Enron to ensure that LJM2 receives, at a minimum, its invested [equity] capital . . . on or before originally projected distribution dates.").

126 *See, e.g.*, 10/18/05 Deposition Transcript of Patty Grutzmacher ("10/18/05 Grutzmacher Depo. Tr.") at 1322:16-1325:2.

127 Solomon Report at 104.

128 *Id.*

129 Ex. 58 at AASDTEX000614979, AASDTEX000614996-97.

130 Solomon Report at 104-05.

exposure in the timeframe that LJM did."[131] The sale of the MEGS note resulted in a $2.4 million gain to Enron.[132]

The year-end LJM2 transactions that Merrill Lynch approved and funded should not be viewed in isolation. At year-end 1999, Merrill Lynch was already working on two other big phony deals with Enron – the manipulative Nigerian Barges and Electricity Trades deals which were to create millions in fictitious income for Enron's year-end 1999 results. As a result, Merrill Lynch knew how badly Enron needed the "earnings" from these phony deals. The Merrill deals (including the LJM2 deals) created about 30% of Enron's reported earnings for the quarter – and by fair implication Merrill had to have known the consequences of Enron missing earnings by a large amount and thus the consequences of its actions in disguising the truth from the market.

Merrill's knowing participation in the phony LJM2 deals did not end in December 1999. LJM2 continued transacting earnings management deals with Enron throughout 2000, and Merrill knowingly and willingly provided funding for each one. LJM2 was responsible, all told, for hundreds of millions of dollars of phony earnings booked and reported by Enron. It also served as a vehicle for the manipulation of Enron's debt and operating cash flow on a massive scale. Merrill Lynch continued, through the life of the LJM2 structure, to fund bogus LJM2 transactions with the purpose and effect of creating fictitious Enron earnings. In each instance, Merrill Lynch was informed in advance what transactions would be funded, and in each instance Merrill Lynch knowingly and voluntarily provided capital, pursuant to capital calls, to fund these illicit deals.[133]

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131 Ex. 59 at ASF_CIV_000014994.

132 Solomon Report at 105.

133 Thus, for example, Merrill Lynch was informed about the original Raptor deal, including its purpose and basic structure, no later than March 20, 2000. Ex. 55 at MLNBY0226436-49. It nevertheless responded to the capital call and thereby funded Raptor.

Raptors

For example, in 2000 Merrill Lynch engaged in the Raptor transactions knowing the structure and purpose of the transactions and that a side agreement provided for the return on and of LJM2's investment through a put. *See infra* at 47-49, 57-60. The original Raptor transaction, Talon (aka "Raptor I"), served as a model for the following Raptor transactions: Timberwolf (aka "Raptor II"), Bobcat (aka "Raptor III"), and Porcupine (aka "Raptor/TNPC"). Created as of April 18, 2000, Talon was capitalized with cash and Enron stock by an Enron subsidiary and cash "equity" from an LLC which was almost entirely owned by LJM2.[134] LJM2 invested its "equity" in Talon (like the other Raptors) through a capital call made to Merrill Lynch and the other LJM2 limited partners.[135] Enron's subsidiary contributed a $50 million note and restricted shares of Enron stock derived from a forward contract.[136] Talon used this as credit capacity to engage in derivatives hedging transactions, as Merrill Lynch was told, "up to a notional value of $1 billion."[137]

As Merrill Lynch knew, however, pursuant to a side agreement LJM2 was to receive the return on and of its "equity" investment before any hedging could begin, *i.e.*, before being exposed to any risk. *See infra* at 47-49, 57-60. LJM2's investment deceptively looked like equity but in fact it was not because (as Merrill knew) it was not exposed to any risk through the side agreement and, furthermore, because (as Merrill knew) LJM2 was not independent from Enron. *See infra* §III.A.3.

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[134] Ex. 55 at MLNBY0226444-45.

[135] Ex. 55 at MLNBY0226436; Ex. 60 at MLNBY0191432.

[136] Ex. 55 at MLNBY0226436; Ex. 60 at MLNBY0191432.

[137] Ex. 55 at MLNBY0226436; Ex. 60 at MLNBY0191432; Ex. 4.

And as in all the Raptor transactions, LJM2 did receive the return on and of its investment before any hedging began, *i.e.*, before being exposed to any risk.[138]

Backbone

As the second quarter of 2000 was coming to a close, Enron was yet again faced with an earnings shortfall. Moreover, its broadband business ("EBS"), which it had touted to great effect at the January 2000 analyst conference, had been unable even to come close to its revenue and earnings targets. So, consistent with its earnings management purpose, LJM2 stepped into the breach with a transaction known as "Backbone," through which it purchased (on paper) a large quantity of "dark fiber"[139] from EBS in a transaction valued at about $100 million: $30 million cash, the remainder in seller financing in the form of a $70 million non-recourse promissory note.[140] This transaction alone

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[138] Ex. 61 at AB000059835 (Talon return on and of LJM2 "equity" investment to LJM2 subsidiary); Ex. 62 at AB000164838 (Timberwolf return on and of LJM2 "equity" investment to LJM2 subsidiary); Ex. 63 at AB000061893-94 (Bobcat return on and of LJM2 "equity" investment to LJM2 subsidiary); Ex. 65 at AB000164992 (Porcupine return on and of LJM2 "equity" investment to LJM2 subsidiary).

[139] "Dark fiber" refers to strands of optical fiber that have been laid, generally underground, but which have not been "lit" and thus are not in use. Generally, dark fiber is not usable until it is mated with additional infrastructure and incorporated into a network.

[140] In form, EBS sold 7-year IRU's for 40 dark fibers to LJM2-Backbone2, LLC for approximately $100 million, comprised of approximately $30 million in cash plus a note for about $70 million. *See* Ex. 58 at AASDTEX000614979, AASDTEX000614985; Ex. 66 at ECTe003181105-11. LJM2 acquired the dark fiber through a two-tier structure. Ex. 67 at ASF_CIV_000001587-92. LJM2-Backbone2, LLC, wholly owned by LJM-Backbone, LLC purchased the dark fiber and was the counterparty for future IRU's. *Id.* LJM2-Backbone, LLC guaranteed the seller note to EBS and pledged its interest in LJM2-Backbone2, LLC as security. However, LJM2-Backbone, LLC's only asset was its interest in LJM2-Backbone2, LLC; the additional "security" was illusory. *Id.* EBS acted as marketing agent to sell the fiber on behalf of LJM2 to other third parties and the commission for this service equated to the majority of the upside on the sale in excess of LJM2's return. Ex. 58 at AASDTEX000614979, AASDTEX000614985. Thus, upon sale of any of the fiber routes, the proceeds were distributed to pay down the note and make payments to LJM2 such that LJM2 earned an 18% return in the first two years and a 25% return after that, and all excess proceeds went to EBS. *Id.* The note was to be repaid from proceeds of fiber sales to third-party buyers and was non-recourse to the partnership. Ex. 68 at

constituted about 67% of gross revenues reported by EBS for the quarter.[141] It also accounted for about $67 million in gross margin for EBS (out of total EBS gross margin of $75 million).[142] But for this transaction, EBS would have been forced to report a significant loss and Enron would have been required to explain why its broadband business was performing so far below the expectations set at the analyst conference and thereafter carefully nurtured by Skilling and others. In short, the Backbone transaction permitted Enron to continue hawking its broadband story, even though the underlying economic performance of EBS was far worse than it portrayed to the public.

Merrill knew, in advance, about the facts and essential details of the Backbone transaction.[143] And Merrill knew this was an earnings management deal – another asset warehousing deal – designed to prop up EBS. As Merrill knew, LJM2 was not in the dark fiber business and had no use for dark fiber. Moreover, dark fiber sales were rarely transacted for cash; most transactions involved fiber "swaps."[144] LJM2, however, was not in a position to transact swaps for its own account. Swap transactions – and thus most sales opportunities – would necessarily be for the account of EBS, not LJM2. It thus was obvious – and Merrill knew – that this was nothing more or less than an asset-warehousing transaction designed to create the false appearance of earnings and cash flow on Enron's books. Merrill nevertheless agreed to and funded the Backbone transaction by responding to the capital call made in connection with it.

ASF_CIV_000001455-57. In fourth quarter 2000, LJM2 was taken out and repaid their cash investment plus the promised 18% return in the Backbone 2 transaction.

141 Ex. 69 at AASDTEX000371201.

142 *Id.*

143 *See, e.g.*, Ex. 70 at MLNBY0313681-83.

144 *See, e.g.*, Ex. 71 at ECv000547062.

EBS recognized income of approximately $67 million (initially, EBS recognized $53 million in pretax income, but the amount was raised later in 2000 to $67 million) and recorded $30 million in cash flow from operations from this warehousing transaction.[145] Fastow's "Benefit[s]" summary states that Backbone "[c]reated funds flow," "[g]enerated earnings to reach EBS's earnings targets," and "[p]rovided upside to EBS on ultimate sale to 3rd party."[146]

Nigerian Barges Buyback

In June 2000, LJM2 was used to fulfill Enron's side agreement with Merrill Lynch concerning the Nigerian Barges by "purchasing" Merrill Lynch's "equity" in EBARGE, LLC.[147] Internally, Merrill Lynch described the transaction as follows: "the way we are getting out of the Enron investment on MLIBK Positions books ($7.0m + interest) is having LJM2 Co-Investment LP buy us out through LP Capital Calls, in which MLIBK is also a limited partner."[148] Merrill Lynch knew it was parking the barges for Enron once again, this time with LJM2, for LJM2 was stepping into the same side agreement whereby the equity "purchase" was in fact a loan.

LJM2's summary to LJM2 limited partners (including Merrill Lynch) stated:

> LJM2 expects to be bought out by Enron within 7 months at a 15% annualized IRR. LJM2 will also receive an upfront fee of $350,000.[149]

Indeed, Fastow and Glisan directly informed Merrill Lynch of the Skilling "bear hug"/side agreement that LJM2 had in "purchasing" the barges. *See infra* at 48, 88-89. That side agreement

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145 1/17/06 Expert Report of Bernard Black ("Black Report") at 38-39; Ex. 58 at AASDTEX000614979, AASDTEX000614985 (LJM Transactions Support File, Vol. I).

146 Ex. 57 at ASF_CIV_000014973-75 (LJM Investments Deal Benefit Summary).

147 Ex. 70 at MLNBY0313686.

148 Ex. 72 at ML6892.

149 Ex. 64 at MLNBY0076479.

was contained in the Global Galactic, in terms almost verbatim to those described to Merrill Lynch and the other limited partners in LJM2: "LJM2 agrees to repurchase prior to January 30, 2001, at an amount equal to the invested amount ($7.525 million) plus a 15% IRR plus $350,000."[150]

LJM2 made the "purchase" of the barges on June 30, 2000, and, fulfilling the side agreement between Fastow and Skilling, Enron arranged for a purchaser that bought LJM2's interest on September 30, 2000.[151] LJM2 netted a gain of approximately $700,000, in return for parking the barges three months, consistent with the return and upfront fee it was promised.[152] As a result of parking the barges once again, Enron maintained $7 million understated debt and $13 million of falsely inflated earnings.[153]

Merrill Lynch, indeed, embraced the role LJM2 played in the overall Enron fraud, as illustrated by an August 2001 Merrill Lynch email commenting on the potential benefit to LJM2 of Skilling's sudden resignation: "***If anything, it could be a positive [for LJM2] as Michael [Kopper] believes there will be more pressure on Enron to achieve its earnings numbers to prove they can do so after Skilling's departure. This may result in more deal flow for LJM***."[154] In other words, Merrill saw earnings pressure on Enron as a good thing for LJM2 (and by extension for Merrill) because it created more pressure to resort to phony earnings-management deals with LJM2.

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150 Ex. 32041 at 2, 4.

151 Ex. 73 at AB025205426.

152 *Id*.

153 Solomon Supp. Report, Schedules 3, 5; Ex. A (financial statement effect chart).

154 Ex. 74 at MLBE0334986.

3. LJM2 Was an Artifice Through Which Merrill Lynch and Others Engaged in Deceptive Transactions

Merrill Lynch's structuring, funding and syndication of LJM2, and its authorization and funding of deceptive transactions between LJM2 and Enron, each created the false appearance that LJM2 was a partnership independent from Enron entering arm's-length transactions with Enron, when in fact that was not so.

a. LJM2 Was Structured by Merrill Lynch and Fastow to Appear Independent from Enron

As Fastow and Merrill Lynch developed LJM2, Andersen reviewed the entity "to determine whether necessary features existed which would enable Enron to do transactions with the entity that would result in third party accounting recognition."[155] Using Andersen's advice concerning the requirements for Enron to obtain the accounting it desired, Merrill and Fastow attempted to demonstrate the outward appearance that LJM2 was a partnership sufficiently independent from Enron. That was done by placing significant limitations on the General Partner's (Fastow's) control over LJM2 in the partnership agreement and by giving limited partners – such as Merrill Lynch – certain rights and responsibilities.

Limitations were placed on the investments in which LJM2 could engage and those limitations were documented at §1.4 of the partnership agreement.[156] Limited partners in LJM2 were provided information about individual transactions before they were asked to fund them, and they were "free to object" and by vote they could "prohibit" Fastow "from making the

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155 Ex. 75 at AA-EX00153091-94.

156 Ex. 76 at MLNBY0254282 (12/20/99 Amended and Restated Limited Partnership Agreement); Ex. 77 at MLNBY0092833 (3/2/00 Second Amended and Restated Limited Partnership Agreement); Ex. 78 at MLNBY0160190 (4/05/00 Third Amended and Restated LJM2 Limited Partnership Agreement); Ex. 79 at AB000002593 (6/30/00 Amendment to Third Amended and Restated Limited Partnership Agreement of LJM2).

investment."[157] The side deals, of course, completely circumvented the checks and balances suggested by Andersen.

b. In Truth, as Merrill Lynch Knew, LJM2 Was Not Independent from Enron but Was a Conduit for Deceptive Transactions and Was Governed by Side Agreements Between Fastow and Enron Officers

LJM2's outward appearance depended on a fiction, which Merrill Lynch knew. ***Omitted*** from the LJM2 partnership agreement was the true intent of Fastow, Enron and Merrill Lynch, that LJM2 merely be a conduit by which Merrill Lynch and other banks would fund and engage in deceptive transactions to manage Enron's earnings and balance sheet. As Fastow testified:

> The way I viewed it and the way I often talked about it or characterized it was as a ***conduit*** for the limited partners to be able to invest in the – the Enron-related deals.[158]

He further testified that "in many cases" he described LJM2 as a "conduit" to the limited partners.[159] As Merrill Lynch knew, LJM2 was secretly controlled by Enron and LJM2 through side agreements. Fastow testified:

Q. Did you and Enron influence and control certain transactions in LJM2?

* * *

A. Yes.

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157 10/24/06 Fastow Depo. Tr. at 368:14-20. An advisory committee supposedly limited Fastow's control by imposing management and oversight over LJM2 and Fastow, and by having the power to approve investments and participate in the removal of Fastow. Ex. 76 at MLNBY0254301, MLNBY0254315-16; (12/20/99 Amended and Restated Limited Partnership Agreement); Ex. 77 at MLNBY0092853, MLNBY0092868 (3/2/00 Second Amended and Restated Limited Partnership Agreement); Ex. 78 at MLNBY0160210, MLNBY0160225-26 (4/5/00 Third Amended and Restated LJM2 Limited Partnership Agreement). However, the advisory committee was composed of individuals who were representatives of the limited partners, the exact same limited partners who were benefiting from the parking transactions.

158 10/24/06 Fastow Depo. Tr. at 417:2-11.

159 *Id.* at 515:18-516:8.

Q. Was that done in some ways through side agreements?

A. Yes, in some cases.

Q. And did you tell any of the limited partners about those side agreements?

A. Yes . . . I did, in some cases.[160]

As Fastow set forth in his declaration, "Merrill understood that in conjunction with some of the transactions, LJM2 received certain assurances from Enron management or structural features attendant to the transactions that caused the equity holders – LJM2 – to have less risk in their investment than a true arms-length third party would have had."[161]

Also omitted from the LJM2 partnership agreement were the oral side agreements between Fastow and members of Enron's senior management that Merrill knew eliminated all significant risk to LJM2 in numerous LJM2 transactions. Indeed, as of the time LJM2 was funded and closed its first transactions, Merrill Lynch knew Fastow and Enron were entering side agreements. Fastow states in his declaration:

> I had at least one private conversation with Schuyler Tilney in December 1999 about Merrill buying the barges. In response to his query, I discussed with Mr. Tilney why Enron was asking Merrill, rather than LJM2, to purchase the Barges at that time, and I told him of the assurance Skilling had given to me with respect to the barges.[162]

Fastow testified in the Lay/Skilling trial that the "bear hug or guaranty" to which he refers was that if LJM2 bought the Nigerian Barges it would not lose money.[163]

Concerning the Raptors structure, Fastow admitted "I and others at Enron, including Enron's Chief Accounting Officer, had an unwritten agreement that LJM2 would be paid the return of its

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160 *Id.* at 514:21-515:8.

161 Fastow Decl., ¶44.

162 *Id.*, ¶33.

163 3/7/06 Lay/Skilling Trial Tr. at 6488:5-6489:6.

investment, plus a profit, prior to Talon engaging in any hedging."[164] Fastow told Merrill Lynch about the side agreement, whose purpose was to eliminate LJM2's exposure to risk. In one instance Fastow did so on a conference call on March 21, 2000, held "to discuss the commercial attributes of . . . Raptor in detail."[165]

> Q. And did you tell any of the limited partners about those side agreements?
>
> * * *
>
> A. In the case of the Raptor transactions, any of the limited partners who participated in that phone call I believe heard me say, or should have heard me say – or describe the Raptor structure, which included the understandings between Enron and LJM – or between Enron and me.[166]

Indeed, David Sullivan of Merrill Lynch called up Fastow after the conference call and gave Fastow "feedback" that too much detail had been given in the call.[167] In his declaration, Fastow further states: "I discussed the Raptor I concept and structure with Merrill. I explained to Merrill how the Raptor vehicle would be used by Enron to increase its current period earnings, and the fact that LJM2 would receive the return of and on its investment before any hedging would begin."[168]

Merrill Lynch understood that the Raptors and Nigerian Barges transactions were the types of transactions in which LJM2 would engage and was engaging in. As Fastow stated in his declaration, Merrill Lynch understood that "LJM2 would be used to manage Enron's earnings and balance

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164 Ex. 13448, Ex. A at 2.

165 Ex. 55 at MLNBY0226436.

166 10/24/06 Fastow Depo. Tr. at 515:3-15.

167 *Id.* at 380:18-2, 381:7-10.

168 Fastow Decl., ¶46. *See also* 10/24/06 Fastow Depo. Tr. at 376:6-15 ("I recall discussing it with Mr. Tilney and David Sullivan.").

sheet,"[169] and that this would "mak[e] the numbers what Enron desired them to be," "to create the false appearance of earnings and funds flow, and lower debt, thereby obfuscating the true underlying economic performance and health of the Company."[170] Merrill Lynch knew, and certain of Enron's Tier One banks were told, LJM2's purpose was parking or "***warehousing***" Enron assets and that LJM2 (and its investors) would receive "compensation" on the asset purchases by "effective puts" of assets back to Enron or on to third parties with "escalation of price/margins."[171] As Fastow testified, "I described to potential investors and to investors . . . that one of the purposes of LJM was to be a ***warehouse*** for Enron . . . that LJM would not be the permanent owner of the assets but would temporarily own the assets until, typically, Enron would find the real or permanent buyer for the assets."[172]

Thus, in contrast to LJM2's outward appearances, it was understood:

- "When LJM effectively '***warehouse'*** [sic] assets for Enron, the return of these assets to Enron (and the need for LJM to achieve an appropriate level of compensation) is negotiated case-by-case but is generally achieved through escalation of price/margins etc."[173]

- "LJM is seen by Enron as ***simply another vehicle*** company (one that offers certain advantages in terms of recognizing income/cashflow on specific assets . . .) and not a means whereby they can divest themselves of 'problems.'"[174]

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169 Fastow Decl., ¶41.

170 *Id.*, ¶42.

171 Ex. 80 at AB000214263.

172 10/24/06 Fastow Depo. Tr. at 362:7-21.

173 Ex. 80 at AB000214263.

174 *Id.*

- "[T]he same level of control will be exercised over LJM assets, as is the cases with other Enron 'vehicles' in order to ensure lenders/investors ***are protected*** as far as possible."[175]

- "Enron's senior management are consistent in ***strongly representing verbally that Enron will do everything in their power to protect the investors and lenders involved***."[176]

- Assets purchased from Enron will be "***[s]elf-liquidating***" by virtue of secret buyback agreements – "***[e]ffective' put[s]***" – with Enron.[177]

Consistent with Merrill Lynch's understanding of LJM2, the Nigerian Barges transaction involved "verbal" support, namely Skilling's bear hug, and the Raptors involved "puts," the secret purpose of which was to eliminate LJM2's exposure to risk and generate a return to LJM2 for its role in the transactions.

For these same reasons, Merrill Lynch also understood that LJM2's "investment" of "independent equity" in Enron-sponsored SPEs depended on a fiction. The obvious import of the side agreements between Fastow and Enron, of which Merrill Lynch was aware, was that Enron and Fastow were asserting influence and control over LJM2 such that LJM2 was not independent of Enron. But as Fastow testified he informed Merrill Lynch, the vision for LJM2's use was that it would provide the 3% equity in Enron-sponsored SPEs.[178] As Fastow discussed, LJM2 was "viewed" as "third-party equity for accounting purposes, and Enron . . . needed that in order to meet its financial reporting . . . objectives."[179] Of course, as Fastow and Merrill knew, the "view" that LJM2 was a third party was from the outside. In contrast, ***inside*** LJM2 Merrill knew Fastow was

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175 Ex. 80 at AB000214264.

176 *Id.*

177 Ex. 81 at AB000350523 (10/15/01 LJM2 Co-Investment, L.P. Annual Partnership Meeting).

178 10/24/06 Fastow Depo. Tr. at 363:1-364:6.

179 *Id.* at 363:7-14.

using side agreements with Enron to eliminate risk in asset-parking transactions. Fastow's expressed perspective on the 3% "equity investments" was they "would be very profitable to me and my partners because I considered it a very high rate of return, considering how little risk there was."[180]

Merrill Lynch executives Bayly and Brown invoked the Fifth Amendment in response to numerous questions concerning their knowledge that LJM2 was secretly controlled by Fastow and Enron.

Bayly and ***Brown*** invoked the Fifth Amendment in response to the following questions.

- "[In December 1999,] you also understood Enron and its CFO Andrew Fastow controlled and would control LJM2, contrary to accounting requirements that LJM2 be independent of Enron?"[181]

- "Enron CFO Andrew Fastow informed you that LJM2 was formed so Enron could dump underperforming assets for which there was no market to falsely inflate Enron's reported financial results and then repurchase the assets at a return to LJM2, after recording the inflated financial results?"[182]

- "While Merrill Lynch solicited investors for LJM2, you knew that Enron and its CFO Andrew Fastow intended to use LJM2 as a vehicle for Enron to manage its income statement?"[183]

- "While Merrill Lynch solicited investors for LJM2, you knew that Enron and its CFO Andrew Fastow intended to use LJM2 as a vehicle for Enron to manage its balance sheet?"[184]

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180 *Id.* at 363:15-21.

181 Ex. 14385 at 16; 9/29/06 Deposition Transcript of Daniel Bayly ("9/29/06 Bayly Depo. Tr.") at 35:4-13; Ex. 14386 at 14; 10/12/06 Deposition Transcript of James Brown ("10/12/06 Brown Depo. Tr.") at 41:24-42:11.

182 Ex. 14385 at 26; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 24; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

183 Ex. 14385 at 26; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 24; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

184 Ex. 14385 at 26; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 24; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

- “As of December 1999, you understood from Enron CFO Andrew Fastow that LJM2 would not lose money on distressed assets purportedly sold to LJM2 by Enron because Enron would do everything in their power to protect LJM2’s investors from losses, correct?”[185]

- “You further understood that in these situations Enron was ‘warehousing’ assets with LJM2 and LJM2 would be compensated for holding those assets for a temporary period of time through sales of the assets back to Enron affiliates at higher prices than at what the assets were acquired, correct?”[186]

- “You also understood this oral side agreement between LJM2 and Enron, the same oral side agreement as in the Nigerian Barges deal, was referred to by LJM2 as an ‘effective put’ exit strategy correct?”[187]

- ”You also understood this oral side agreement between LJM2 and Enron, the same oral side agreement as in the Nigerian Barges deal, was referred to by LJM2 as a ‘self-liquidating’ exit strategy, correct?”[188]

- “In fact, at this time you also understood that like with respect to LJM2’s take out of Merrill Lynch in the Nigerian Barges deal, LJM2 received undocumented oral side agreements from Enron that LJM2 would be made whole on purported purchases of assets from Enron, plus it would make a return, correct?”[189]

- “And you also understood that at this point and all times thereafter that when Enron repurchased assets from LJM2 which LJM2 purportedly earlier purchased from Enron, those repurchases were according to oral side agreements, just like the oral side agreement Merrill Lynch received from Enron CFO Andrew Fastow in the Nigerian Barges deal, namely that LJM2

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[185] Ex. 14385 at 26; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 24; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[186] Ex. 14385 at 27; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 24-25; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[187] Ex. 14385 at 32; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 30; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[188] Ex. 14385 at 32; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 30; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[189] Ex. 14385 at 33; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 31; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

would be taken out of the transaction by a certain time at a specified rate of return, correct?"[190]

- "And so you also understood just like Enron CFO Andrew Fastow promised Merrill Lynch a specific rate of return in the Nigerian Barges deal, Enron promised LJM2 a specific rate of return in LJM2's purported purchases of assets from Enron, right?"[191]

- "And just like Enron CFO Andrew Fastow promised Merrill Lynch it would be taken out of the Nigerian Barges deal by a specific date, Enron promised LJM2 it would be taken out of its purported purchases of assets from Enron by a specific date, right?"[192]

c. Deceptive LJM2 Transactions Involving Side Agreements

Fastow admitted in his criminal plea, "Certain LJM transactions lacked economic substance and were improper for accounting purposes, in part because I and others secretly agreed that LJM would not lose money through participation in the transactions."[193] Similarly, Michael Kopper, Fastow's Lieutenant at LJM2, testified:

> Enron would use LJM as essentially an off-ramp on deals that they needed to use to make earnings for any given quarter. Even though they may only be using the balance sheet of LJM for a short period of time, they would misstate that they'd actually sold an asset, when what they might be doing is warehousing the asset with LJM . . . ."[194]

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[190] Ex. 14385 at 33; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 31; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[191] Ex. 14385 at 33; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 32; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[192] Ex. 14385 at 33; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 32; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

[193] Ex. 13448, Ex. A at 2.

[194] *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Sept. 27, 2004) ("9/27/04 Barges Trial Tr.") at 1331:13-19 (Kopper testimony).

As demonstrated above and herein, Merrill Lynch knew this and knew Fastow and Enron were accomplishing this with side agreements. *See supra* §III.A.3.b. Numerous side agreements (the purpose of which Merrill Lynch was informed when it created LJM2), were not only secretly documented in the Global Galactic (referred to by Fastow as "a list of these undocumented side agreements"),[195] they were also knowingly participated in by Merrill Lynch.

In fact, each of the transactions below was subject to a side agreement between Fastow and other members of Enron's senior management. Through side agreements in these transactions, LJM2 (and Merrill as a limited partner in LJM2) obtained huge returns – as high as ***5000%*** – risk free, unlike the risk that would be born by any partnership independent of Enron.

- In ***CLO Trust***, LJM2 purchased from Enron equity in a trust holding collateralized loan assets and purchased certain BB-rated notes issued by that trust that third parties refused to purchase. Enron repurchased the equity and notes at a return to LJM2 of over $4 million. Enron booked at year-end 1999 approximately $19 million in fictitious earnings and fictitious funds flow of $174.2 million.[196]

- In ***MEGS***, LJM2 purchased and resold to Enron within three months interests in the right to purchase certain offshore natural gas gathering systems, receiving over $500,000 and an additional 25% return on equity invested. Enron booked at year-end 1999 approximately $2.5 million in fictitious earnings and $25 million in fictitious funds flow.[197]

- In ***Nigerian Barges***, LJM2 "purchased" from Merrill Lynch and resold three months later an interest in the barges, receiving a gain of $700,000, completing the back end of the Merrill Lynch 1999 fictitious sales.[198]

- In ***Nowa Sarzyna Holdings***, LJM2 purchased and resold to Enron within three months an interest in a Polish power plant, receiving a fee of $750,000

195 3/7/06 Lay/Skilling Trial Tr. at 6498:20 (Fastow testimony).

196 *See* Ex. A; Solomon Report at 101, 104, 109; Second Interim Report of Neal Batson, Appendix L, Annex 4 (Ex. 82) at 21-29.

197 *See* Ex. A; Solomon Report at 101, 104-05, 109; Ex. 82 at 30.

198 *See supra* at 44-45.

and an additional return of exactly 25%. Enron booked at year-end 1999 approximately $20 million in fictitious earnings and $38 million in fictitious funds flow.[199]

- In ***Raptors***, LJM2 purportedly capitalized risk management transaction structures with $30 million cash and received its money back plus huge internal returns within six months. In Raptor I, LJM2 received an internal rate of return of ***89%***.[200] In Raptor II, ***290%***.[201] In Raptor III, over ***5000%***.[202] In Raptor IV, ***213%***.[203] Enron avoided recognizing approximately $1 billion in losses on its merchant investment portfolio.[204]

These asset buybacks and huge financial returns were consistent with Fastow's and Merrill Lynch's plan for LJM2. Enron's Bankruptcy Examiner, Neal Batson, found that in the 14 of 21 Enron-related investments held for less than seven months before repurchase by Enron or an affiliated SPE, the transactions took place "***without any known attempt at determining and using fair market value***."[205] He also found that LJM2 did not lose money in its "parking" or "warehousing" transactions with Enron, "***even when LJM2 purchased assets that apparently declined in value after the purchase***."[206] Enron's Bankruptcy Examiner concluded: "***As a direct***

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199 *See* Ex. A; Solomon Report at 101, 103, 109; Ex. 82 at 20-21.

200 Ex. 83 at MLNBY0204065.

201 *Id.*

202 *Id.*

203 *Id.*

204 *See* Solomon Report at 101-02, 106, 109; Second Interim Report of Neal Batson, Appendix L, Annex 5 (Ex. 84) at 2.

205 Second Interim Report of Neal Batson, Appendix L (Ex. 85) at 18.

206 Ex. 82 at 2; *see also* Report of William J. Powers, dated February 1, 2002 (Ex. 86) at 68.

and indirect result of its transactions with LJM2, Enron realized earnings of over $1.3 billion and cash flow of over $3.5 billion."[207]

Merrill Lynch even used LJM2 for performing the secret repurchase/resale agreement it had with Enron regarding the Nigerian Barges, knowing LJM2 was "rolling" them beneficially from the same secret side deal Merrill Lynch had. *See infra* §III.C.

d. The Deception of Andersen by Secret Control of LJM2 Through Side Agreements

Andersen was not privy to Fastow's private conversations with Merrill Lynch and was not aware that Merrill Lynch and Fastow had set up LJM2 to enter risk-free transactions through side agreements. Indeed, Andersen was deceived by LJM2, for that was the purpose of the secret control of LJM2 by Enron through side agreements among senior management – with Fastow as the critical link. As testified to by former Andersen audit partners Carl Bass and Thomas Bauer, neither they nor anyone to their knowledge was aware of any agreements among executives at Enron that LJM and LJM2 would not lose money through participation in certain transactions with Enron and in particular the Raptors.[208] Had anyone at Andersen become aware of that, alarm bells would have gone off at Andersen.[209]

As Andersen auditors testified, side agreements such as the ones Merrill Lynch entered into with Enron and was aware of with respect to LJM2 caused a critical impact on Enron's accounting and financial reporting for LJM2/Enron transactions. Thomas Bauer testified as follows.

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207 Ex. 82 at 2-3.

208 7/18/06 Deposition Transcript of Carl Bass ("7/18/06 Bass Depo. Tr.") at 410:10-411:7, 412:25-413:22; 8/22/06 Bauer Depo. Tr. at 421:19-422:8. *See also* 10/18/05 Grutzmacher Depo. Tr. at 1299:16-1300:24.

209 7/18/06 Bass Depo. Tr. at 411:4-7; 8/22/06 Bauer Depo. Tr. at 422:6-8.

Q. And there were a number of transactions where LJM2 purchased assets from Enron, right?

A. That's correct.

Q. And you were aware of that when you were auditing at Andersen, correct?

A. I was.

Q. Now, if Andersen discovered that Andy Fastow and other members of Enron's senior management, including Jeffrey Skilling and Rick Causey, had a side agreement in any of those transactions that the assets would be repurchased by Enron, there would have been serious ramifications, right?

A. That's correct.

Q. For one thing, the side agreement would indicate to Andersen LJM2 was not independent from Enron, right?

A. It would.

Q. And, so, LJM2 would have to be consolidated onto Enron's financial statements, which would not have been favorable to Enron from an accounting standpoint, right?

A. That's correct.

* * *

Q. For another thing, the side agreement to repurchase the assets would mean that the so-called asset sales would not, in fact, be sales because there would be no transfer of the risks of true ownership, right?

A. That's correct.

Q. And no sales, gains on the transfers or proceeds from the sales of the assets could have been reported in Enron's financial statements, correct?

A. That's correct.

Q. Now, the reason the SEC forbids asset parkings or – at least among other things, is because it causes a deceptive effect on financial statements, right?

A. I believe that's consistent with their views.

Q. And it's always been your understanding, has it not, that that's pretty obvious to anybody with financial knowledge or knowledge of the accounting world, right?

A. I believe it is.[210]

Patty Grutzmacher testified that if Andersen had become aware of side agreements of the nature Merrill Lynch was aware of with respect to LJM2, it would have changed the accounting for the transactions in which LJM2 invested the so-called 3% independent equity: "I think if there was a guaranteed return to the equity holders, that the three percent equity would be considered not at risk and the initial accounting on such transactions would not have been proper."[211]

Grutzmacher further testified specifically with respect to the LJM2-Raptors transactions:

> Q. To your knowledge, did anyone at Andersen, before Enron went bankrupt, become aware of any unwritten agreements among executives at Enron that LJM2 would be paid the return of its investment, plus a profit, prior to Talon engaging in any hedging transactions?
>
> A. No.
>
> Q. If Andersen discovered this while you were working on the Enron engagement, do you think it would have been brought to your attention?
>
> A. Yes.
>
> Q. Why is that?
>
> A. Same as before. It's a very significant, critical fact that would have needed to be considered for this transaction, as well as any other ones, and would have changed the accounting answer associated with all of the Raptors probably.[212]

Bass also testified the side agreements in the Raptors would have changed the proper accounting, because "[f]or accounting purposes, [the Raptors] wouldn't be valid SPEs; and, therefore, the hedging transactions would not be a hedging transaction with an outside party. So,

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[210] 8/22/06 Bauer Depo. Tr. at 424:3-425:23.

[211] 10/18/05 Grutzmacher Depo. Tr. at 1291:18-1292:17.

[212] 10/18/05 Grutzmacher Depo. Tr. at 1300:6-1301:9.

therefore . . . the accounting that [Enron] achieved in the financial statements would not have been appropriate."[213]

B. Merrill Committed Acts of Deception and Manipulation by the Phony Nigerian Barges Sale

The facts regarding Merrill with respect to the fraudulent Nigerian Barges sham sale transaction are exceptionally strong. Indeed, four former Merrill executives who worked on the Nigerian Barges deal were indicted for their ***conduct*** in ***knowingly manipulating*** Enron's financial statements through the Nigerian Barges deal. Merrill knew it was committing fraud; it had qualms about its conduct in the fraud, but to sweeten the Enron relationship and continue reaping the rewards of that relationship, Merrill went along, and, on December 29, 1999, entered into the Nigerian Barges sham sale – but insisted on (and got) ***secret verbal assurances from Fastow that it would be "taken out" of the deal within six months***. Enron recorded $12 million in bogus year-end income due to the fictitious sale – at the same time, hiding millions in debt. And, six months later, as secretly promised, Merrill was "taken out" of the deal at the agreed upon rate of return. A guaranteed risk-free profit for Merrill in return for its deceptive and manipulative conduct in furtherance of the scheme.

1. Merrill Engaged in a Bogus Barges Sale with Enron

Prior to year-end 1999, Enron had tried to sell electricity generating barges moored off Nigeria but could not find a legitimate buyer.[214] Enron's strategy with respect to the Nigerian Barges was to identify a bank that would enter a transaction that would "'have a ***big impact*** for

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213 7/18/06 Bass Depo. Tr. at 413:23-415:1.

214 *See* Ex. 5 at MLNBY0911188-89 (Credit Flash Report) ("Enron had been speaking with another investor that apparently could not close on the deal prior to year-end."); Ex. 6 at ETF-BFG-000117 (12/8/99 internal Enron email from James Hughes, "subject: Nigerian Barge Mo[n]etization"); 9/23/04 Barges Trial Tr. at 1046:12-14 (Trinkle testimony) (Enron wanted Merrill to do the deal "to help them get the sale done by the end of the year and book these earnings.").

Enron.'"[215] One key part of the 1999 year-end hijinks was the Nigerian Barges deception. Although "***Merrill Lynch is not in the business of owning barges***,"[216] to get more investment banking business (fees) from Enron and in return for a huge short-term payoff, Merrill took part in what it ***knew*** was a sham/phony sale, the sole purpose and effect of which was to create the fictional earnings for Enron.[217] Enron needed a transaction to take the barges off its hands ***just long enough*** for it to book a profit in 1999, at which point it would buy back the barges or "***facilitate [Merrill Lynch's] exit from the transaction*** . . . ."[218] Merrill's internal documents frequently described the barges scheme as a "'relationship' loan."[219]

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215 3/7/06 Lay/Skilling Trial Tr. at 6491:13-23 (Fastow testimony).

216 Ex. 87 (7/10/02 Sworn Testimony of Daniel Bayly, former Global Head and Chairman of Investment Banking at Merrill, to the SEC) at 65:10-11; *id.* at 67:2-3 ("Merrill Lynch is not in the business of owning barges."); *id*. at 96:13-14 (same); *id* at 71:12-13 ("***It's not a deal we would do in the normal course of our business***.").

217 *See, e.g.*, Fastow Decl., ¶34 ("I believe that Merrill agreed to purchase the Nigerian Barges from Enron on a temporary basis only because I gave assurances that I intended as a guarantee that Merrill would receive three things: return of its investment, return on its investment, and an exit from ownership within six months."); Ex. 50033 at MLBE0111739 (12/21/99 James Brown handwritten note regarding the transaction: "***reputational risk is aid/abet Enron income statement manipulation***"); Ex. 5 at MLNBY0911188 (Credit Flash Report) ("The transaction will allow Enron to . . . book future cash flows currently as 1999 earnings (approximately $12mm)."); Ex. 87 at 81:2-4 ("[T]he whole transaction was driven by the relationship with Enron, and generating revenues out of Enron.").

218 Ex. 50034 at MLBE0111776 ("Dan Bayly will have a conference call with senior management of Enron confirming this commitment to guaranty the ML takeout within six months."). *See also* Fastow Decl., ¶33 (stating that in 12/99, Fastow told Merrill's Tilney why Enron was "asking Merrill, rather than LJM2, to purchase the [b]arges at that time, and I told him of the assurance Mr. Skilling had given me with respect to the barges").

219 *See, e.g.*, Ex. 5 at MLNBY0911188 (Credit Flash Report) ("[m]ost unusual transaction of the week was IBK request to approve Enron Corporation 'relationship' loan"); Ex. 7 at MLBE0281216-17 (12/29/99 Minutes of ML IBK Positions, Inc. Board of Directors Special Meeting (particularly MLBE0281216) (describing the Nigerian Barge transaction as a "financing")); Ex. 8 at MLBE0176538-81 (8/4/00 Merrill Discussion Materials Prepared For Fixed Income Discussion with Enron) (particularly MLBE0176543) (the "8/4/00 Merrill Lynch discussion materials") (referencing, under work for Enron, participation in the "Nigerian Barge Loan"); Ex. 9 at MD037396-403; Ex. 9

Enron worked with Merrill banker Furst (later indicted), and his boss Tilney.[220] Furst's December 21, 1999 memorandum explaining the deal stated:

> Enron is a top client to Merrill Lynch. ***Enron views the ability to participate in transactions like this as a way to differentiate ML from the pack and add significant value***. I completed several financings like this at CSFB and they all worked to CSFB's advantage. I strongly recommend we complete this transaction.[221]

Similarly, Merrill's internal Appropriation Request stated:

> Jeff McMahon, EVP and Treasurer of Enron Corp. has asked ML to purchase $7MM of equity in a special purpose vehicle that will allow Enron Corp. to book $12MM of earnings. Enron must close this transaction by 12/31/99. Enron is viewing this transaction as a bridge to permanent equity ***and they have assured us that we will be taken out of our investment within six months***. The investment would have a maximum 22.5% return.
>
> . . . Dan Bayly will have a conference call with senior management of Enron ***confirming this commitment to guaranty the ML takeout within six months***.
>
> ***Enron has strongly requested ML to enter into this transaction. Enron has paid ML approximately $40 million in fees in 1999 and is expected to do so again in 2000***.[222]

Merrill's December 23, 1999 "Credit Flash Report" admitted the "***transaction will allow Enron to move assets off-balance sheet and book future cash flows currently as 1999 earnings***."[223]

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at MD0373402-03 (Merrill's Kathrine Zrike's handwritten notes "relationship loan that looks like equity" "undoc hand shake loan to Enron"); Ex. 87 at 67:11 ("Very much of a relationship-driven decision."); *id.* at 71:9-16, 99:14-15 (Bayly called Fastow, in part, "trying to make sure [Enron] understood that this is something we're doing to enhance our relationship with Enron."); *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Oct. 11, 2004) ("10/11/04 Barges Trial Tr.") at 4120:6-7 (Zrike testimony) (Davis was supportive of the deal in light of Merrill's "desire to build a stronger relationship with Enron"); Government Ex. 519 (1/4/00 internal Enron email describing the deal as "the Nigeria loan"). All references to "Government Exhibits" are to the exhibits marked by the Government in the *United States v. Bayly* case.

[220] Ex. 50029 (12/21/99 memorandum from Robert Furst to Dan Bayly and others at Merrill).

[221] Ex. 50029 at MLBE0305288.

[222] Ex. 50034 at MLBE0111776.

[223] Ex. 5 at MLNBY0911188-89 (Credit Flash Report).

There was a secret agreement whereby Enron would cause Merrill to be taken out of the Nigerian Barges transaction within six months at an agreed rate of return. Jeffrey McMahon made these assurances in his initial conversations with Furst regarding the proposed transaction.[224] Fastow subsequently confirmed Enron's secret commitment to Bayly, the head of Merrill's investment banking division.[225] Beyond the testimony, Merrill's internal documents supporting the existence of the secret verbal agreement are overwhelming. They include:

- Appropriation Request regarding the Nigerian Barges transaction dated December 23, 1999 stating: "Enron is viewing this as a bridge to permanent equity ***and they have assured us that we will be taken out of our investment within six months. . . . Dan Bayly will have a conference call with senior management of Enron confirming this commitment to guaranty the ML takeout within six months," i.e., a takeout by June 30, 2000***.[226]

- Merrill Credit Flash Report for week ending December 23, 1999, describing Nigerian Barges transaction as a "relationship loan" and stating: "IBK [investment banking] was supportive based on Enron relationship (approx. $40mm in annual revenues) and ***assurances from Enron management that we will be taken out of our $7mm investment within the next 3-6 months***."[227]

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[224] *See* Ex. 88 at MLBE0305288 (12/21/99 Memorandum from Robert Furst, Merrill to Dan Bayly and Schuyler Tilney, *et al.*, Merrill, regarding Enron Corp. (the "Furst/Bayly Memo")). *See also* Ex. 50034 at MLBE0111776 (Appropriation Request cover page).

[225] 3/7/06 Lay/Skilling Trial Tr. at 6492:20-23 (Fastow testimony) ("I let [Bayly] know that Merrill Lynch would be out of the deal in six months. That means by June 30, 2000, they'd get their specified rate of return and the fee as – we had agreed on a fee as well."); Ex. 87 at 95-99, 101-03, 129; Ex. 89 at MLBE0242936 (3/2/01 email from James Brown, Merrill, to Robert Lyons, Merrill); Ex. 50034 at MLBE0111776; Fastow Decl., ¶33 ("On December 23, 1999, I participated in a conference call, during which I assured Merrill's Daniel Bayly that the bank's investment would be repaid within six months and that the bank would receive its pre-determined rate of return.").

[226] Ex. 50034 at MLBE0111776. The Appropriation Request also indicated a fee for the transaction of $250,000 plus 15% per annum or a flat 22.5%. *Id*.

[227] Ex. 90 at MLBE0016558 (1/22/02 email from Vincent J. DiMassimo, Merrill to Kevin Cox, Merrill); *see also* Ex. 7 at MLBE0281216-17 (12/29/99 Minutes of ML IBK Positions (particularly MLBE0281216) (describing the Nigerian Barge transaction as a "financing")); Ex. 8 at MLBE0176538 (8/4/00 Merrill Discussion Materials (particularly MLBE0176543) (referencing, under work for Enron, participation in the "Nigerian Barge Loan")).

- December 1999 handwritten notes by Merrill lawyer Kathrine Zrike: "***verbal assurances that we will be out of this***."[228]

- December 27, 1999 email from Enron's Garrett to Merrill's Brown and Fuhs: "Attached is an abbreviated version of our Nigeria Barge Model. It shows the project cashflows, cashflows to Merrill Lynch, ***a 6-month buyout schedule and amortization of the Enron/Merrill loan***."[229]

- June 13, 2000 email from Kira Toone to Alan Hoffman, counsel for Merrill in the Nigerian Barges transaction: "As we approach June 30, 2000 I am getting questions concerning Ebarge, LLC. ***It was our understanding that Merrill Lynch IBK positions would be repaid its equity investment as well as a return on its equity by this date. Is this on schedule to occur?***"[230]

- June 14, 2000 email from Merrill's Geoffrey Wilson ("Wilson") to Furst and Fuhs attaching draft letter to Enron's Boyle "Re: Equity Investment in Enron Nigeria Barge Ltd.": "***Enron has agreed to purchase the shares from Ebarge by June 30, 2000 for a purchase price, net of the balance on the loan from Enron Nigeria Power Holding, Ltd., of $7,510,976.65. Please wire this amount to the following account on or before June 30, 2000***."[231]

- June 14, 2000 email from Fuhs responding to Wilson's June 14, 2000 email and stating Fuhs "just had a call with Boyle (he pre-empted our letter) about the Nigerian Barges transaction. Enron has lined up a new buyer. ***This new buyer will purchase our ownership interest in the EBarge for the agreed upon amount outlined in the previously forwarded memo***."[232]

- June 14, 2000 email from Valenti to Gary Carlin: Valenti, after viewing a slide depicting LJM2 activity, wrote: "This is kind of interesting. Look at slide "Barge%2BSlide.ppt" below. ***It appears that the way we are getting***

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[228] Ex. 9 at MD037402. *See also* 10/11/04 Barges Trial. Tr. at 4093:2-11 (Zrike testimony); (these are notes Zrike took either before or at the DMCC meeting); *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Oct. 12, 2004) ("10/12/04 Barges Trial Tr.") at 4217:10-4218:24 (Zrike testimony); 10/11/04 Barges Trial Tr. at 4102:6-18 (testified that during 12/99 she was concerned that Merrill was engaging in "inappropriate or improper, illegal" "earnings management" by entering into the barges deal).

[229] Government Ex. 511.

[230] Ex. 91 at SEC00668111 (6/13/00 email from Kira Toone, Merrill, to Alan Hoffman, Whitman, Breed, Abbott & Morgan, and copies to Joseph Valenti and Gerard Haugh, Merrill).

[231] Government Ex. 228 at MD081821.

[232] Government Ex. 230 at MD082119.

out of the Enron investment on MLIBK Positions books ($7.0m + interest) is having LJM2 Co-Investment LP buy us out through LP Capital Calls, in which MLIBK is also a limited partner. On one hand we get our money back, on the other we will make a prorata investment back into LJM2 which will invest. I guess this also means that the employee syndication will also put funds up for its prorata share as well."[233]

- March 2, 2001 email from Brown referencing oral assurances in Nigerian Barges transaction: "***[W]e had Fastow get on the phone with Bayly and lawyers and promise to pay us back no matter what. Deal was approved and all went well***."[234]

Internal communications at Enron from the same period also evidence Enron's secret agreement with Merrill:

- May 2000 email exchange between Boyle, Glisan and Hughes: "As you know, ML's decision to purchase the equity was based solely on personal assurances by Enron senior management to ML's Vice Chairman that the transaction would not go beyond June 30, 2000." Glisan responds: "***[T]o be clear, [Enron] is obligated to get Merrill out of the deal on or before June 30. We have no ability to roll the structure***." And, Hughes responds: "***We have always understood that is required***."[235]

- May 12, 2000 internal Enron email from Boyle: "The deal with ML was to get them a total annualized return of roughly 20%. ***ML is expecting to receive a minimum of $7.525 million when they sell there [sic] equity on June 30, 2000*** (15% annualized return on this portion). ***In addition, we paid ML a $250,000 advisory fee at closing which, combined with the take out on June 30, results in a return of approximately 20%***."[236]

- A June 1, 2000 email "Re: Nigeria Barge Project," discusses "formulating" a "story" to sell Arthur Andersen on Enron's buyback: "***We sold AA in December on the idea that ML was really wanting to take equity type risk in the deal***. We will have to be able to explain why we want to take ML out of

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[233] Ex. 72 at ML6892.

[234] Government Ex. 240 at MD069699.

[235] Government Ex. 532; *see also United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Oct. 7, 2004) ("10/7/04 Barges Trial Tr.") at 3858:17-18 (Glisan testimony) ("based on an oral guarantee," Merrill fully expected to be taken out by June 30th).

[236] Government Ex. 533 (5/12/00 email from Dan Boyle, Enron, to Sean Long, Enron, and copies to Ben Glisan and Barry Schnapper, *et al*.).

the deal and why we are willing to finance the take out. (I need help formulating this story, if it is even possible)."[237]

- In a document titled "Benefits to Enron Summary," "Compiled by: Ace Roman," Roman wrote about how LJM2 stepped in to fulfill Enron's "promis[e]" to Merrill in the barges scam: "***Enron sold barges to Merrill Lynch (ML) in December of 1999, promising that Merrill would be taken out by sale to another investor by June, 2000. The project could not be sold by June, so without LJM2's purchase Enron would have had to strain the ML/Enron relationship or repurchase the assets and reverse earnings and funds flow on the original transaction***."[238]

Fastow testified at the Lay/Skilling criminal trial that Merrill agreed to the deal after there was a secret side agreement that Merrill would "get out" of the transaction in six months with a guaranteed rate of return:

> Q. Okay. And who was it that you called? Did you call, then, someone at Merrill Lynch?
>
> A. Well, there was a call. I don't remember if I placed the call. But there was a call between myself and Mr. Bayly and some other people.
>
> Q. And who is Mr. Bayly?
>
> A. Mr. Bayly was the head of investment banking at Merrill Lynch.
>
> Q. And in summary, what did you convey to Mr. Bayly?
>
> A. ***I let him know that Merrill Lynch would be out of the deal in six months***. ***That means by June 30, 2000, they'd get their specified rate of return and the fee as – we had agreed on a fee as well***.
>
> Q. By the time you hung up the phone, what had you conveyed to Merrill Lynch?
>
> A. ***That I'd make sure, as CFO of Enron, that they would be out of this deal and they'd get their rate of return***.
>
> Q. Did you use the actual word "guaranty"?
>
> A. No.

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237 Ex. 92 at EC04519A0121285-86.

238 Ex. 93 at DP036766.

Q. Why not?

A. I didn't have to use the word "guaranty." ***It was so clear what I was doing, and using the word "guaranty" would have been a little too – just a little too blatant***.

Q. ***All right. Once you provided that guaranty, did Merrill Lynch go forward with the deal?***

A. ***Yes***.[239]

Glisan corroborated Fastow's testimony.

Q. All right. In December of '99, did you learn that Enron was trying to sell some Nigerian power barges?

A. Yes, I understood that.

Q. And did you learn that Enron had arranged to sell those barges to Merrill Lynch?

A. Yes.

Q. Merrill Lynch is an investment bank; is that right?

A. Yes, that's right.

Q. Was Merrill Lynch in the business of owning Nigerian power barges?

A. No.

Q. ***And did you learn that there was a verbal agreement between Enron and Merrill Lynch that was not contained in the official deal documents?***

A. ***Yes***.

* * *

Q. All right. ***And what did you learn about this verbal agreement?***

A. ***That Merrill Lynch was promised by Mr. McMahon that, if they were to purchase the barges, they would be taken out at six months with no risk of loss and at a stated yield***.

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239 3/7/06 Lay/Skilling Trial Tr. at 6492:11-6493:11.

Q. ***All right. Is there a – in the context of this transaction between Enron and Merrill Lynch, is there anything wrong with that?***

A. ***Yes***.

Q. ***What's wrong with it?***

A. ***That would violate accounting rules. So, the transaction should not have been treated as a sale***.[240]

Glisan's testimony also confirmed the purpose of the Nigerian Barges transaction was to generate earnings to meet Enron's budgeted target for the fourth quarter of 1999:

Q. What did you understand to be Enron's purpose in doing this Nigerian barge deal with Merrill Lynch in the fourth quarter of '99?

A. To generate earnings to help meet the budgeted target for the quarter.

Q. ***Given the existence of this handshake deal, was – was it proper for Enron to record those earnings in the fourth quarter of '99?***

A. ***No***.[241]

Enron's Boyle testified that the Nigerian Barges transaction had a "***side deal***" that Merrill would be taken out within six months,[242] and was "***an asset parking transaction***."[243]

Q. And do you agree with me now, based on what you now know, that this was an asset parking transaction?

A. Yes, sir, I do.

Q. ***That was wrong?***

A. ***That was wrong***.

Q. ***That caused Enron's books to be misstated?***

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240 3/22/06 Lay/Skilling Trial Tr. at 9406:25-9408:8 (Glisan testimony).

241 *Id*. at 9409:13-21.

242 *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Oct. 14, 2004) ("10/14/04 Barges Trial Tr.") at 5038:5-8.

243 *Id.* at 5035:16-18.

A. Yes, sir.[244]

Numerous Merrill Lynch executives invoked the Fifth Amendment in response to questions concerning the existence of the oral guarantee in the Nigerian Barges transaction. For example, ***Dan Bayly***, the former head of Merrill Lynch's Global Investment Banking division and one of the executives to whom Fastow gave the oral assurances, invoked the Fifth Amendment in response to the following questions:

- "On or about December 23, 1999, you called Enron's CFO, Andrew Fastow, to receive assurance that Merrill Lynch would be taken out of the proposed Nigerian Barge transaction within six months after the transaction closed; correct?"[245]

- "And on or about December 23, 1999, you told Enron's CFO, Fastow, and other Enron personnel, that Merrill Lynch was not in the business of owning barges; correct?"[246]

- "On or about December 23, 1999, you and other Merrill Lynch personnel told Enron's CFO, Fastow, and other Enron personnel, that Merrill Lynch was engaging in the Nigerian Barge transaction because it was trying to improve business relationships with Enron; correct?"[247]

- "On or about December 23, 1999, you told Enron's CFO, Fastow, and other Enron personnel, that Merrill Lynch expected to be rewarded with future Enron business for participating in the Nigerian Barge transaction; correct?"[248]

- "On or about December 23, 1999, Enron's CFO Fastow assured you and other Merrill Lynch personnel that Merrill Lynch would not lose money from its participation in the Nigerian Barge transaction; correct?"[249]

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244 *Id*. at 5035:16-22.

245 9/29/06 Bayly Depo. Tr. at 20:18-21:2.

246 *Id.* at 21:13-21.

247 *Id.* at 21:22-22:9.

248 *Id.* at 22:10-20.

249 *Id.* at 22:21-23:6.

- "And on or about December 23, 1999, Enron's CFO Fastow assured you and other Merrill Lynch personnel that Merrill Lynch's financial commitment in the Nigerian Barge transaction would be repurchased within six months after the transaction closed, and from that repurchase Merrill Lynch would receive the return of its capital and interest, and a $250,000 fee amounting to a total return of approximately 22 percent; correct?"[250]

- "On or about December 23, 1999, Enron's CFO Fastow assured you Merrill Lynch would be taken out of the deal within six months at the agreed rate of return because he would cause LJM2 to make the repurchase at the promised terms; correct?"[251]

- "On July 10, 2002, you testified under oath in a deposition concerning the Nigerian Barge transaction; correct?"[252]

- "During your July 10, 2002 testimony, you testified falsely when you stated you did not know of any oral guarantee between Enron and Merrill Lynch relating to the Nigerian Barge transaction; correct?"[253]

2. Merrill Knew the Nigerian Barges Transaction's Purpose and Effect Was to Manipulate Enron's Financial Results

The sole purpose of the Nigerian Barges deal was to manipulate Enron's reported profits. As Merrill's Brown has admitted, Enron needed to close the deal by year end "***to make their financial statements look good and show a gain before year end***."[254] One Merrill banker, Brown, raised objections, including concern about the propriety of Enron's intended accounting for the transaction[255] – questioning how Enron could account for the transaction as a sale[256] and how Enron

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250 *Id.* at 23:7-23.

251 *Id.* at 23:24-24:10.

252 *Id.* at 25:12-17.

253 *Id.* at 25:18-26:3.

254 *See* Government Ex. 965D (9/25/02 Grand Jury testimony of James Brown) at 97:11-16.

255 *See* Ex. 12 at MLNBY0303142-47; *see also* Ex. 94 at MLBE0111739-63 (12/21/99 facsimile from Robert Furst, Merrill to James Brown, Merrill).

256 Ex. 12 at MLNBY0303142-45.

could book a $12 million gain when Merrill was investing only $7 million.[257] Brown also raised concerns that Merrill's participation in the transaction presented "reputational risk" to Merrill because Merrill was engaging in ***Enron "income [statement] manipulation***."[258]

Some bankers objected to the lack of a written agreement by Enron to buy back the barges from Merrill.[259] Merrill then required Bayly to call Fastow and confirm Enron's commitment to take the bank out of the transaction within six months,[260] and impress upon Enron that it expected to be rewarded with future business from Enron for its conduct in the transaction.[261] Merrill secured oral assurances from Fastow that Enron would take Merrill out of the transaction within six months. Fastow testified: "***I let [Bayly] know that Merrill Lynch would be out of the deal in six months. That means by June 30, 2000, they'd get their specified rate of return and the fee as – we had agreed on a fee as well***."[262] Only then did Merrill agree to go ahead with this fake sale.[263]

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[257] *Id*. at MLNBY0303142-47. Although the purchase price was $28 million, Merrill invested only $7 million in the Nigerian Barges transaction as Enron funded the remaining $21 million of the purchase price through a non-recourse loan. *See* Ex. 95 at MLBE0049945-49 (12/29/99 Letter Agreement); Ex. 96 at MLBE0050409-27 (12/29/99 Loan Agreement between Enron Nigeria Power Holding, Ltd. and Ebarge (the "Barge Loan Agreement")); Ex. 12 at MLNBY0303146.

[258] Ex. 50033 at MLBE0111739. *See also* 9/23/04 Barges Trial Tr. at 1043:11-12 (Trinkle testimony) (during the DMCC meeting Furst and Tilney said the deal needed to be done by the end of the year to allow Enron to "book additional earnings in 1999").

[259] Ex. 12 at MLNBY0303140, MLNBY0303151; 9/23/04 Barges Trial Tr. at 1071:3-5 (Trinkle testimony). *See also* Ex. 87 at MLNBY0303982-90, MLNBY0304016; Ex. 50022 at 2-3; Ex. 87 at MLNBY0303961, MLNBY0303969-70, MLNBY0303976, MLNBY0303992; 10/11/04 Barges Trial Tr. at 4116:21-4123:7 (Zrike testimony) (Davis approved the deal but requested that Bayly have a "personal conversation with a senior person at Enron about our accommodation to them in this transaction and buying this barge entity.").

[260] *See* Ex. 50034 at MLBE0111776; *see also* Ex. 12 at MLNBY0303153-55.

[261] *See* Ex. 12 at MLNBY0303153-54; *see also* Ex. 87 MLNBY0304014.

[262] 3/7/06 Lay/Skilling Trial Tr. at 6492:20-23.

[263] Ex. 12 at MLNBY0303184-85.

Merrill's early draft "sales" agreement for the Nigerian Barges transaction[264] made reference to the 15% rate of return[265] to be paid to Merrill on the $7 million investment and stated that Merrill's equity interest would be subsequently sold to third-party equity investors or purchased by Enron or an Enron affiliate.[266] The inclusion of a rate of return or a reference to the commitment by Enron to buy back Merrill's interest (or to arrange for a third party to buy Merrill's interest) would

have precluded Enron's intended accounting for the transaction.[267] So, the formal deal documents omitted the oral guarantee Merrill had extracted from Enron.[268]

Merrill knew why the deal documents were sanitized. In fact, a Merrill committee of top executives that reviewed the Nigerian Barges transaction discussed Enron's intended accounting for

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264 *See* Ex. 97 at MLBE0294423-26 (12/23/99 Draft Letter Agreement between Merrill and Enron (the "Draft Letter Agreement")).

265 *See* Ex. 97 at MLBE0294423. When coupled with the $250,000 up front fee to be paid by Enron to Merrill, the total rate of return to Merrill on its investment for the expected six-month life of the transaction was 22.14%. Ex. 13 at MLBE0296773.

266 Ex. 97 at MLBE0294423 (Draft Letter Agreement).

267 An agreement as to a rate of return or a subsequent takeout would preclude accounting for the transaction as a sale. *See* Ex. 98 at 11/16/00 Sales of Future Revenues, 1 EITF Abstracts 88-18; Accounting for Sales of Real Estate; Statement of Financial Accounting Standards No. 66 (Financial Accounting Standards Bd. 1982) (Ex. 99) (precluding sales treatment where, among other reasons, risks of ownership do not pass to purchaser); Solomon Report at 321-23. *See also* Solomon Report at 323 ("Enron's verbal guarantee to repurchase Ebarge's investment in Nigerian Barge in less than six months causes the transaction to fail to qualify as a sale. In substance, Enron was economically at risk for the Nigerian Barge Transaction and had, in effect, simply borrowed $7 million from Merrill. The cash Enron received should have been recorded as cash flow from financing rather than from operations. Enron should not have recognized $12 million of income from this transaction.").

268 *See* Ex. 95 at MLBE0049945-49 (12/29/99 Letter Agreement); *see also* Ex. 100 at MLBE0050388-407 (12/29/99 Share Purchase Agreement between Enron Nigeria Barge Holdings Ltd. and Ebarge, LLC (the "Ebarge, LLC Share Purchase Agreement")); Ex. 96 at MLBE0050409-27 (12/29/99 Barge Loan Agreement; Pledge Agreement between Enron Nigeria Power Holding, Ltd. and Ebarge, LLC (the "Barge Pledge Agreement")); Ex. 101 at MLBE0050529-32 (12/30/99 Confirmation Letter from Dan Boyle, Enron, to Ebarge (the "Dan Boyle Confirmation Letter")).

the transaction.[269] When they asked "if we can get a written guaranty to support that representation being made by Enron,"[270] they were told "'***No, they can't do that because, otherwise, they won't get the right accounting treatment***.'"[271]As Fastow states in his declaration: "In my opinion, the guarantee from me reduced the risk to Merrill in a manner sufficient so that Arthur Andersen, had it known of the guarantee, would not have treated the transaction as a true sale."[272]

As also demonstrated elsewhere herein, Merrill knew how Enron intended to account for the Nigerian Barges transaction, *i.e.*, earnings of $12 million. In his declaration, Fastow states:

> Based upon my discussions with senior Merrill executives, I believe that Merrill understood the impact this transaction would have on Enron's financial statements, that the guarantee provided by me would likely change the accounting treatment of the transaction, and that the only reason for the transaction was to receive the desired accounting . . . treatment.[273]

A December 23, 1999 Merrill document noted that "[Enron Corp.] has asked ML to purchase $7MM of equity in a special purpose ***vehicle that will allow Enron Corp. to book $12MM of earnings. Enron must close this transaction by 12/31/99***."[274] These statements were repeated in numerous other documents circulated internally at Merrill, prior to the closing of the transaction.[275]

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269 Ex. 12 at MLNBY0303146-47, MLNBY0303156-57.

270 9/23/04 Barges Trial Tr. at 1045:25-1046:1 (Trinkle testimony).

271 *Id*. at 1046:23-24.

272 Fastow Decl., ¶34.

273 *Id.*, ¶34.

274 *See* Ex. 50034 at MLBE0111776.

275 *See* Ex. 88 at MLBE0305288; Ex. 90 at MLBE0016557-59; Ex. 90 at MLBE0016558; Ex. 102 at MLBE0152865-70 (12/22/99 email from Brad Bynum, Merrill, to Mark Devito, James Brown and Bill Fuhs, Merrill); Ex. 102 at MLBE0152867 (email attachment – Draft Memorandum from James Brown, *et al*., Merrill, to Debts Market Commitment Committee, Merrill Lynch).

Numerous Merrill Lynch executives invoked the Fifth Amendment in response to questions concerning their actual knowledge of the impropriety of the oral guarantee in the Nigerian Barges transaction. For example, ***Dan Bayly***, the former head of Merrill Lynch's Global Investment Banking division and one of the executives to whom Fastow gave the oral assurances, invoked the Fifth Amendment in response to the following questions:

- "On or about December 23, 1999, you asked Enron's CFO Fastow whether Enron's guarantee to repurchase Merrill Lynch's interest in the Nigerian Barge transaction within six months after the transaction closed could be in writing; correct?"[276]

- "On or about December 23, 1999, Enron's CFO Fastow told you and other Merrill Lynch personnel that Enron's guarantee to repurchase Merrill Lynch's interest in the Nigerian Barge transaction within six months after the transaction closed could not be in writing otherwise Enron would jeopardize its desired accounting treatment; correct?"[277]

- "On or about December 21, 1999, James Brown informed you that Enron intended to book approximately $10 million of earnings in fourth quarter 1999 from the proposed Nigerian Barge transaction; correct?"[278]

- "On or about December 21, 1999, James Brown informed you that Enron intended to recognize $28 million in cash flow in fourth quarter 1999 from the proposed Nigerian Barge transaction; correct?"[279]

- "On or about December 21, 1999, James Brown informed you that the proposed Nigerian Barge transaction would yield a 22-1/2 percent rate of return for Merrill Lynch; correct?"[280]

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276 9/29/06 Bayly Depo. Tr. at 24:11-21.

277 *Id.* at 24:22-25:11.

278 *Id.* at 15:11-20.

279 *Id.* at 16:23-17:8.

280 *Id.* at 16:14-22.

- "James Brown informed you on or about December 22, 1999 that he was concerned that the Nigerian Barge transaction was merely a means for Enron and Merrill Lynch to manipulate Enron's financial statements; correct?"[281]

- "During the meeting of the Merrill Lynch DMCC on or about December 22, 1999, James Brown questioned whether Enron could account for the proposed transaction as a sale; correct?"[282]

- "Also during a meeting of the Merrill Lynch DMCC on or about December 22, 1999, James Brown expressed concern that Merrill Lynch engaging in the proposed transaction posed a reputational risk to Merrill Lynch?"[283]

- "During a meeting of the Merrill Lynch DMCC on or about December 22, 1999, James Brown expressed concern that Merrill Lynch engaging in the proposed Nigerian Barge transaction posed a risk to Merrill Lynch of engaging with Enron in its income statement manipulation; correct?"[284]

- "You knew that James Brown said Merrill Lynch would cause Enron financial statement manipulation by engaging in the Nigerian Barge transaction, but approved of Merrill Lynch's participation in order to strengthen the relationship between Merrill Lynch and Enron; correct?"[285]

3. The Takeout – Another Parking Transaction

Merrill did nothing to monitor its $7 million investment prior to this sale because it knew that the holding was only short-term.[286] To complete the Nigerian Barges deception, on June 29, 2000, ***exactly six months after the closing of this transaction***, Enron arranged for Merrill's position to be

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281 *Id.* at 20:8-17.

282 *Id.* at 18:23-19:8.

283 *Id.* at 19:9-19.

284 *Id.* at 19:20-20:7.

285 *Id.* at 17:9-20.

286 Ex. 103 at MLNBY0274608 (5/29/03 Sworn Statement of Joseph Valenti, Controller of Private Equity Group); *see also United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Sept. 29, 2004) ("9/29/04 Barges Trial Tr.") at 2109:11-14 (Long testimony) (between January and June of 2000, no one from Merrill ever contacted him to see what was going on with the barges).

bought out by an SPE controlled by LJM2,[287] which purchased Merrill's $7 million equity interest for $7.525 million[288] – the $7 million put up by Merrill plus a rate of return of 15% per annum and Merrill's upfront fee of $250,000.[289] Counting the $250,000 payment to Merrill for entering into this contrived transaction, ***Merrill received a return of 22.14% on its $7 million advance***[290] – just as secretly promised to Merrill at year-end 1999. The June 2000 purchase price was ***not*** subject to negotiation, but rather was determined simply by calculating the return due to Merrill at the 15% rate previously agreed to by the parties.[291] Fastow stated in his declaration: "As discussed on the conference call, I arranged for LJM2 to purchase the barges from Merrill in June 2000. Merrill received the pre-arranged compensation."[292]

In fact, Merrill knew it was parking the barges once again to get out of the transaction with its agreed-upon return. For not only did Merrill arrange, sponsor and pre-fund LJM2 for the purpose of engaging in multiple year-end 1999 bogus deals (asset dumps) for Enron and Fastow, it also used LJM2 to further the fraud, deceptively "rolling" the parked Nigerian Barges to LJM2 in June 2000 to complete the back end of that deceit. *See infra* §III.C.

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287 *See* Ex. 10 at SEC00444604 (6/14/00 email from Bill Fuhs, Merrill, to Geoffrey Wilson, Merrill); *see also* Ex. 11 at MLBE0295112-34 (6/29/00 Share Purchase Agreement between ML IBK Positions, Inc. and LJM2-Ebarge, LLC (the "LJM2-Ebarge, LLC Share Purchase Agreement")).

288 Ex. 11 at MLBE0295112-34 (LJM2-Ebarge, LLC Share Purchase Agreement).

289 Ex. 12 at MLNBY0303177; *see also* Ex. 11 at MLBE0295112-34 (LJM2-Ebarge, LLC Share Purchase Agreement).

290 *See* Ex. 13 at MLBE0296773.

291 *See* Ex. 12 at MLNBY0303222-23; Ex. 10 at SEC00444604; 9/27/04 Barges Trial Tr. at 1348:15-17 (Kopper testimony) ("[Fastow] said that the price that LJM would have to pay was already predetermined; that – and that the transaction we'd enter into would also have a predetermined price.").

292 Fastow Decl., ¶35.

4. Enron's Auditor Was Deceived by the Secret Verbal Agreement Between Enron and Merrill, Which Falsified the Accounting and Financial Reporting for Enron in Fourth Quarter and Year-End 1999

The conduct of Merrill falsified Enron's accounting by (among other things) deceiving Enron's auditors, Andersen, and by inevitably falsely inflating earnings and cash flow from operations. Experts and fact witnesses in this case agree that "collusion," a term of art in the accounting and auditing profession, is deceptive conduct by parties to a transaction that impacts the accounting for the transaction.[293] Experts and fact witnesses in this case also agree that Merrill's conduct in connection with the Barges Transaction ***was collusion***.[294] For example, both former Andersen partners Bass and Bauer testified Merrill's conduct with Enron in the Nigerian Barges transaction was "highly deceptive."[295]

Any financial sophisticate such as a banker knows oral or written side agreements – which are, in substance, guarantees – affect the accounting for any transaction they involve – just as Merrill's own documents here reflect. Side agreements (verbal assurances, verbal understandings, oral guarantees, etc.,) such as the ones that are prevalent in this case between Enron and certain of its

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[293] *See* 1/17/06 Expert Report of Charles R. Drott ("Drott Report") at §2.11; 5/15/06 Deposition Transcript of John Foster ("5/15/06 Foster Depo. Tr.") at 279:13-19; 5/17/06 Deposition Transcript of Stephen McEachern ("5/17/06 McEachern Depo. Tr.") at 229:17-230:1; 5/23/06 Deposition Transcript of Mark Murovitz ("5/23/06 Murovitz Depo. Tr.") at 117:1-6; 7/5/06 Deposition Transcript of Michael Odom ("7/5/06 Odom Depo. Tr.") at 237:3-16; 7/17/06 Deposition Transcript of Carl Bass ("7/17/06 Bass Depo. Tr.") at 291:4-15; 8/21/06 Deposition Transcript of Thomas Bauer ("8/21/06 Bauer Depo. Tr.") at 214:7-15.

[294] *See, e.g.*, 9/29/05 Deposition Transcript of John Stewart ("9/29/05 Stewart Depo. Tr.") at 1197:23-1198:18; 10/26/05 Deposition Transcript of Richard Petersen ("10/26/05 Petersen Depo. Tr.") at 434:15-436:5; 7/18/06 Bass Depo. Tr. at 426:15-427:5; 8/22/06 Bauer Depo. Tr. at 413:14-22; *infra* §III.B.4-5.

[295] 7/18/06 Bass Depo. Tr. at 427:2-5; 8/22/06 Bauer Depo. Tr. at 413:20-22.

banks (including Merrill) are a perilous form of deception.[296] Such deception – collusion – is widely recognized as extremely dangerous to a company's financial statements and the auditing of those financial statements. For example, Audit Standard AU §230 states:

> Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. Characteristics of fraud include (a) concealment through collusion among management, employees, or third parties; (b) withheld, misrepresented, or falsified documentation . . . . For example, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among personnel within the entity and third parties or among management or employees of the entity. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. . . . Furthermore, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed.[297]

As former Chairman of the SEC, Harvey Pitt stated: collusion perpetrated by management with third parties (such as with the banks in this case) is "difficult, and often impossible, to discover."[298] In fact, in a publication of its views regarding the significance of oral guarantees to the financial reporting process, the SEC warned financial institutions that oral guarantees cause "improprieties in the . . . financial statements" of the issuer of the oral guarantee.[299]

As former Andersen audit partner Debra Cash ("Cash") testified with respect to verbal assurances by Enron concerning the repayment of equity to SPE investors in FAS 125/140

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[296] It does not matter what one calls the communication between the parties for purposes of determining whether the communications at issue between Enron and certain of its banks in this case evaded accounting requirements. *See* 7/17/06 Bass Depo. Tr. at 304:8-305:16; 5/15/06 Foster Depo. Tr. at 54:4-22; 5/17/06 McEachern Depo. Tr. at 221:16-222:9.

[297] Drott Ex. 46, §.12. *See also* 12/7/04 Cash Depo. Tr. at 1649:23-1650:7.

[298] Drott Ex. 49 at 4.

[299] Drott Ex. 48; 8/25/06 Deposition Transcript of Thomas Bauer ("8/25/06 Bauer Depo. Tr.") at 1431:17-1432:22.

transactions, "the fact that this arrangement exists is material to Enron's financial statements."[300] Andersen partner Cash also testified Andersen was misled by the secret verbal agreement in the Nigerian Barges transaction.[301] She was ***not*** aware of the oral side agreement.[302] Had she known, she would have raised the issue with Andersen partners, Enron and even Enron's board, as such an agreement would have threatened Enron's status as an Andersen client.[303] She believes the secret agreement that Enron would repurchase the Nigerian Barges within six months was purposely oral to avoid Andersen's detection of fraud.[304]

Andersen's Jones, a member of the Enron engagement team that evaluated and audited the Nigerian Barges transactions,[305] stated that to qualify for revenue recognition, and for Enron to be able to generate a gain and book a profit from the purported sale of Enron's interest in the Nigerian Barges, the risks and rewards of ownership in the barges had to change hands. In this respect, one of

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[300] 12/7/04 Cash Depo. Tr. at 1664:4-6, 1664:22-25 ("[W]ith respect to the income itself, it's not the relevance to me with respect to this agreement. It's – the fact that there was such an arrangement is a material fact."). *See also id.* at 1663:2-1665:15.

[301] The purpose of Andersen's "clearance" memoranda was supposed to be (among other things) to alert Andersen and Enron of material omissions or misstatements in Enron's financial statements. *See, e.g.*, 12/7/04 Cash Depo. Tr. at 1608:2-1610:6, Exs. 40327, 40329. For example, in the "Yearend 1999 Financial Statement and Controls Clearance," concerning the financial statements falsified by the Nigerian Barges transaction, Cash was informed by her colleagues at Andersen (including Jones) that except for certain noted matters those financial statements presented "fairly, in all material respects, the financial position of Enron International and Enron Global Exploration and Production." Ex. 40332 at AASDTEX000030833-84. *See also* 12/7/04 Cash Depo. Tr. at 1686:8-17. The Nigerian Barges transaction, in particular the unwritten agreement to repurchase the barges, was not noted.

[302] *See id.* at 1688:14-1690:24.

[303] *Id.* at 1690:12-1691:15.

[304] *See, e.g.*, 9/23/04 Barges Trial Tr. at 1046:25-1047:23-24 (Trinkle testimony). *See also* Ex. 40333, ¶14; Ex. 40523.

[305] 8/24/05 Deposition Transcript of Michael Jones ("8/24/05 Jones Depo. Tr.") at 647:15-648:13; *id*. at 650:18-651:1.

the things Andersen had to make sure of was that Enron was not "propping . . . up" the barges in any way.[306]

> Q. But you didn't know about a verbal buyback agreement between Enron and Merrill Lynch at this time, right?
>
> * * *
>
> A. I – I was not aware of any such agreement.
>
> Q. That's something you would have wanted to know, right?
>
> * * *
>
> A. If – if such agreement existed, that would have been something that we would have wanted to know about and to consider.[307]

Jones testified that if he was aware of such an agreement, it would have been appropriately communicated.[308] He further testified that if Andersen found deception, it would have been important for him to know if deception existed elsewhere in connection with Enron transactions.[309]

Andersen's John Stewart is one of the foremost accounting experts in the United States,[310] head of the Accounting Principles section of Andersen's Professional Standards Group and regularly consulted in evaluating Enron's accounting.[311] He is also familiar with the Nigerian Barges transaction.[312] Stewart testified, if Andersen did become aware of such an oral side agreement, the accounting on the transaction would have changed.

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306 *Id.* at 660:25-662:13.

307 *Id*. at 663:11-24.

308 *Id.* at 699:4-700:25.

309 *Id.* at 704:4-18.

310 9/29/05 Stewart Depo. Tr. at 1093:6-1097:20.

311 *Id*. at 1187:23-1188:8.

312 *Id*. at 1148:10-1149:4.

> Q. If you or anyone at Andersen became aware of an oral side deal between Enron and Merrill Lynch that Enron would find a buyer for Merrill Lynch's interest in the Nigerian barges within six months of Merrill Lynch's purchase and Merrill Lynch would not lose money, would Andersen have approved Enron's accounting for the Nigerian barges transaction?
>
> * * *
>
> THE WITNESS: ***In my view, no***.
>
> Q. How would such an oral side deal have affected the accounting for Enron's sale of the Nigerian barges to Merrill Lynch?
>
> * * *
>
> THE WITNESS:
>
> * * *
>
> ***Had Andersen known about the oral side agreements and the assurances that Merrill would not have lost money, assurances of a fixed return, the appropriate accounting would have been it would not have been a sale at all because of the retention by Enron of the risks and awards of ownership***.[313]

Richard Petersen worked for Stewart in the Professional Standards Group at Andersen and consulted with the Enron engagement team.[314] Petersen was not aware of the oral side agreement in the Nigerian Barges transaction nor, to his knowledge, was anyone else at Andersen aware of it.[315] He was emphatic that if he or anyone knew about it, however, Andersen would not have approved Enron's accounting for the transaction.

> Q. If you or anyone at Andersen became aware of an oral side deal between Enron and Merrill Lynch that Enron would find a buyer for Merrill Lynch's interest in the Nigerian Barges within six months of Merrill Lynch's purchase and Merrill Lynch would not lose money, would Andersen have approved Enron's accounting for the gain in the Nigerian Barges transaction?
>
> * * *

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313 *Id.* at 1152:18-1153:17.

314 10/26/05 Petersen Depo. Tr. at 366:5-7, 366:18-367:3, 420:8-18; 425:8-24, 425:25-426:11.

315 *See id*. at 409:11-410:1, 415:3-8, 417:4-21.

> A. ***Andersen would not have accepted gain recognition in the circumstances that you're describing***.
>
> Q. ***And why would the accounting not have been approved like that***?
>
> * * *
>
> A. ***The shortest statement is just simply that there had been no transfer of risks and rewards at this point with respect to the assets that were purportedly sold***.[316]

Michael Odom, an Andersen audit partner,[317] testified that Enron management colluded with Merrill in connection with the Nigerian Barges transaction:[318]

> Q. And, with respect to the side agreement between Enron Management and Merrill Lynch in the Nigerian Barges transaction, can you think of any persuasive reason why Enron and Merrill Lynch would have participated in that side agreement other than to escape the detection of the understanding between Enron and Merrill Lynch?
>
> * * *
>
> A. I can't think of any reason.[319]

Another Andersen partner, Bass, testified that no one at Andersen was aware of the secret agreement wherein Enron would make sure Merrill was taken out of the Nigerian Barges transaction within six months.[320] Bass agreed "***[t]his [was] the sort of thing that would have sent alarm bells going off at Andersen***,"[321] and that Glisan's and Fastow's testimony indicates ***collusion*** occurred

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316 *Id.* at 410:18-411:14.

317 7/5/06 Odom Depo. Tr. at 18:21-19:18.

318 7/6/06 Deposition Transcript of Michael Odom ("7/6/06 Odom Depo. Tr.") at 319:4-10.

319 *Id*. at 326:10-18.

320 7/18/06 Bass Depo. Tr. at 418:15-419:6.

321 *Id.* at 419:3-6.

between executives at Enron and Merrill and that they were engaged in "***highly deceptive conduct***."[322]

> Q. ***And from the information you have seen now, it appears that Enron and Merrill Lynch did intentionally engage in deceptive conduct, right?***
>
> * * *
>
> A. ***Based on what I've seen, yes, I would agree with that***.[323]

The deception practiced by Merrill was so dangerous, so serious, and had such a devastatingly deceptive effect on the financial reporting that – as testified by Bauer – had the conduct been discovered, Andersen likely would have withdrawn from the Enron engagement and withdrawn its audit opinions for Enron's financial statements affected by the conduct.[324] Indeed, both of Andersen's Audit Practice Directors during 1997-2001 testified that discovery of any such side agreement (verbal assurance, verbal understanding, oral guarantee, etc.,) between Enron management and any bank would have triggered a full scale investigation of the conduct that would have to be resolved before Andersen would have signed another audit opinion or quarterly report for Enron.

Michael Odom, the Andersen Audit Practice Director on the Enron engagement team during 2000-2001, testified if undocumented verbal understandings such as the ones engaged in by Merrill were discovered, "***Certainly, I would have been concerned that we had more than an accounting***

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322 *Id*. at 426:15-427:5.

323 *Id*. at 444:18-24.

324 8/25/06 Bauer Depo. Tr. at 1427:12-24.

***issue*. . . . *[W]e would have a potential situation where a fraud is involved*.”[325] And Andersen’s other Audit Practice Director for the Enron engagement, Gary Goolsby, testified:

> [O]ur process would have been to not sign an audit report or sign off on a quarterly review report until a thorough and complete investigation was performed by the company, the board of directors, audit committee, under their supervision, and present it to us as evidential matter the results of that finding, but – but not issue an audit report until that would be completed.[326]

Goolsby’s and Bass’s testimony indicates such an investigation would have likely led to the withdrawal of Andersen’s audit opinions and the resignation of Andersen from the Enron engagement.[327]

5. Expert Testimony Demonstrates Merrill’s Conduct in the Nigerian Barges Transaction Was Deceptive

Experts who have examined the Nigerian Barges deal have concluded Merrill’s conduct in the fictional sale ***was deceptive in purpose and effect***. Charles R. Drott, an expert in accounting and auditing, concluded:

> It is, therefore, clear, based on above-referenced evidence, that material information regarding the Nigerian Barge Transaction was concealed from Andersen. As a result, Andersen did not have sufficient relevant information to reasonably evaluate Enron’s accounting and financial reporting under GAAP for the Nigerian Barges Transaction.[328]

During his deposition, Drott testified:

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325 7/6/06 Odom Depo. Tr. at 289:10-20. *See also* 7/18/06 Bass Depo. Tr. at 433:6-434:1; 11/30/05 Deposition Transcript of Gary Goolsby (“11/30/05 Goolsby Depo. Tr.”) at 469:4-471:7.

326 11/30/05 Goolsby Depo. Tr. at 469:17-470:2. *See also* 7/6/06 Odom Depo. Tr. at 290:2-4, 323:20-324:23.

327 11/30/05 Goolsby Depo. Tr. at 471:18-473:2; 7/18/06 Bass Depo. Tr. at 431:9-17, 561:9-562:12.

328 Drott Report at §3.5.

A. And my opinion, as you will see in Paragraph 2.11 of my report, was that there was collusion between Enron and the financial institutions referenced in my report, by the use of secret side agreements, and that as a result of that, Enron manipulated its financial statements and engaged in fraudulent financial reporting.[329]

John M. Foster, an expert in accounting, testified:

Q. Based on what you've reviewed, would you agree with me that facts concealed from Andersen in the Nigerian Barges transaction would have caused a material change in the proper accounting?

* * *

A. Yes, they would.[330]

* * *

Q. . . . I take it you're familiar with the term "collusion" as it's used in accounting?

A. Yes.

Q. Would it be fair to say that collusion is deceptive conduct by parties to a transaction that impacts the accounting?

* * *

A. I would phrase it "deceptive conduct by parties to a transaction that affects the accounting is collusion."

Q. Okay. Would it be fair to say that examples of collusion that you have seen in this case include the use of secret verbal assurances and written and oral side agreements by parties to a transaction at or about the time the transaction is executed?

* * *

A. Yes.[331]

* * *

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329 4/28/06 Deposition Transcript of Charles Drott ("4/28/06 Drott Depo. Tr.") at 729:21-730:3; *see also* Drott Report at §2.11.

330 5/15/06 Foster Depo. Tr. at 273:25-274:5.

331 *Id.* at 279:3-280:2.

Q. And Merrill Lynch had a responsibility to not engage in secret side agreements with Enron in the Nigerian Barges and electricity trades transactions, correct?

* * *

A. That's correct.

Q. And accountants reasonably expect that banks and other third parties are not going to engage in this type of deceptive conduct, right?

* * *

A. I think that accountants generally do not expect that their – that people will engage in fraud, which it's clear that that's what was happening here.[332]

Stephen M. McEachern, an expert in accounting and auditing, testified about how Andersen was deceived by the secret verbal agreement in the Nigerian Barges sham:

Q. Now, you used the term "collusion" in one of your conclusions we reviewed a few minutes ago. Would it be fair to say that collusion is deceptive conduct by parties to a transaction that impacts the accounting?

* * *

A. In this – in this context, yes.

* * *

Q. Would it also be fair to say that examples of collusion that you have seen in this case include the use of secret verbal assurances and written and oral side agreements by parties to a transaction at or about the time the transaction is executed?

A. I've seen evidence that there were secret oral agreements, some which were later reduced to writing and remained secret; some that were put in writing initially and remained secret, yes.

* * *

Q. ***And based on your review of evidence, you found there was collusion between Enron and Merrill Lynch in certain transactions, correct?***

* * *

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332 *Id.* at 283:13-284:1.

A. ***Yes***.

Q. ***The Nigerian Barges transaction?***

* * *

A. ***That's correct***.

Q. ***The 1999 electricity trades transaction?***

* * *

A. ***Yes***.[333]

Q. And would you agree with me that testimony [(Fastow's testimony that there was a secret verbal assurance made by him to Merrill)] supports your conclusion; ***specifically, that Merrill Lynch and Enron made a deliberate and concerted effort to conceal the true nature of the Nigerian Barges transaction from Andersen?***

* * *

A ***It does***.[334]

C. Merrill Lynch Committed Acts of Deception and Manipulation by Parking the Barges with LJM2

Not only did Merrill Lynch arrange, sponsor and pre-fund LJM2 for the purpose of engaging in multiple year-end 1999 bogus deals (asset dumps) for Enron and Fastow, it also used LJM2 to further the fraud, ***deceptively "rolling" the parked Nigerian Barges to LJM2*** in June 2000 to complete the back end of that deceit. As Kopper testified in the Nigerian Barges trial, "Enron would use LJM as essentially an off-ramp on deals that they needed to use to make earnings for any given quarter . . . warehousing the asset with LJM for six months with an idea that, six months down the

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333 5/17/06 McEachern Depo. Tr. at 229:17-231:12.

334 5/18/06 Deposition Transcript of Stephen McEachern ("5/18/06 McEachern Depo. Tr.") at 374:9-15.

road, they would deal with it."[335] An example of an asset "***warehousing deal***" that Kopper gave was Merrill Lynch's sale of the Nigerian Barges to LJM2.[336]

Merrill Lynch executives Furst, Fuhs and Brown fully understood this and deceptively parked or "warehoused" the Nigerian Barges with LJM2 from their own "parking lot" to LJM2's "warehouse." As Merrill Lynch internally discussed, "the way we are getting out of the Enron investment on MLIBK Positions books ($7.0m + interest) is having LJM2 Co-Investment LP buy us out through LP Capital Calls, in which MLIBK is also a limited partner."[337] In fact, Enron's former Treasurer, Ben Glisan, helped arrange and directly told Furst that Enron would honor the oral side agreement with Merrill Lynch by having Merrill Lynch "roll" the loan/parking arrangement to another Enron controlled entity. As Ben Glisan testified, in April or May of 2000, he told Furst Enron would be "***rolling***" the secret side deal with Merrill Lynch. He did so singing the *Rawhide* song:

> I was trying to make a joke, and so I sang to him "***Rolling, rolling, rolling***," meaning roll a loan.
>
> Q. And what – and what was his reaction with you when you sang the song?
>
> A. He didn't think that was funny.
>
> * * *
>
> Q. Did Merrill Lynch, when it was taken out by LJM, get its guaranteed rate of return?
>
> A ***Yes, they did***.

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335 9/27/04 Barges Trial Tr. at 1331:13-20 (Kopper testimony).

336 *Id*. at 1332:15-18 ("***There was this Nigerian barge deal where we knew that we would only be holding this asset no longer than through year-end and that Enron would get – take us out of that deal***. And it wasn't documented . . . .").

337 Ex. 72 at ML6892.

Q. And when LJM bought the barges from Merrill Lynch, what terms did LJM get?

A. ***They stepped into Merrill Lynch's shoes and received the same terms***.

Q. And when you say "stepped into the shoes," what do you mean?

A. ***They received the same return as Merrill Lynch and the same promise to be taken out of the transaction***.[338]

Fastow's testimony corroborated this.

Q. And, Mr. Fastow, based on that guaranty or bear hug from Mr. Skilling, did you then take those barges off Merrill Lynch's hands?

A. Yes.

* * *

Q. Do you recall any negotiation between LJM and Merrill Lynch over the price that was going to be set?

A. Well, there's negotiation over – I don't know if there was negotiation over the price. I think there was negotiation over the rate of return they were going to get.

Q. All right.

A. So price really didn't matter if they knew they were getting out with their – what they had paid.

Q. And then from Merrill Lynch, it goes to LJM; correct?

A. Yes.

Q. That's what people saw on the outside, is that right, investors?

A. Yes.

Q. Go underneath that. The first guaranty that you provided to Merrill Lynch; is that right?

A. Yes.

Q. And then another one?

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[338] *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Oct. 6, 2004) ("10/6/04 Barges Trial Tr.") at 3619:16-3621:15 (Glisan testimony).

A. Yes.

Q. Is that the guaranty from Mr. Skilling to you?

A. Yes.[339]

Furst, Fuhs and Brown not only knowingly deceptively re-parked the Nigerian Barges from Merrill Lynch's "parking lot" to LJM2's "warehouse," the two of them joked about it. When the "sale" of the Nigerian Barges from Merrill Lynch to LJM2 closed, Fuhs emailed Brown and Furst, both of whom funded and acted in arranging LJM2, to note the barges ***were "not completely eliminated from [their] book of exposures***."[340] Acknowledging the barges were being "rolled" to LJM2, Fuhs quipped: "***Enjoy the barges on the other side of this trade*** . . . ."[341] Brown responded, alluding to the fact the barges were being parked from one space to the next: "***thanks Bill . . . . wanna buy a barge***?"[342] Fuhs, obviously understanding, responded "***only if I can have a guarantee of make-whole at par + return in case of civil unrest/war***."[343]

Merrill Lynch's "sale" of the Nigerian Barges it was holding for Enron to LJM2 was another act of collusion by Merrill Lynch and Enron. Andersen audit partner Thomas Bauer testified as follows:

> Q. Now, if Enron and Andrew Fastow intended that LJM2 be used to park Enron assets, would that be proper?
>
> A. No, that would not be proper.
>
> Q. Why?

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[339] 3/7/06 Lay/Skilling Trial Tr. at 6497:1-6498:5 (Fastow testimony).

[340] Ex. 33800.

[341] *Id.*

[342] Ex. 33800.

[343] *Id.*

A. Because the transaction – if the intent is really for the risk and rewards to remain with Enron, it would be improper to – to derecognize the asset and place it on the books of someone else outside of Enron.

* * *

Q. Now, if Merrill Lynch sold the Nigerian barges to LJM2 to further park the assets for LJM2 and Enron, that would be another instance of collusion, would it not?

A. It would indicate to me an intent to collude.

Q. Deceptive conduct by Merrill Lynch and Enron, the sort of conduct that a former chairman of the Securities & Exchange Commission has said is difficult and often impossible to detect, right?

A. He did.[344]

Similarly, Andersen audit partner Carl Bass testified:

Q. And if Merrill Lynch sold its interest in the Nigerian Barges to LJM2 to further park the assets for Enron, would that be another instance of collusion?

* * *

A. If I understood the – everything we went over a minute ago, that the assertion is that the – LJM was not really at risk because of promises, such that it was, in essence, controlled by Enron – if I understood all of that, then, in effect, what's occurring here is that they're – they sold it to Merrill Lynch, who then sold it back to Enron. And that would be the promise to buy it back. So . . . ***yes, that would be a form of collusion***.[345]

Merrill Lynch executives Bayly and Brown invoked the Fifth Amendment in response to numerous questions concerning their knowledge that Merrill Lynch parked the barges with LJM2 for Enron. ***Bayly*** and ***Brown*** invoked the Fifth Amendment in response to the following questions:

- "You knew that on June 29, 2000, LJM2-Ebarge LLC bought Merrill Lynch's investment in the Nigerian Barge transaction for $7,525,000?"[346]

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[344] 8/22/06 Bauer Depo. Tr. at 419:11-420:13.

[345] 7/18/06 Bass Depo. Tr. at 440:8-22.

[346] Ex. 14385 at 20; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 18; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

- "You knew that Merrill Lynch and LJM2-Ebarge LLC never negotiated the sale price for Merrill Lynch's ownership interest in the Nigerian Barge transaction?"[347]

- "You knew that LJM2 E-Barge LLC was a special-purpose entity established by Enron CFO Andrew Fastow's LJM2 Co-Investment L.P. to repurchase Merrill Lynch's interest in the Nigerian Barge transaction?"[348]

- "Consistent with the oral side agreement in the Nigerian Barges deal, by approximately June 30, 2000, Merrill Lynch's purported interest in the Nigerian Barges was purchased at the rate of return orally agreed upon with Enron CFO Andrew Fastow in December 1999, correct?"[349]

- "At that time you understood LJM2 entered a transaction with Merrill Lynch that appeared to be a purchase of Merrill Lynch's interest in the Nigerian Barges?"[350]

- "At or about this time you also understood from executives at Merrill Lynch, including Robert Furst, that LJM2 had the same oral side agreement with Enron that Enron had made with Merrill Lynch in December 1999, correct?"[351]

- "Specifically, you understood LJM2 would receive the same return as Merrill Lynch and the same promise to be taken out of the transaction as Merrill Lynch did in the Nigerian Barges deal, correct?"[352]

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347 Ex. 14385 at 20; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 18; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

348 Ex. 14385 at 20; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 18; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

349 Ex. 14385 at 31; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 29; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

350 Ex. 14385 at 31; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 30; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

351 Ex. 14385 at 32; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 31; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

352 Ex. 14385 at 33; 9/29/06 Bayly Depo. Tr. at 35:4-13; Ex. 14386 at 31; 10/12/06 Brown Depo. Tr. at 41:24-42:11.

D. Merrill Committed Acts of Deception and Manipulation by the Bogus Electricity Trades Deal

In December 1999, Enron approached Merrill about a transaction between Enron Power Marketing, Inc. and Merrill Lynch Capital using two electricity derivative contracts.[353] This was another of the three major transactions Merrill and Enron engaged in for the purpose of falsifying Enron's year-end 1999 earnings. Like the Nigerian Barges transaction, Merrill and Enron unwound the Electricity Trades ***after*** Enron reported its fourth quarter and year-end 1999 earnings pursuant to a clandestine understanding. And like the Nigerian Barges transaction, Merrill and Enron entered contracts that on their face appeared to be physical and financial trading contracts and appeared to transfer risk but omitted the true contrary intent of the parties that the transaction was structured to be risk free.

One of the contracts was a physically settled call option contract which on its face indicated Enron intended to deliver power to Merrill from three mid-west peaking power plants starting September 1, 2000.[354] The other contract was a financially settled call option contract granting Enron the right to obtain from Merrill the difference (in dollars) between (i) the market price of energy in the future, and (ii) the price set forth in an agreement (the "strike price").[355] Enron intended to "mark-to-market" the financial contract and immediately record approximately $50

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353 *See* Ex. 50006.

354 *See* Foster Ex. 6A at AASDTEX003048459-60, 65-66 (discussing delivery points, term and quantity); Ex. 51091 at AA-EX00152793, 95; 4/13/06 Expert Report of John M. Foster ("Foster Report"), Ex. 81 at AASDTEX002377855 ("AALLP reviewed the contract terms, noting that delivery is specified at points near the peaker plants."); Solomon Report at 137.

355 *See* Foster Report, Ex. 79; Solomon Report at 137.

million in earnings, and separately account for the physical delivery contract on an accrual basis.[356] Presto – $50 million in profits.

Fundamental accounting requirements for the transaction included that the two contracts not "relate to the same risk."[357] Significant risk had to pass to Merrill in the transaction for it not to be a sham. Not only was this a well known accounting requirement under Derivative Implementation Group (DIG) Issue K1 ("Determining Whether Separate Transactions should be viewed as a Unit"), it was also published guidance by the SEC. For example, in an enforcement action release dated December 31, 1997, the SEC found a ***sham*** two contemporaneous commodities supply transactions where no significant risk passed to a counterparty that was effectively paid a fee for generating accounting earnings.[358]

On the face of the contracts there ***appeared*** significant risk associated with delivery of the electricity. For example, Andersen accountants Thomas Bauer and James Brown wrote:

> We believe significant risk has passed to MLC and the contracts are separate and should be accounted for independently. . . . [W]hile the physical contract requires delivery of power at the busbar near the plant, the financial contract settles against an "Into" index. MLC would need to buy Financial Transmission Rights (FTRs) to bring the power to the "Into" index point which is more widely traded.[359]

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356 Ex. 51091 at AA-EX00152793.

357 Ex. 51091 at AA-EX00152794-95 (original emphasis omitted).

358 McEachern Ex. 23A at AASDTEX001039358 (finding transaction that "failed to transfer significant risk to a bona fide third party" did not comport with regulatory requirements); 5/17/06 McEachern Depo. Tr. at 276:7-279:1; 5/15/06 Foster Depo. Tr. at 127:25-132:1; 8/22/06 Bauer Depo. Tr. at 393:18-24.

359 Ex. 51091 at AA-EX00152794. *See also* Foster Report, Ex. 81 at AASDTEX002377854-55 (AALLP concluded that significant risk had passed to MLC and the contracts should be accounted for independently.); 5/15/06 Foster Depo. Tr. at 118:6-15, 122:8-19; 5/17/06 McEachern Depo. Tr. at 271:18-272:15.

Also fundamental to the accounting requirements for the transaction was that Merrill and Enron intend for power to be delivered under the physical contract, *i.e.*, the physical contract actually had to be a legitimate physical contract. Again, all ***appearances*** were that the physical contract was not an energy trading contract, but rather that physical power would be delivered. Andersen accountants Bauer and Brown understood "Enron intend[ed] to serve the contract from an Enron Plant," "delivery is near Enron's plants," and "Enron intend[ed] to deliver physical power to MLC and settle gross."[360] Thus, Andersen found the physical contract was indeed a physical contract.[361] In fact, the Electricity Trades depended on the fiction that power would be delivered.

But, as Merrill and Enron knew, there was an oral side agreement that the transaction would be unwound and reversed. *See infra* §III.D.4. Thus, as there was virtually no risk associated with delivery of the electricity, there was no significant risk that would pass between Enron and Merrill in the transaction. *See infra* §III.D.2., 5.-8. Indeed, Enron and Merrill never negotiated for delivery of power and understood power would not be delivered. Rather, Merrill and Enron intended that Merrill be paid a fee in part for the accounting results Enron sought and the transaction was unwound before any trade was ever exercised. Notwithstanding, Enron booked and reported $49 million in earnings from the electricity trades transaction.[362]

1. Merrill Knew the Electricity Trades Were Not to Deliver Power but Were "for Accounting Purposes" and Was Motivated to Make the Transaction "Truly Risk Free"

Merrill knew at the outset the purpose of the Electricity Trades was solely to create phony profits for Enron, therefore it expected and was motivated to execute a transaction that was risk free.

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[360] Ex. 51091 at AA-EX00152795.

[361] *Id.*; Foster Report, Ex. 81 at AASDTEX002377854-55; 5/15/06 Foster Depo. Tr. at 120:2-121:1.

[362] *See* Ex. 104 at AASDTEX000397529.

In an email dated December 16, 1999, Merrill energy trader Barry Kostiner wrote Dan Gordon, a Managing Director in the Derivatives Trading division of Merrill's Global Trading Power Group, and discussed the electricity trades. He wrote, "[i]t is not merely a question of should the premium be $0.20/MWh or $0.50/MWh, but how we handle the execution issues."[363]

Kostiner explained by "a few key points" in his email.[364] The first "key point" was that "$0.20/MWh does not justify doing anything unless it is ***truly risk free*** or the benefits can be clearly articulated."[365] Kostiner acknowledged the purpose of the Electricity Trades was not to deliver power, but rather was "for accounting" and emphasized the need for the transaction to have "***no execution risk***," *i.e.*, be risk free:

> ***If Enron is committed to making this transaction for accounting purposes, they should be able to either demonstrate to us that there is no execution risk or give us an actual financial back to back trade independently with ECT*** e.g. we charge them $0.75 for this trade and pay ECT $0.73 for the financial component.[366]

As Merrill knew, Enron ***was*** committed to making the Electricity Trades for accounting purposes and ***did*** demonstrate there was no risk through an understanding that the trades would be terminated/unwound prior to delivery of any power.

Indeed, Merrill had less concern about whether the transaction was bogus than whether it could make money without significant risk. Merrill's electricity business generated "very little" in fees in 1999, "maybe even a little less than 15 million," and that included the $8.5 million that was

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363 Drott Ex. 44 at MLNBY0270408.

364 *Id.*

365 *Id.*

366 *Id.*

reaped from the unwound electricity contracts with Enron.[367] Thus, ***the bogus Electricity Trades accounted for over half of the fees generated by Merrill's electricity business in 1999***.

If Merrill was actually going to take delivery of power from Enron in this transaction (not feign it intended to take delivery of power) it would have to develop operations it did not even have at year-end 1999. "***[O]ne of our concerns was the ability not just to resell it but actually when you take delivery of electricity you've got to schedule it, operationally schedule it over the lines***."[368] "The – this was a sizeable physically settled transaction that would have required Merrill to staff the desk 24 hours a day. ***It was a transaction we had never done before***. There were discussions at the meeting about how [Merrill] would have to hire several people just to manage this one transaction . . . ."[369] Of course, this potential ramp up in operations devoted to the trades did ***not*** occur, for Merrill's investment bankers understood the transaction would be unwound before any scheduled delivery of power.

2. Merrill Structured the Electricity Trades to Have No Risk, But Was Promised a Huge Payment Because of the False Accounting Results Its Conduct Generated

As the year-end 1999 Electricity Trades went to Merrill's Special Transactions Review Committee (the "STRC") alarm bells went off, due to the fact Merrill was about to falsely inflate Enron's fourth quarter and year-end 1999 earnings. After the presentation for the transaction review was distributed to the committee, the committee's chairman delayed the meeting.[370] Then, as members of the STRC learned more about the transaction, the meeting was stopped and then started

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[367] Ex. 50001 at 29:22-30:16.

[368] Ex. 50001 at 47:16-22.

[369] 10/31/05 Deposition Transcript of Locke McMurray ("10/31/05 McMurray Depo. Tr.") at 120:14-20.

[370] Ex. 50002 at 182:18-183:6.

again "at least three times," to (among other things) speak directly to Enron's Chief Financial Officer and directly to Enron's outside auditors, Andersen.[371]

Indeed, by a number of accounts there were "strange" or "unusual" happenings at the meeting. The lawyer on the STRC was asked to leave the room.[372] The STRC's chairman departed from the "usual" procedure and required the department head where the transaction originated to stay in conference for the vote to approve the transaction.[373] In an unprecedented event, the Committee asked to speak directly to Enron's Chief Financial Officer and Enron's outside auditors, Andersen.[374]

Yet the chairman of the STRC, McCann, who, according to those at the meeting, asked the most questions and was most concerned about the transaction, claims not to recall asking to speak directly to Andersen, does not recall the department head being present in the approval vote, does not recall if he was informed of Enron's intent to unwind the Electricity Trades shortly after the transaction's close (*i.e.*, before any scheduled delivery of power), and does not recall hearing the transaction would create year-end earnings for Enron.[375] Incredibly, ***there are no minutes of the STRC meeting to help him recall***, or the Court or a jury determine, all that truly occurred. Why not? In yet another unusual event concerning the meeting, ***minutes were not recorded – despite***

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[371] Ex. 11657 at 56:2-9.

[372] 10/31/05 McMurray Depo. Tr. at 97:10-14 ("I thought it was strange."); *id.* at 192:13 ("I was surprised.").

[373] 6/17/04 Kronthal Depo. Tr. at 335:13-336:8; Ex. 50002 at 132:12-21 ("Q. Did you stay on the phone for the vote? A. Unusually, yes. Mr. McCann asked me to.").

[374] 6/17/04 Kronthal Depo. Tr. at 315:8-12, 320:5-9, 321:16-25, 325:17-20.

[375] 9/22/05 Deposition Transcript of Robert McCann ("9/22/05 McCann Depo. Tr.") at 116:13-117:3, 139:20-140:12, 222:14-18, 225:5-15, 227:14-24**.**

Merrill Lynch's by-laws – which specifically required minutes be prepared at "each meeting," and "retained by the Chairman."[376]

a. The STRC Learns the Electricity Trades Will Cause Enron to Falsely Book at Least $50-$60 Million Fourth Quarter and Year-End Earnings and Boost Officer Compensation

The presentation to Merrill's STRC made it obvious the Electricity Trades would not transfer significant risk to Merrill. Merrill was being paid a $17 million fee directly for the accounting effect of the transaction, and the transaction was otherwise recommended to improve Merrill's relationship with Enron.[377] The STRC presentation was circulated three times prior to the STRC meeting for the Electricity Trades and was verbally presented during the meeting.[378]

Repeatedly, the STRC presentation communicated there would be no significant risk that would pass to Merrill in the electricity trades:

- "The Global Power Trading Group requests permission to enter into a '***back-to-back***' electricity derivative transaction with Enron Power Marketing, Inc. ('EPMI')."[379]
- "The quantities, pricing points, market locations and term are ***'mirror' image***."[380]

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376 *See* Ex. 21338A at DLNBY000222 ("The CICG Counsel Representative present at the STRC meeting shall be responsible for preparing minutes of each meeting, which shall consist of the name of the client, a brief description of the transaction, a list of persons participating in the meeting and their votes, if any. The minutes, the term sheet (or other transaction details) and a copy of the Client Transaction Checklist should be retained by the Chairman and CICG Counsel."); 9/22/05 McCann Depo. Tr. at 42:21-43:15 (can't recall any minutes); 10/31/05 McMurray Depo. Tr. at 82:3-4 ("the STRC did not have formal minutes").

377 *See* Exs. 50008, 50010, 50011.

378 *See* Exs. 50008, 50010, 50011; 6/16/04 Deposition Transcript of Jeffrey Kronthal ("6/16/04 Kronthal Depo. Tr.") at 213:18-214:1.

379 Ex. 50011 at MLBE0370934.

380 *Id.*

- "The two call options . . . serv[e] to create a ***delta-neutral*** position for both parties . . . ."[381]

- "**Market Risk Management** . . . . ***The proposed transaction is 'back-to-back' and is therefore 'delta-neutral.'***"[382]

Members of the STRC meeting as well as accounting and auditing experts agree the terms above communicated no significant risk would pass to Merrill in the transaction.

For example, the lawyer who was asked to leave the STRC meeting at one point testified that at the meeting "***the discussion was that the trades were largely without market risk***."[383] He further testified:

> Q. Is it the fact that the principal terms of the two trades are mirror images, mirror image of each other that leads to there being little or no market risk?
>
> * * *
>
> A. ***Yes.***
>
> * * *
>
> A. Okay. So you have the one contract with market risk in it, right? And you can mitigate that market risk in a variety of ways. One of which is to do a transaction with equal and opposite terms with somebody else, right?
>
> A. Or indeed, as happened here, with the same counterparty, although the transactions weren't identical in the sense that one was physical and one was financial. And there was also, there was actually, the actual prices that were being used in the trades were not exactly identical
>
> A. So that – so they were – this is what I mean by largely offsetting but not 100 percent offsetting.[384]

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381 Ex. 50011 at MLBE0370935.

382 Ex. 50011 at MLBE0370936.

383 10/31/05 McMurray Depo. Tr. at 185:13-186:8; Ex. 11657 at 58-61.

384 Ex. 11657 at 59:13-60:12; *see also* 10/31/05 McMurray Depo. Tr. at 57:16-20 ("I think delta neutral is a highly technical term. . . . ***[I]t means that whatever happens in the market is not going to have an impact on the value of transactions in that market.***"); Ex. 21881 at MLBE0354395 ("Booked large 'back-to-back' financial and physical call option trades on electric power . . . .

As Merrill STRC member and department head Jeffrey Kronthal admitted:

> Q. And you wouldn't have to do any hedging because basically both parties were not in or out of the money with respect to each other, correct? Is that what delta-neutral means?
>
> A. ***Yes***.
>
> Q. That's, in part, related to the mirror-image aspect of the two options, right?
>
> A. ***Correct***.
>
> Q. And the back-to-back nature of the transactions?
>
> A. ***Correct***.[385]

Experts agree the terms "***delta-neutral***," "***mirror-image***," and "***back-to-back***" and their context within the STRC presentation communicate no significant risk would pass to Merrill in the Electricity Trades. Stephen McEachern, a former member of the Auditing Standards Board, testified:

> Q. (BY MR. JACONETTE) Let's take a look at the section entitled Market Risk Management on the page ending 936. There, in the first bullet point, it states, quote: The proposed transaction is back-to-back and therefore delta-neutral. Do you see that?
>
> A. Yes.
>
> Q. ***Back-to-back and therefore delta-neutral is another way of saying there's no risk, correct?***
>
> A. ***That's what I would . . . interpret that to mean, yes***.
>
> * * *
>
> Q. ***Would you agree with me this internal Merrill Lynch document indicates that Merrill Lynch also believed that the two transactions represented no risk to Merrill Lynch, as the risks in the two contracts exactly offset?***

Because the trades offset, they are market neutral."); 10/31/05 McMurray Depo. Tr. at 164:10-11 ("I would suspect that [market neutral] is pretty close to being the same meaning as delta neutral.").

385 Ex. 50001 at 204:13-22.

*   *   *

A. ***Yes***.[386]

STRC members could not recall Merrill ever entering a transaction such as this, with back-to-back, delta-neutral, mirror-image trades.[387] As Locke McMurray testified, "I don't think Merrill Lynch did other trades like that."[388] And as Robert McCann testified, "[t]his was the only transaction of this type that came in front of the STRC in the period when I was the chairman."[389]

The transaction clearly raised red flags of accounting manipulation and financial reporting falsification, as the STRC presentation twice in block letters attempted to disclaim responsibility for the transaction's accounting treatment.[390] Dan Gordon and Schuyler Tilney, the authors of the STRC presentation, ***invoked the Fifth Amendment in response to numerous questions concerning their knowledge that the accounting treatment resulting from the Electricity Trades was false***.[391]

Indeed, when the STRC learned Enron would book year-end 1999 profits on this no-risk transaction, as alleged by the SEC, "Merrill Lynch executives were angry and embarrassed at this revelation" and "***a Merrill Lynch employee expressed reservations about the transaction because it***

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386 5/17/06 McEachern Depo. Tr. at 289:8-290:10. *See also* 4/26/06 Deposition Transcript of Charles Drott ("4/26/06 Drott Depo. Tr.") at 602:1-6 ("To me, ***delta neutral and mirror image means that two trades offset one another such that both parties have virtually no impact***."); 5/15/06 Foster Depo. Tr. at 148:14-150:4 ("Q. Back – quote, ***back-to-back and, quote, therefore delta-neutral, close quote, is another way of saying there is no risk***? A. ***Yes, it is***.").

387 6/17/04 Kronthal Depo. Tr. at 374:2-375:6.

388 10/31/05 McMurray Depo. Tr. at 55:15-16.

389 9/22/05 McCann Depo. Tr. at 61:20-22.

390 *See* Ex. 50011 at MLBE0370934.

391 8/22/05 Deposition Transcript of Daniel Gordon ("8/22/05 Gordon Depo. Tr.") at 20:14-21:4, 22:13-23, 30:19-31:14, 34:2-12, 34:23-35:6; Ex. 14096 at 7 (Question No. 31); 6/7/04 Deposition Transcript of Schuyler Tilney ("6/7/04 Tilney Depo. Tr.") at 13:20-14:1, 18:7-13, 28:5-13, 30:1-7.

appeared to him to be a ploy by Enron to manipulate its earnings."[392] As one STRC member testified:

> Q. [O]ne of the reasons ***Enron wanted to enter into these trades was to achieve earnings for year-end purposes***, correct?
>
> A. ***Yes***.
>
> * * *
>
> A. At the STRC meeting the issue was definitely discussed.
>
> * * *
>
> ***The – one of the major topics of discussion at the STRC was the appropriateness of Enron's accounting treatment for these transactions. And that concern was raised in large part by the fact that it was so, you know, kind of time-sensitive driven*** . . . .
>
> Q. ***And when you say time sensitively driven . . . do you mean, by that do you mean that Enron wanted to enter into these transactions by year-end?***
>
> A. ***Yes***.
>
> Q. And tell me what you recall about the discussion at the STRC with respect to this issue?
>
> A. ***Well, Bobby McCann, in particular, was concerned about the Enron's motivations and accounting treatment of the transaction. And he was repeatedly asking Dan, and probably Jeff Kronthal, what those reasons were and whether or not it was appropriate for Enron to be doing the transaction and accounting for it the way we understood them to be accounting for it***.[393]

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[392] Ex. 50024, ¶42.

[393] Ex. 11657 at 54:8-55:24. *See also* Ex. 11657 at 62:7-62:19; 10/31/05 McMurray Depo. Tr. at 71:3-12, 73:10-21; 6/16/04 Kronthal Depo. Tr. at 188:16-24 ("***They had a desire to . . . print some profits from the transaction.***"); 6/16/04 Kronthal Depo. Tr. at 244:13-23; Ex. 50002 at 161:21-25 ("***Q. Can you recall anyone raising a concern about this transaction being used by Enron to manipulate its earnings? A. As I recall, at the STRC there was a discussion that this would create earnings***."); Ex. 105 (10/29/04 Allegheny Deposition Transcript of Jeffrey Kronthal) at 41:24-42:1 ("we understood . . . one of the purposes was to create year-end earnings"); 8/22/05 Gordon Depo. Tr. at 29:23-31:4.

As Schuyler Tilney wrote internally at Merrill, "***we were clearly helping them make earnings for the quarter and the year (which had great value in their stock price, not to mention personal compensation***").[394]

Thus, understanding the transaction transferred little or no risk yet would result in Enron "creating" or "printing" profits at year-end (*see supra* n.393) to boost personal compensation for Enron's officers, the STRC was under no illusions here. STRC member Locke McMurray further testified:

> Q. Okay. And do you recall any concerns on the part of any of the STRC members or anyone else who was present at the meeting with respect to the fact that the offsetting trades had little or no market risk?
>
> A. Well, that was – that was, I think, probably fair to say, that coupled with the year-end nature of the transactions were, you know, really the sources of most, if not all, of the concerns.[395]

Alarmed by these concerns, the STRC immediately stopped their meeting and sought to contact both Enron's Chief Financial Officer and Enron's outside auditors, Andersen. STRC members could not recall ***ever*** asking to speak directly to a client's Chief Financial Officer or outside auditors in connection with a transaction's approval.[396] ***Not once***.

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[394] Ex. 50028 at MLBE0370956. *See also* 6/17/04 Kronthal Depo. Tr. at 452:6-22 ("[I]t came up as part of the STRC meeting.").

[395] Ex. 11657 at 60:13-22. *See also* 10/31/05 McMurray Depo. Tr. at 71:3-12 (McCann "was concerned about what he viewed as the accounting driven nature of the transaction and the timing of the transaction."); Ex. 50002 at 98:2-10; 6/16/04 Kronthal Depo. Tr. at 7-19; 6/17/04 Kronthal Depo. Tr. at 313:6-15, 315:23-25 ("I think it was a very natural reaction, when you are dealing with 50 to 60 million of profits at year-end . . . .").

[396] *See, e.g.*, 6/17/04 Kronthal Depo. Tr. at 320:5-9 ("Q. In the years that you have been on the STRC, has the STRC had a client senior management officer join the STRC meeting or at any other meeting, that you can recall? A. I can't recall.").

Gordon, Furst and Tilney, each of whom was present at the STRC meeting in person or by phone, invoked the Fifth Amendment in response to numerous questions regarding their knowledge that the Electricity Trades were shams where no significant risk would pass to Merrill.

Furst invoked the Fifth Amendment in response to the following questions:

- "In December 1999 you knew that the 1999 Electricity Trades Transaction had no legitimate economic purpose for Enron?"[397]

- "You knew that Merrill Lynch's Special Transaction Review Committee was informed, on or about December 29, 1999, that the proposed 1999 Electricity Trades Transaction had no market risk for Merrill Lynch?"[398]

Tilney invoked the Fifth Amendment in response to the following questions:

- "Merrill Lynch entered into virtually offsetting electricity-derivative transactions that you knew Enron was using to achieve target year-end earnings and as to which you knew Enron's accounting was improper?"[399]

- "And Merrill Lynch knew the two call options in the proposed EPM energy transaction eliminated the risk of loss to Merrill Lynch?"[400]

- "Merrill Lynch's special transactions review committee was informed on or about . . . 12/29/99, that the proposed EPM transaction had no market risk for Merrill Lynch, correct?"[401]

Gordon invoked the Fifth Amendment in response to the following questions:

- "Is it true you knew in December of 1999 that Merrill Lynch's Special Transactions Review Committee was informed on or about December 29,

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397 8/22/05 Deposition Transcript of Robert Furst ("8/22/05 Furst Depo. Tr.") at 32:11-22; Ex. 31746 at 27 (Question No. 183).

398 8/22/05 Furst Depo. Tr. at 32:11-22; Ex. 31746 at 29 (Question No. 197).

399 6/7/04 Tilney Depo. Tr. at 18:7-13.

400 6/7/04 Tilney Depo. Tr. at 26:17-22.

401 6/7/04 Tilney Depo. Tr. at 27:6-12.

1999, that the proposed 1999 Electricity Trades Transaction had no market risk for Merrill Lynch?"[402]

- "Is it true you knew in December of 1999 that the only risk to Merrill Lynch as a result of its involvement in the 1999 Electricity Trades Transaction was credit risk?"[403]

It's no wonder that those involved took the Fifth Amendment and that Merrill attempted to shield itself from liability.

b. After Being Blocked from Communicating with Enron's Auditors, Andersen, Merrill Attempts to Shield Itself from Liability

Realizing that Merrill was about to engage in a transaction structured such that no significant risk would pass to Merrill and yet Enron would book huge year-end profits, the STRC tried to speak directly to Enron's Chief Financial Officer and directly to Enron's outside auditor, Andersen.[404] They contacted Enron's Chief Accounting Officer, Causey, who ***confirmed Enron intended to take $50-$60 million in earnings on the transaction and that it would affect bonuses of senior management at Enron***.[405] But Causey ***refused*** to allow the STRC to speak with Andersen:

> Q. Did the STRC ask Mr. Causey if the STRC could have a conversation with Arthur Andersen?
>
> A. To the best of my recollection, that was brought up in the conversation . . . he said that his preference would be that he would – he would have the conversations with Andersen . . . .

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[402] 8/22/05 Gordon Depo. Tr. at 28:7-16.

[403] 8/22/05 Gordon Depo. Tr. at 28:17-24.

[404] *See* 6/17/04 Kronthal Depo. Tr. at 313:6-15, 315:8-12, 315:16-316:3; 10/31/05 McMurray Depo. Tr. at 93:16-23.

[405] 6/17/04 Kronthal Depo. Tr. at 316:20-317:6.

> Q. And Mr. Causey said that he would prefer that you not speak with Arthur Andersen, correct?
>
> A. That is the best of my recollection, yes.[406]

Notwithstanding that Enron would book $50+ million year-end earnings on a transaction that had little or no risk transfer and the clear indication that Enron did not want Merrill to make Andersen aware of the accounting falsification, Merrill went ahead with the deal.

Merrill obviously did not trust Causey because when he orally represented he had spoken with Andersen concerning the transaction, Merrill asked for a written representation, and then conditioned its participation on receiving a written "warrant letter" from Enron.[407] Given all these accounts, this letter was nothing more than a contrivance and a "CYA" – to try separating Merrill from what it clearly knew it was doing. As the SEC put it, this conduct showed Merrill "attempted to create a record that it thought would shield itself from liability or exposure."[408] As found by the SEC, given the circumstances, this disclaimer letter was not only inappropriate, it further implicates Merrill in the accounting manipulation.[409] STRC members could not recall ever asking for a letter such as this.[410] ***Not once***.[411]

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406 6/17/04 Kronthal Depo. Tr. at 325:17-326:21.

407 Ex. 50002 at 135:16-136:13; Ex. 11657 at 61:11-15, 64:12-13 ("The STRC approved the trades subject to getting that letter."); Ex. 11661 (approval "given based on . . . Enron . . . sign[ing] a letter requested by the STRC").

408 Ex. 50024, ¶43.

409 *See* Ex. 50024, ¶43; 5/15/06 Foster Depo. Tr. at 243:5-15.

410 2/16/05 Deposition Transcript of David Lund ("2/16/05 Lund Depo. Tr.") at 131:24-132:10.

411 Notably, Merrill's electricity trading expert testified that in his electricity trading career he had never heard of such a practice. 5/10/06 Deposition Transcript of Gary Dorris ("5/10/06 Dorris Depo. Tr.") at 218:20-24.

Gordon, Furst and Tilney have all invoked the Fifth Amendment in response to the following questions regarding their knowledge the Electricity Trades would falsify Enron's financial statements.

Furst invoked the Fifth Amendment in response to the following questions:

- "You knew that Enron's financial statements for the fourth quarter and year-end of '99 were false due to the electricity trades transaction, correct?"[412]

Tilney invoked the Fifth Amendment in response to the following questions:

- "Likewise, you knew that the so-called power swaps were a phony sham transaction that was entered into with the express intent of falsely representing the financial results of Enron?"[413]

- "Merrill Lynch knew that Enron's proposed accounting for the EPM energy transaction was in violation of generally accepted accounting principles?"[414]

Gordon invoked the Fifth Amendment in response to the following questions:

- "Is it true you knew in December 1999 that Enron's proposed accounting for the 1999 Electricity Trades Transaction violated Generally Accepted Accounting Principles?"[415]

It's no wonder that those involved took the Fifth Amendment and that Merrill attempted to shield itself from liability. Bauer, an auditor who was deceived by Merrill's conduct in the Electricity Trades transaction, testified:

> Q. Making trades that are mirror image and back-to-back is a way to make a commodity trading transaction without significant economic risk, right?
>
> * * *
>
> A. It – it would eliminate the risk transference, yes.

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412 8/22/05 Furst Depo. Tr. at 31:20-32:2.

413 6/7/04 Tilney Depo. Tr. at 13:20-14:1.

414 6/7/04 Tilney Depo. Tr. at 30:1-7.

415 8/22/05 Gordon Depo. Tr. at 34:23-35:6.

Q. In the enforcement action we've been discussing, the SEC found that it was false and misleading for a company to report earnings based on mirror-image commodity trades that it entered, right?

A. It did.

Q. And from your work, you understood the Merrill Lynch power contracts were not mirror image and back-to-back, right?

A. Based on the representations that we received from management and the language in the contracts that we reviewed, we understood they were not mirror contracts and not back-to-back contracts.

Q. And you would have wanted to know if, at the time of the transaction's close in December 1999, Merrill Lynch understood the Merrill Lynch power contracts would be treated as mirror image and back-to-back, right?

A. That would have been very important information and would have altered the conclusion that we reached on the transaction.

Q. And – and so if you became aware Merrill Lynch had such an understanding, you would have treated that very seriously, correct?

A. Yes, sir.

Q. That would have indicated to you deceptive conduct, would it not?

A. It would.

Q. Deceptive conduct that causes impropriety in financial statements?

A. Yes.

Q. Deceptive conduct that would have caused Enron to file materially false and misleading statements with the Securities and Exchange Commission?

A. If the agreement had gone forward and accounted for as it was accounted, I believe that would result in a false filing in the financial statements.[416]

[416] 8/25/06 Bauer Depo. Tr. at 1434:12-1436:4.

3. In Addition to Improving Its Lucrative Investment Banking Relationship with Enron, Merrill Had "17 Million Reasons" for Executing the Bogus Transaction

The weightiest reason for Merrill engaging in this transaction was to improve its lucrative investment banking relationship with Enron. As stated in the STRC presentation:

- Enron is a core client of Merrill and the Energy & Power IBK Group, in particular (ML Relationship Manager Robert Furst)
- Merrill has earned over $50 million in fees from Enron in 1999, including $40 million resulting from the IPO of Azurix, Inc. – an Enron company
- There have been recent "strains" in the relationship with Enron relating to an aborted Weather-Bond issuance
- IBK has indicated that the execution of this transaction is one of the highest priorities for both Enron and for the Merrill Energy & Power IBK Group

Conclusion

- In consideration of all the aforementioned, the Global Power Trading Group believes that this transaction is beneficial to Merrill, both financially and with respect to the client relationship, and requests permission from the STRC to enter into the proposed transaction.[417]

In addition to the fact that engaging in this deception would help secure further lucrative business downstream, Merrill engaged in the Electricity Trades because it was promised $17 million. The STRC presentation stated: "***The proposed transaction is expected to generate an upfront fee of $17 million***."[418] One STRC member admitted, Merrill approved the Electricity Trades because Enron was an investment banking client and it would receive a $17 million fee.[419] Indeed, the SEC

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417 Ex. 50011 at MLBE0370937. *See also* 2/16/05 Lund Depo. Tr. at 92:17-93:25 ("Merrill Lynch and Enron were trying to develop an expanded relationship . . . ."); *id.* at 94:2-16 ("Q. So it was your understanding that [this transaction] was important to Enron? A. Yes."); Ex. 11660 ("Enron is anxious to execute the trade ASAP.").

418 Ex. 50011 at MLBE0370934.

419 10/31/05 McMurray Depo. Tr. at 183:20-184:24.

found a "high level Merrill Lynch executive stated that Merrill Lynch had '***17 million reasons***' for getting the transaction approved."[420]

And not only did Merrill understand it was engaging in conduct that would falsify Enron's accounting, it understood the fee it was to be paid was in part specifically for causing Enron's desired accounting effect.[421] Not only was this communicated to the STRC, but it was also internally acknowledged at Merrill between the executives who originated the transaction with Enron.

> Talking with Dan Gordon this evening, with Robert in close attendance . . . . Per Dan, the actual components of the ***original*** 17mm NPV of the premiums was split as 50% fee, 50% option value. In other words, ***50% of the premium value was not from the optionality, but was a flat fee for doing the trade and servicing their particular accounting need***.[422]

As Gordon wrote to Tilney and Furst, when the trades were unwound in mid-2000, "***in light of their earnings number (and personal compensation benefits), the $17 million does not seem too significant for them***."[423]

4. Merrill and Enron Had an Oral Side Agreement that the Year-End 1999 Electricity Trades Would Be Unwound and Reversed

The back-to-back, mirror-image, delta-neutral, and little- or no-risk nature of the Electricity Trades was structured with an oral side agreement between Enron and Merrill at the transaction's outset that the trading contracts would be ***unwound*** prior to the delivery of power. As Fastow states in his declaration:

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420 Ex. 50024, ¶42.

421 *See, e.g.*, Ex. 50011 at MLBE0370935 ("This fee has been based on the term of the trade, the size of the trade and the [accounting] benefits enjoyed by Enron as a result of the transaction . . . .").

422 Ex. 11664 at MLNBY0394451 (emphasis in original).

423 Ex. 50028 at MLBE0370956.

> ***Based on my conversations with senior Enron and Merrill executives, I understood that, at the time the transaction closed in December 1999, there was a verbal agreement between Mr. Baxter and Mr. Tilney to unwind the transactions in 2000 in exchange for a predetermined fee to be paid by Enron to Merrill. Before the transaction closed I assured Mr. Tilney that Mr. Baxter's verbal agreement would be honored by Enron. I do not believe Merrill would have entered into these transactions absent the agreement to unwind the transactions and to pay the predetermined fee***.[424]

This oral side agreement, of course, did not appear in the power purchase contract governing the transaction and which was relied upon by Enron's auditors, Andersen. *See infra* at 123-125. This is in part how Merrill satisfied its desires to enter a "truly risk free" transaction. *See supra* §III.D.1.

Gordon, Furst and Tilney, the former Merrill executives who spoke with Enron at the outset of the Electricity Trades regarding the promised unwind of the trades and/or who were principally involved with the origination and unwind of the trades, have all invoked the Fifth Amendment in response to the questions regarding the secret oral side agreement to unwind and reverse the transaction.

Furst invoked the Fifth Amendment in response to the following questions:

- "Merrill Lynch had an unwritten agreement with Enron with respect to the 1999 electricity trade transactions that the physical contracts between Enron and Merrill Lynch would be terminated before physical delivery of power, correct?"[425]
- "Enron orally promised Merrill Lynch that it would not have any risk and/or liability on the Peakers transactions, correct?"[426]
- "Enron told Merrill Lynch that if the Peakers transactions did not involve any risk to Merrill Lynch that Arthur Andersen would disapprove of Enron's desired accounting treatment for the Peakers transactions, correct?"[427]

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424 Fastow Decl., ¶36. *See also id.*, ¶¶37-40; 10/23/06 Fastow Depo. Tr. at 268:2-275:6.

425 8/22/05 Furst Depo. Tr. at 34:5-9.

426 8/22/05 Furst Depo. Tr. at 34:19-35:3; Ex. 31748 at 6 (Question No. 38).

427 8/22/05 Furst Depo. Tr. at 34:19-35:3; Ex. 31748 at 6 (Question No. 39).

- "Enron explained to Merrill Lynch that any agreement regarding the guarantee that Merrill Lynch would have no risk had to be kept oral so that Arthur Andersen would not know of it, correct?"[428]

- "The unwritten agreement between Merrill Lynch and Enron was intentionally concealed from Arthur Andersen by Merrill Lynch, correct?"[429]

- "You knew that Enron's financial statements for the fourth quarter and year-end of '99 were false due to the electricity trades transaction, correct?"[430]

- "By at least December 1999 you knew the purpose of the 1999 Electricity Trades Transaction was to inflate Enron's reported net income by approximately $50 million?"[431]

Tilney invoked the Fifth Amendment in response to the following questions:

- "Likewise, you knew that the so-called power swaps were a phony sham transaction that was entered into with the express intent of falsely representing the financial results of Enron?"[432]

- "Merrill Lynch entered into virtually offsetting electricity-derivative transactions that you knew Enron was using to achieve target year-end earnings and as to which you knew Enron's accounting was improper?"[433]

- "Merrill Lynch knew Enron would unwind the sham . . . electricity trade before a single option was exercised?"[434]

- "And during that 12/30/99 meeting of the special transactions review committee, at least one or maybe more members of the committee expressed concerns about the propriety of Enron's intended accounting for the proposed EPM transaction, right?"[435]

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428 8/22/05 Furst Depo. Tr. at 34:19-35:3; Ex. 31748 at 6 (Question No. 40).

429 8/22/05 Furst Depo. Tr. at 34:13-18.

430 *Id.* at 31:20-32:2.

431 *Id.* at 32:11-22; Ex. 31746 at 26 (Question No. 176).

432 6/7/04 Tilney Depo. Tr. at 13:20-14:1.

433 *Id.* at 18:7-13.

434 *Id.* at 19:12-17.

435 *Id.* at 28:5-13.

- "Merrill Lynch knew that Enron's proposed accounting for the EPM energy transaction was in violation of generally accepted accounting principles?"[436]

- "In fact, you had been informed by an Enron executive in December 1999 before Merrill Lynch executed the trades that he believed Enron would want to unwind the trade, hadn't you?"[437]

- "Isn't it true that, before the 1999 Electricity Trades Transaction closed, Enron's Cliff Baxter told you that Enron intended to unwind the 1999 Electricity Trades Transaction before maturity?"[438]

Gordon invoked the Fifth Amendment in response to the following questions:

- "Is it true you knew in December of 1999 before finalizing the 1999 Electricity Trades Transaction, that Enron was going to unwind the transaction?"[439]

- "Is it true you knew in December 1999 that Enron's proposed accounting for the 1999 Electricity Trades Transaction violated Generally Accepted Accounting Principles?"[440]

- "Is it true that before the 1999 Electricity Trades Transaction closed Enron's Cliff Baxter told you that Enron intended to unwind the 1999 Electricity Trades Transaction before maturity?"[441]

Tilney recently partially recanted his Fifth Amendment responses to certain questions, agreeing to testify about all topics except the Nigerian Barges transaction. In response to a question by his counsel at deposition, he testified that to his knowledge Merrill and Enron never entered an

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436 *Id.* at 30:1-7.

437 *Id.* at 32:4-11; Ex. 30065 (Lead Plaintiff's Deposition Questions to Schuyler Tilney at 37 (Question No. 424)).

438 Ex. 30065 (Lead Plaintiff's Deposition Questions to Schuyler Tilney at 41 (Question No. 271)).

439 8/22/05 Gordon Depo. Tr. at 19:15-22.

440 *Id.* at 34:23-35:6.

441 *Id.* at 38:16-24.

agreement to unwind the Electricity Trades prior to June of 2000.[442] According to Tilney, however, his recollection of events in December 1999 is quite limited.[443] This is all belied by Fastow's declaration. Fastow states not only was there an oral side agreement to unwind the Electricity Trades in December 1999, but ***Tilney was the one who required it***. Furthermore, in December 1999, Tilney called Fastow and "asked whether he could trust Mr. Baxter to honor the oral agreement to unwind the power-trade deal and to pay Merrill the prearranged compensation."[444] And Tilney called Fastow again in the first half of 2000 and asked for Fastow to back up the side agreement when Baxter tried to renege on it.[445] As Fastow testified, he then went to Skilling to make sure Enron would honor its side deal, and explained to Skilling, "if we made deals like this with the

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442 8/18/06 Deposition Transcript of Schuyler Tilney ("8/18/06 Tilney Depo. Tr.") at 577:17-21.

443 *See* Ex. 106 (6/14/06 Arkansas Deposition Transcript of Schuyler Tilney) at 197:15-18 ("I don't remember the exact conversation, it being a number of years hence"); *id.* at 198:9-14 ("[a]gain, I don't remember the specific conversation"); *id.* at 200:19-23 ("I can't remember the specific call as I mentioned to you."); *id.* at 200:24-201:4 ("As I said, I can't remember the specific call."); *id.* at 205:9-12 ("I can't remember the call specifically."); *id.* at 205:16-19 ("I can't really remember the call."); *id.* at 206:23-207:4 ("I don't really remember the issue."); *id.* at 207:5-8 ("I don't really remember."); *id.* at 207:16-18 ("Q. Did you ever speak to Andy Fastow about the 1999 year-end energy transactions? A. Not to my recollection, no."); *id.* at 208:2-4 ("I can't remember."); *id*. at 208:18-20 ("I don't remember."); *id.* at 209:9-13 ("I don't remember."); *id.* at 209:15-18 ("I don't remember."); *id.* at 210:23-211:4 ("I don't remember specific conversations whether these took place. . . . I don't remember specific conversations . . . ."); *id.* at 217:9-11 ("I don't remember why."); *id.* at 217:19-22 ("Again, I don't remember sending this email . . . ."). *See also* 8/17/06 Tilney Depo. Tr. at 242:5-9 ("I don't remember."); *id.* at 242:10-13 ("I don't have a great amount of recall. I really don't remember that call very well."). *See also* 8/18/06 Tilney Depo. Tr. at 414:18-23 (As I said, I don't remember my conversations with Mr. Baxter during the end of 1999."); *id*. at 415:5-10 ("As I remember, that – again, I don't remember our specific conversations."); *id.* at 417:5-11 ("I don't remember this email."); *id.* at 439:11-19 ("As I testified a little bit earlier, I don't remember any of my conversations with Mr. Baxter at the end of 1999, so I don't remember him telling me that."); *id.* at 494:25-495:7 ("I don't remember . . . . I'm very hazy on all that."); *id.* at 496:3-8 ("I have no recollection.").

444 Fastow Decl., ¶38. *See also* 10/23/06 Fastow Depo. Tr. at 270:12-271:12.

445 Fastow Decl., ¶39. *See also* 10/23/06 Fastow Depo. Tr. at 271:17-273:5.

banks, we had to live by our deals."[446] Skilling said he would "take care of it."[447] And, of course, it is now well established the Electricity Trades were unwound and the fee paid.

5. The Oral Side Agreement Shows the Physical Contract Was Not Legitimate and There Was No Significant Risk in the Transaction

The understanding the Electricity Trades would be unwound is inconsistent with the notion that the physical trading contract was a physical trading contract or an energy trading contract or was ever intended to be treated as such. John Foster, who was a member of the Financial Accounting Standards Board ("FASB") for 10 years, from 1993 to 2003, and an expert in accounting for energy trading contracts, testified that although the physical contract appeared to be a physical contract, in fact it was not.[448] Even Merrill's expert, Gary Dorris, admits that he cannot recall ever in his trading career discussing at a transaction's close that a trade would be unwound.[449] He also admits that if there was an agreement to unwind the Electricity Trades such as the one evidenced here, "then there would be no delivery risks."[450]

Indeed, the understanding the transaction would be unwound prior to any delivery of power indicates the physical contract was ***not*** a physical contract. As Foster testified, "***if there was an agreement to unwind before any delivery of power, that would indicate that the physical contract was probably not a physical contract***."[451] "***There is evidence that there was intention to unwind***

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[446] 10/23/06 Fastow Depo. Tr. at 273:19-25.

[447] 10/23/06 Fastow Depo. Tr. at 274:3-6.

[448] 5/15/06 Foster Depo. Tr. at 117:17-127:2, 186:19-187:7, 207:5-209:9; 5/17/06 Deposition Transcript of John Foster ("5/17/06 Foster Depo. Tr.") at 726:20-728:11, 734:3-5.

[449] 5/10/06 Dorris Depo. Tr. at 297:25-298:10.

[450] 5/10/06 Dorris Depo. Tr. at 52:13-24; *see also id*. at 53:21-23.

[451] 5/15/06 Foster Depo. Tr. at 207:21-25.

the contracts before the deliveries ever occurred, in which case they would have never made any deliveries."[452] "***[T]hese transactions weren't real transactions***."[453]

6. The Termination of the Power Trades Demonstrates They Were Never Legitimate Contracts Involving Significant Economic Risk

There is additional evidence that this transaction was not legitimate and there was an oral side agreement between Enron and Merrill that the Electricity Trades would be ***unwound***, effectively canceling the transaction as if it did not exist, after Enron reported its year-end 1999 earnings.

Under the physical contract, power deliveries could be scheduled not sooner than September 1, 2000.[454] Yet less than 60 days after execution of the contracts (and seven months prior to any scheduled delivery of power) Cliff Baxter contacted Dan Gordon at Merrill to ***unwind*** the Electricity Trades.[455] Not a single option had been exercised under the contracts. Not one watt of power delivered. Baxter, however, would not agree to pay the $17 million fee promised to Merrill by Enron, and so Gordon would not unwind the transaction early pursuant to the parties' understanding at the outset of the transaction.[456]

Baxter again contacted Merrill and sought to unwind the transaction pursuant to the earlier understanding. But once again, Enron sought to renegotiate the $17 million fee promised Merrill. Executives at Merrill were furious. On May 30, 2000, Gordon reported that Rodney Malcolm of

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452 5/17/06 Foster Depo. Tr. at 723:3-728:11.

453 5/17/06 Foster Depo. Tr. at 734:3-5. *See also* 5/17/06 McEachern Depo. Tr. at 271:15-275:24; 5/3/06 Deposition Transcript of Saul Solomon ("5/3/06 Solomon Depo. Tr.") at 744:8-24.

454 Ex. 107 at MLNBY0244509, MLNBY0244515, MLNBY0244519.

455 *See* Ex. 50022 at 8.

456 *See id.*

Enron had called him and Malcolm "indicated that he expected Merrill Lynch to terminate the trade for nothing – ie. no fee would be paid to Merrill Lynch."[457] Merrill executives Robert Furst and Schuyler Tilney had participated in the negotiation with Cliff Baxter to garner the $17 million fee and the understanding to unwind the transaction after Enron got its accounting results. Now, somebody else from Enron was seeking to unwind the transaction after Enron got its accounting results, but without paying a fee. Furst's response to Gordon's email was terse: "***He is obviously smoking dope***." *Id*.

Tilney also responded to Gordon's email, stating that he, Furst and Baxter had discussed the "***unwind***," "***at yearend when we did this trade***,"[458] and 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***)."[459] Gordon agreed: "in light of their earnings number (and personal compensation benefits), ***the $17 million does not seem too significant for them***."[460]

Tilney also called up Fastow to complain that Baxter was cutting Merrill's fee. Fastow stated in his declaration: "In the first half of 2000 Mr. Tilney called me again about this transaction and told me that Mr. Baxter was trying to 're-trade' (*i.e.*, renege on) the oral agreement by cutting Merrill's fee. He asked if I knew anything about it and if I could do anything. I told Mr. Tilney that I would talk to Mr. Skilling about it."[461]

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457 Ex. 108 at MLNBY0360162.

458 Ex. 50028 at MLBE0370956.

459 *Id*.

460 *Id.* Merrill later agreed to take $8.5 million.

461 Fastow Decl., ¶39.

Nonetheless, Gordon, Furst and Tilney all recognized that Enron's attempt to renegotiate the $17 million fee would have to be accommodated and the trades could not be resolved like true energy contracts, given the secret understanding of the parties at the outset of the transaction. Tilney asked Gordon and Furst: "What would you think was a 'fair' number in the absence of relationship issues?"[462] Gordon responded: "$17 million sounds fair to me."[463] Indeed, Gordon, Furst and Tilney also understood that if they forced Enron to abide by the trading contracts on their face (without regard to the secret understanding of the parties) Merrill could settle the trades for much more than $17 million.

7. Merrill's Conduct in Negotiating the Termination of the Power Trades Demonstrates the Physical Contract Was Not Legitimate and There Was No Significant Risk

Energy traders take their gains by settlement or otherwise and do not "unwind" trades, certainly not for half of the money to which their trades entitle them. Discussions between Gordon, Furst and Tilney illustrate Merrill's unwind of the Electricity Trades was at odds with what Merrill was entitled to from Enron on the face of the trading contracts had they been legitimate and truly subject to market risk– but consistent with the parties' verbal understanding at the outset that the transaction would be unwound after Enron booked its earnings. The circumstances of the termination confirm the physical contract was never a real physical trading contract or a real energy trading contract.

Discussing how to respond to Enron's attempt to renegotiate Merrill's fee, Gordon posited what would happen if Merrill acted according to "reality" instead of according to the understanding

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[462] 3/17/06 Expert Report of Stephen McEachern ("McEachern Report"), Ex. 41 at MLBE0370956. *See also* Ex. 108 at MLNBY0360162 ("Let [Malcolm] get back to you with a bid.").

[463] McEachern Report, Ex. 41 at MLBE370956.

that the trades would be unwound prior to delivery of power. "Honestly, the trade has significantly moved against [Enron] so ***in reality to 'rip' the trade up at the original fee of $17 million sounds fair to me. Otherwise, we would simply run the trade for 4 years which would cost them significantly more than the $17 million***."[464] Indeed, Merrill believed that it was "in the money" on the Electricity Trades significantly more than $17 million if one abided by the trading contracts.

First, a $17 million premium – the "upfront fee" – was built into the trading prices agreed to in the contracts.[465] Second, according to what Merrill told a Senate Permanent Subcommittee, the trades increased in value by $2 million as of when the transaction was fully unwound.[466] Thus, according to Merrill the value of the trades was at least $19 million when unwound. As one Merrill executive testified to the SEC, Dan Gordon expressed in a meeting in his office that a valuation of "north of $20 million" was justified.[467] Finally, Furst wrote on June 7, 2000 that "the trade has moved away from Enron by $8mm," which would place the value at $25 million.[468]

Notwithstanding that "in reality" the Electricity Trades would have resulted in a profit of significantly more than $17 million, up to $25 million as of June 7, 2000, Merrill unwound the trades for $8.5 million. The justification known at Merrill for accepting the lower $8.5 million, was that 50% of the original $17 million fee agreed to was "***a flat fee for doing the trade and servicing [Enron's] particular accounting need***."[469] As Paul Copson wrote:

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464 McEachern Report, Ex. 41 at MLBE0370956.

465 2/16/05 Lund Depo. Tr. at 292:2-8; 6/16/04 Kronthal Depo. Tr. at 189:18-191:23; Ex. 50011 at MLBE0370934.

466 Ex. 50022 at 8.

467 Ex. 109 at 164:23-165:12 (9/13/02 Sworn Testimony of Rob L. Jones to the SEC).

468 *See* Ex. 110 at MLNBY0360096.

469 Ex. 11664 at MLNBY0394451.

> Per Dan, the actual components of the *original* $17mm NPV of the premiums was split as 50% "fee" 50% "option value." ***In other words 50% of the premium value was not from the optionality, but was a flat fee for doing the trade and servicing their particular accounting need***. In unwinding the trade we have just priced the option which is why the ***fee*** from ENRON is only $8.5 mm."[470]

Acknowledging that the transaction was to service Enron's particular accounting need, Merrill accepted an $8.5 million fee, at least $10 million less than what the purported trading contracts stated Merrill was entitled to.

All of this is inconsistent with the notion that the physical trading contract was a physical trading contract or an energy trading contract or was ever intended to be treated as such.

As Foster testified:

- "[A]nother factor that – that causes me to believe that is the manner in which it was unwound. . . . [T]ypically if traders don't like a position they're in, they don't go back to the counterparty and say, let's unwind this transaction. They enter into mirror contracts which effectively negate their position, either with the same current counterparty or another counterparty. ***That this was a negotiated settlement indicates to me that there was some understanding that this thing was going to be unwound and we're not going to pay attention to the contract terms***."[471]

- "The fact that it was a – again, a negotiated settlement versus do what the contracts say, ***all indicate to me that there was another understanding which hasn't been expressly documented***. I understand that . . . that these transactions weren't real transactions. And if it wasn't a real transaction . . . . [i]t doesn't constitute an energy contract that's not an energy trading contract."[472]

- "[A]gain, what traders do is they – they don't go back and say, tear it up or rip the trade up. Nobody would – would agree to that if they were in the money on the trade. They don't negotiate settlements. They go by the contract terms. So what – what this really says to me is there is something else going on in this trade."[473]

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470 *Id.*

471 5/17/06 Foster Depo. Tr. at 729:9-730:12.

472 *Id.* at 733:24-734:9.

473 *Id.* at 737:12-19.

- "And just think about it. From a – from a reasonableness standpoint, ***why would the person with a gain be willing to take less than that gain or the person with a loss be willing to pay more than that gain, when there is a liquid market for these things?*** All they have to do is go to the market, and they can get exactly what that gain is."[474]

- "Why would Enron call Merrill Lynch and expect them to terminate the trade for anything other than the value in the trade, ***unless there is some other understanding other than the trade itself? It's very clear to me there is an understanding in this transaction that's not documented in those two trades***."[475]

Indeed, Foster ***testified that although the physical contract appeared to be a physical contract, in fact it was not***. *See supra* §III.D.5.

8. The Electricity Trades Transaction Deceived Andersen and Falsified Enron's Financial Statements, Artificially Inflating 1999 Earnings by $50 Million

Experts and fact witnesses in this case agree that "collusion," a term of art in the accounting and auditing profession, is deceptive conduct by parties to a transaction that impacts the accounting for the transaction.[476] Experts and fact witnesses in this case also agree that Merrill's conduct in connection with the Electricity Trades ***was collusion***.[477] Oral side agreements such as the one in this transaction are a perilous form of deception. *See supra* §III.D.4.

Indeed, the collusion between Merrill and Enron evidenced above falsified the accounting treatment for the Electricity Trades transaction. This is demonstrated in testimony by experts, John

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474 *Id.* at 751:6-13.

475 *Id.* at 785:15-22.

476 *See* Drott Report §2.11; 5/15/06 Foster Depo. Tr. at 279:13-19; 5/17/06 McEachern Depo. Tr. at 229:17-230:1; 5/23/06 Murovitz Depo. Tr. at 117:1-6; 7/5/06 Odom Depo. Tr. at 237:3-16; 7/17/06 Bass Depo. Tr. at 291:4-15.

477 *See, e.g.*, Drott Report §§2.11, 3.26-.29; 5/15/06 Foster Depo. Tr. at 278:20-279:6, 281:6-19, 283:13-285:13; 5/17/06 McEachern Depo. Tr. at 230:25-231:10, 242:3-22, 243:5-16; 9/29/05 Stewart Depo. Tr. at 1162:21-1168:3, 1195:25-1199:8.

Stewart, an Andersen accountant who consulted on the Electricity Trades transaction, and Thomas Bauer, the Andersen partner who audited the transaction. Bauer testified:

> Q. And having seen the contracts to the transaction, there was no question in your mind that the parties to this transaction, Merrill Lynch and Enron, understood when they entered it that physical delivery contract had to be honored with physical delivery, right?
>
> A. That's what I understood from the contract terms.
>
> Q. If you discovered that when Enron and Merrill Lynch had entered the Merrill Lynch power contracts transaction they had a verbal understanding that the contracts would be unwound at some point before any power was scheduled to be delivered, you would not have approved Enron's accounting, correct?
>
> A. That's correct.
>
> Q. In fact, if you discovered this, alarm bells would have gone off at Andersen, right?
>
> A. That's correct.[478]

Bauer testified that in auditing the Electricity Trades transaction, he and members of his team reviewed a Power Purchase Agreement and relied on terms in the agreement to reach conclusions about whether this transaction was properly accounted for by Enron.[479] But the oral side agreement between Merrill and Enron to unwind the transaction was, of course, ***omitted*** from the Power Purchase Agreement.

> Q. Those provisions that you reviewed during your audit indicated to you there would be delivery of power in the transaction, correct?
>
> A. It did, and that was one of the points that was critical to the conclusion on the physical contract side, that it was, in fact, a – a contract involving physical delivery.

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478 8/22/06 Bauer Depo. Tr. at 402:16-403:8.

479 8/25/06 Bauer Depo. Tr. at 1437:5-1438:2; *see also* Ex. 44349 at ECTe001129777-78 (Articles 5 and 6, concerning delivery of power); *id*. at ECTe001129779 (Article 7, §§7.1(i)-(k), (n), concerning delivery of power, no representations or assurances, and arm's-length nature of agreement); *id*. at ECTe001129787-88 (Article 16, §16.1, stating agreement constitutes entire agreement of the parties).

> Q. And – and that particular conclusion was one thing that was critical to Enron booking approximately $50 million in profits from this transaction at year-end 1999, correct?
>
> A. It was one of the critical points that are discussed in my memorandum summarizing the conclusions on the transaction.
>
> Q. If Merrill Lynch anticipated there would not be delivery of power in the transaction, that would be inconsistent with those provisions, right?
>
> A. It's inconsistent with my reading of the provisions of the agreement.
>
> * * *
>
> Q. Would you agree with me that if Merrill Lynch anticipated there would not be delivery of power in this transaction, you were deceived by your review of this provision in the power purchase and sale agreement we're talking about? Right?
>
> A. If there was no intent to take the – the power, it would be contrary to the provisions of the agreement and the representations that were provided to me by Enron management.
>
> Q. In such a case, you would be deceived by collusion between Enron and Merrill Lynch, right?
>
> A. I believe so, yes.[480]

Bauer also testified that he was deceived by his review of terms in the Power Purchase Agreement relating to the completeness of that contract:

> Q. And if Merrill Lynch and Enron had an understanding this transaction would be terminated at some point before any scheduled deliveries of power, that would be inconsistent with this clause that we've been looking at Section 16.1 that you reviewed in connection with your audit, right?
>
> A. It would.
>
> * * *

480 8/25/06 Bauer Depo. Tr. at 1439:14-1441:1. *See also* 8/25/06 Bauer Depo. Tr. at 1441:5-1444:17; Ex. 44349 at ECTe001129777-78 (Articles 5 and 6, concerning delivery of power); Ex. 44349 at ECTe001129779 (Article 7, §§7.1(i)-(k), (n), concerning delivery of power, no representations or assurances, and arm's-length nature of agreement).

Q. And would you agree with me that if there was such an understanding, you were deceived by your review of this provision in the power purchase and sale agreement?

* * *

A. I would agree.

Q. Deceived by collusion between Enron and Merrill Lynch?

* * *

A. In my opinion, yes.[481]

Bauer further testified that if Andersen discovered an oral side agreement to unwind the transaction such as the one here it would have ***negated the accounting treatment*** for the transaction and there would have been ***no profits*** to book from the transaction.[482]

Stewart was the head of the Accounting Principles section of Andersen's Professional Standards Group and was the top expert with whom the Enron engagement team regularly consulted in evaluating Enron's accounting.[483] Stewart testified that neither he nor anyone at Andersen, to his knowledge, was aware that Merrill and Enron structured the Electricity Trades such that there was virtually no risk to Merrill.[484] According to Stewart, if Enron planned on unwinding the transaction without delivering power that would have been an "***important difference***" between what Andersen understood and the true facts.[485] Stewart also testified as to how the proper accounting would have

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481 8/25/06 Bauer Depo. Tr. at 1446:15-1447:7; *see also* Ex. 44349 at ECTe001129787-88 (Article 16, §16.1, stating agreement constitutes entire agreement of the parties).

482 8/22/06 Bauer Depo. Tr. at 405:14-407:15.

483 9/29/05 Stewart Depo. Tr. at 1186:23-1187:8. Enron's Court-appointed Bankruptcy Examiner has called John Stewart one of the foremost accounting experts in the United States. *See* Final Interim Report of Neal Batson, App. B (Ex. 111) at 30. Stewart consulted with the Enron engagement team concerning the Electricity Trades. Ex. 51091 at AA-EX00152795.

484 9/29/05 Stewart Depo. Tr. at 1163:21-1164:23.

485 9/29/05 Stewart Depo. Tr. at 1164:10-1165:08.

changed had Andersen become aware that there was an understanding the transaction would be unwound prior to the delivery of power:

> So when you combine the absence of an intent and ability to deliver the power as the SEC alleges and there is really no difference in risk between the two contracts, they presumably should have been viewed as one arrangement.[486]

Stewart testified, if he knew Enron intended to unwind the transaction without delivering any power, Andersen would not have agreed with Enron's accounting on the transaction.[487]

And both Foster (former member of the FASB) and McEachern (former member of the Auditing Standards Board) testified that the intent of the parties reflected in internal Merrill documents would have had a material effect on the accounting for the Electricity Trades transaction had it been disclosed. For example, Foster testified as follows:

> Q. And based on your review of the documents I've shown you concerning the electricity trades transaction and what you've reviewed in Mr. McEachern's report, is it your opinion that facts concealed from Andersen in that transaction would have caused a material change in the proper accounting?
>
> * * *
>
> A. Yes. Again, the fact that there were – was no risk in the transaction which was concealed from Andersen and the fact – and/or the fact that the transaction unwound early would cause the accounting to be materially different.[488]

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486 9/29/05 Stewart Depo. Tr. at 1166:16-20.

487 9/29/05 Stewart Depo. Tr. at 1168:10-19.

488 5/15/06 Foster Depo. Tr. at 256:16-257:3. *See also* 5/15/06 Foster Depo. Tr. at 124:15-127:2, 256:2-9; 5/17/06 McEachern Depo. Tr. at 273:8-275:24; 5/18/06 McEachern Depo. Tr. at 278:18-314:15, 367:24-368:12.

Foster testified that if Enron and Merrill eliminated risk in the Electricity Trades the amount of earnings that should have been properly reported by Enron would have been "***zero***."[489] Foster further testified, "it could have even been a loss recorded."[490]

As Solomon testified, "when you combine the near mirror image of the two contracts with the intent to unwind it before its – you know, actually has to be executed, I think you end up with a – ***a pretty risk-free situation for everybody***."[491] He concluded Enron's financial statements were overstated approximately $50 million by the Electricity Trades transaction.[492]

E. Merrill Lynch Manipulated Its Analyst Coverage to Please Enron – the Firing of John Olson

John Olson was an equity analyst at Merrill Lynch covering the energy sector, including Enron, from 1992 until 1998.[493] In July of 1997, Olson lowered his rating on Enron stock from accumulate to neutral in the intermediate term, with a long-term buy rating.[494] Enron was unhappy with Olson's neutral rating on its stock, and Enron officers, including Fastow, Lay and Skilling,

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489 5/15/06 Foster Depo. Tr. at 257:4-258:18. *See also* Foster Report at 113 ("Had Andersen known that the contracts were going to be cancelled and had no effect, they likely would have viewed the physical contract as an energy trading contract. If so, its value would have substantially offset any value arising from the financial contract and there would have been little, if any, effect on earnings from the two contracts in 1999.").

490 5/17/06 Foster Depo. Tr. at 726:14-15.

491 5/3/06 Solomon Depo. Tr. at 744:19-745:4.

492 Solomon Report at 133.

493 Ex. 52190 at 6-7, 11.

494 *See* Ex. 112 at ELIB00000621-00001 (7/17/97 John E. Olson, Merrill Lynch, Comment: "Enron Corp. – ENE will Rise Again and Fight Another Day: But Not Today"). *See also* Ex. 52190 at 43; Ex. 113 at 1 ("Intermediate Term: Neutral"); Ex. 114 at 1 ("Intermediate Term: Neutral"); Ex. 115 at 1 ("Intermediate Term: Neutral"); Ex. 116 at 1 ("Intermediate Term: Neutral").

pressured Olson and Merrill Lynch to change Merrill Lynch's equity coverage of Enron.[495] As Olson testified:

> Ken Lay once told me over the phone that Enron was for its friends. "We are for our friends. And if you are our friend, you know, you will have a happy ending or be rewarded," presumably with investment banking business or something like that. And Enron would keep a scorecard of every analyst and what his recommendation or her recommendation was every time they wrote a report, they had – and he was fully aware of this, because he was – once he read off over the phone – I never saw this. He read off over the phone what my recommendations were. Neutral, neutral and everyone else is a strong buy, and, you know, sorry, you don't make it, and, you know, you're not one of our friends, by implication.[496]

According to Tilney, Fastow approached him about a large ($800 million-$1 billion) equity offering in early 1998.[497] Fastow told Tilney extreme secrecy was necessary.[498] Based on his conversations with Fastow, Tilney expected that Merrill would be either lead or co-lead manager of the potential offering.[499] Fastow later called Tilney to tell him the offering was going forward, but Merrill would have no part of the offering.[500] Tilney was upset and asked Fastow why Merrill was being excluded from the offering. According to Tilney, Fastow told him, "it was a decision of the two senior managers in the company, Mr. Lay and Mr. Skilling, and that they were disappointed with [Merrill's] research coverage and that that was the reason for [Merrill] not being included."[501]

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495 *See* Ex. 40052 at MLBE0087040-41 (4/18/98 memorandum to Allison from Gordon and Tilney); Ex. 52190 at 50-51, 68-70; Ex. 117 at MLBE0156663 (5/22/98 email from John Olson to Andrew Melnick, Merrill Lynch).

496 12/7/04 Deposition Transcript of John Olson ("12/7/04 Olson Depo. Tr.") at 140:17-141:13.

497 8/17/06 Tilney Depo. Tr. at 152:24-153:18.

498 8/17/06 Tilney Depo. Tr. at 154:14-16.

499 8/17/06 Tilney Depo. Tr. at 156:5-157:4.

500 8/17/06 Tilney Depo. Tr. at 162:11-163:14.

501 8/17/06 Tilney Depo. Tr. at 164:12-16.

According to Fastow, he "drew a short straw" among Enron's senior management in that he was asked to deliver the message to Merrill "that it would be difficult, if not impossible, for Enron to give Merrill the business of leading an equity offering for Enron because their equity analyst was saying not to buy the stock."[502] In other words, John Olson's research cost Merrill a role in the equity offering.[503] Tilney testified this was the "sole reason . . . or the primary reason," Merrill was cut out of the deal.[504] Indeed, "it was well-known to the investment banking community that in order to be a friend of Enron, the analysts had to be on board in giving strong ratings."[505]

Indeed, it was not just Merrill Lynch's ability to participate in a lucrative offering that was at stake. Merrill Lynch had an opportunity to advance its status with Enron in general.

> Q. Did you have any role or any insight into John Olson being removed from covering Enron?
>
> * * *
>
> A. A little bit, yes.
>
> Q. What was that?
>
> A. I had certain interactions with the Merrill Lynch executives – Schuyler Tilney and Rick Gordon, in particular – where we discussed whether or not Merrill Lynch would get certain business from Enron. We discussed whether Merrill Lynch could be a Tier 1 bank, and we discussed changes in their analyst coverage of Enron.[506]

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502 10/24/06 Fastow Depo. Tr. at 519:4-19.

503 8/17/06 Tilney Depo. Tr. at 165:22-24.

504 8/17/06 Tilney Depo. Tr. at 164:19-20

505 8/17/06 Tilney Depo. Tr. at 141:14-19.

506 10/24/06 Fastow Depo. Tr. at 518:11-23.

Merrill Lynch, a Tier Three bank at Enron, had consistently asked Enron to view it as a Tier One bank.[507] After it was communicated that if Merrill Lynch gave positive analyst coverage of Enron it would tend to improve Merrill Lynch's Tier status, Merrill Lynch acted.

Within a month, Merrill Lynch fired Olson.[508] Olson's termination was directly related to his equity coverage of Enron and the criticisms expressed by Tilney and Gordon. *Id*. When asked whether he believed that Merrill fired him because of his coverage of Enron, Olson testified: "100 percent."[509] In fact, Olson had received a very favorable performance review for the previous year, with no indication of dissatisfactory performance. His overall performance had actually improved from 1996 to 1997.[510] And Olson was ranked in Institutional Investor, and on the Institutional Investor list for many years, including 1997.[511]

Internally at Merrill Lynch the move to fire Olson started immediately the day after Merrill Lynch was informed it would be excluded from Enron's equity offering. At that time, Rick Gordon and Schuyler Tilney, senior executives in charge of Merrill's Global Energy & Power division, wrote a memorandum to Merrill's Chief Executive Officer, Herb Allison. In the memorandum they requested Allison call Lay and Skilling to ask Enron to reconsider its decision and insert Merrill as a co-manager in the offering.[512] Tilney and Gordon emphasized that Merrill's research relationship

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507 10/24/06 Fastow Depo. Tr. at 517:11-17.

508 Ex. 52190 at 45-46; *see also* Ex. 117 at MLBE0156663.

509 Ex. 52190 at 52. *See also* 12/7/04 Olson Depo. Tr. at 134:12-19.

510 *See* Exs. 52191, 52192 (1996 and 1997 Olson performance reviews).

511 12/7/04 Olson Depo. Tr. at 147:3-16.

512 Ex. 40052 (4/18/98 memorandum to Allison from Gordon and Tilney); *see also* Ex. 18 at 20.

with Enron had been tense for an extended period of time as a result of Olson's coverage.[513] In response to the memorandum, Allison placed a call to Lay, and as a result, Enron inserted Merrill into the stock offering as co-manager.[514] Internal Merrill Lynch documents indicate that within days of the stock offering the decision was made to terminate Olson and Olson was so informed.[515]

After Merrill fired Olson it appointed another equity analyst, Donato Eassey, to cover Enron.[516] Fastow recalled receiving a phone call from Tilney after the appointment of the new equity analyst where Tilney told him he should expect to see some good coverage of Enron.[517] According to Fastow, Tilney also expressed Merrill's desire to be viewed differently in terms of getting to lead an equity underwriting following Olson's termination.[518] In Eassey's first report on

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513 Ex. 40052.

514 Ex. 50022 (9/13/02 letter from James B. Wiedner, Clifford Chance US LLP, to the Honorable Carl Levin, Chairman, PSI, and the Honorable Susan Collins, Ranking Member, PSI) at 3; Ex. 118 at MLBE0034547-602 (4/23/98 Materials for the Merrill Lynch Equity Strategy Board ("ESB") and Equity Commitment Committee (the "ECC") meeting); *id*. at MLBE0034548 (stating that Enron had "asked Merrill Lynch to co-manage an add-on offering of 15.0 million primary shares of Common Stock"). *See also* Ex. 18 at 21.

515 Ex. 119 at MLNBY0314128-31 (5/15/98 Memorandum from Margot Leffler, Merrill Lynch, to Susan Preli, Merrill Lynch) (attachment – Termination Authorization Form (MLBNY0314129)). *See also* Ex. 18 at 21-22; Ex. 117 at MLBE015663.

516 Ex. 120 (5/21/03 Sworn Statement of Donato J. Eassey, former Vice President in Securities and Research at Merrill Lynch, to Robb Hellwig, A & B) at 14-15.

517 10/24/06 Fastow Depo. Tr. at 520:1-9.

518 10/24/06 Fastow Depo. Tr. at 520:10-16.

Enron, he upgraded Merrill's rating on Enron stock from neutral to accumulate.[519] The ratings in Eassey's reports marked a significant favorable change for Enron as compared to Olson's reports.[520]

Indeed, through Eassey Merrill Lynch issued numerous reports that stoked the price of Enron's securities in 1999-2001, sometimes as many as four reports in a day, and reiterated "BUY" ratings with new reasons to buy or accumulate Enron's stock right up until it was disclosed the SEC was investigating Enron's related-party entities (*e.g.*, LJM2).[521] Merrill's reports contributed to statistically significant stock price increases on January 19, 1999, April 13, 1999, November 9, 1999, January 20, 2000, January 21, 2000, January 24, 2000, April 12-13, 2000, July 27, 2000, January 22-23, 2001, April 18, 2001, May 18, 2001, June 27, 2001, October 10, 2001.[522] Merrill's reports also buoyed Enron's stock price from further declines that would have occurred absent Merrill's reports throughout 1999-2001.

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519 Ex. 112 ELIB00000631-00001-04 (1/20/99 Donato J. Eassey, Merrill Lynch, Comment: "Enron Corp. – Solid Results in A Difficult Environment"); Ex. 120 at 27-28. *See also* Ex. 18 at 22; Ex. 121 at 1 ("Intermediate Term: Accumulate") ("Enron Corp. – Solid Results In a Difficult Environment"); Exs. 122, 123 at 1 ("Intermediate Term: Accumulate"); Ex. 124 at 1 ("Intermediate Term: Accumulate"); Ex. 125 at 1 ("Intermediate Term: Buy") ("Enron Corp. – Strength In Numbers and Then Some"); Ex. 126 at 1 ("Raising the Bar – Again") ("We reiterate our Buy opinions.").

520 *Compare* n.494 (Olson reports) *with* n.519 (Eassey reports).

521 *See* Ex. B.

522 *Compare* Ex. B (referencing analyst reports on or about dates identified) *with* Nye Report, Ex. 11 (indicating statistically significant stock price increases on dates identified).

IV. Merrill's Claims that Its Conduct Was Innocuous Are Belied by the Criminal, Regulatory and Senate Proceedings Brought Against Merrill and Its Former Executives

The Department of Justice ("DOJ"), SEC and United States Senate have all investigated Merrill and uniformly found that Merrill and its executives engaged in deceptive acts as part of the Enron scheme to defraud.

A. Merrill's Former Executives Have Repeatedly Invoked the Fifth Amendment in Response to Probing Inquiries

Lead Plaintiff could not take evidence from ***any*** of the Merrill witnesses with substantial knowledge regarding Merrill's dealings with Enron, including the Nigerian Barges transaction, bogus Electricity Trades transaction and LJM2. The following witnesses, which include the Merrill relationship managers for Enron, have repeatedly asserted their Fifth Amendment privilege and refused to provide testimony:

- Schuyler Tilney (former Head of Global Energy and Power division);[523]
- Robert Furst (former Managing Director in Investment Banking);[524]

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523 Merrill placed Tilney on administrative leave in July of 2002. Merrill subsequently terminated his employment on September 18, 2002. Tilney asserted the Fifth Amendment and refused to testify before the U.S. Senate on July 30, 2002. He asserted his Fifth Amendment rights and refused to provide testimony to the SEC regarding Merrill's dealings with Enron on July 31, 2002. Ex. 50024, ¶11. On May 9, 2003, Tilney's counsel stated that Tilney would also assert his Fifth Amendment privilege if called to testify by the Enron Bankruptcy Examiner. Ex. 33958. On June 7, 2004, Tilney asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron. On August 17, 2006, Tilney recanted his Fifth Amendment assertion with respect to everything except the Nigerian Barges transaction.

524 Furst resigned from Merrill in 2001. Furst asserted the Fifth Amendment and refused to testify before the U.S. Senate on July 30, 2002. He asserted his Fifth Amendment rights and refused to provide testimony to the SEC regarding Merrill's dealings with Enron on August 21, 2002. Ex. 50024, ¶12. On April 18, 2003, Furst's counsel stated that Furst would also assert his Fifth Amendment privilege if called to testify by the Enron Bankruptcy Examiner. Ex. 127 at AB078602601 (4/18/03 letter from Ira Lee Sorkin, Carter Ledyard & Milburn LLP, to Steven M. Collins, A&B). On August 22, 2005, Furst asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron.

- Daniel Bayly (former Global Head and Chairman of Investment Banking);[525]

- Thomas Davis (former Executive Vice President and Global Head of Corporate and Institutional Client Group);[526]

- Dan Gordon (former Managing Director in Derivatives Trading division);[527]

- James Brown (former head of Strategic Asset Lease and Finance Group (formerly known as Global Structured Finance Group));[528] and

- William Fuhs (former Vice President reporting to Brown in Brown's finance group).[529]

Importantly, the assertion of the Fifth Amendment by Merrill's former executives entitles Lead Plaintiff to an adverse inference from the evidence before the Court. *See, e.g.*, *Baxter*, 425

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[525] Bayly retired from Merrill in the fall of 2002. He initially testified before the SEC regarding Merrill's dealings with Enron on July 10, 2002, but later declined to provide additional testimony that the SEC requested. Ex. 50024, ¶10. On June 5, 2003, Bayly's counsel stated that Bayly would assert his Fifth Amendment privilege if called to testify by the Enron Bankruptcy Examiner. *See* Ex. 128 at AB078602671 (6/5/03 letter from Andrew M. Lawler to Steven M. Collins, A&B). Bayly asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron. *See* Ex. 14385; 9/29/06 Bayly Depo. Tr.

[526] Merrill terminated Davis's employment on September 18, 2002. He asserted his Fifth Amendment rights and refused to provide testimony to the SEC regarding Merrill's dealings with Enron on September 10, 2002. Ex. 50024, ¶9. On April 17, 2003, Davis's counsel stated that Davis would also assert his Fifth Amendment privilege if called to testify by the Enron Bankruptcy Examiner. *See* Ex. 129 at AB078602602 (4/17/03 letter from Thomas Fitzpatrick to Steven M. Collins, A&B). On July 20, 2004, Davis asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron.

[527] Gordon left Merrill in 2001 when the group in which he worked was sold to another company. *See* Ex. 50002 at 184-85. On June 5, 2003, Gordon's counsel stated that Gordon would assert his Fifth Amendment privilege if called to testify by the Enron Bankruptcy Examiner. *See* Ex. 130 at AB078602621 (6/5/03 letter from Alan Levine to Robb E. Hellwig, A&B). On August 22, 2005, Gordon asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron.

[528] Brown asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron. *See* Ex. 14386; 9/29/06 Brown Depo. Tr.

[529] On March 24, 2005, Fuhs asserted his Fifth Amendment rights and refused to provide testimony to Lead Plaintiff regarding Merrill's dealings with Enron.

U.S. at 318 ("Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them"); *In re Todd*, 47 B.R. 18, 21 (N.D. Miss. 1984) ("when a party refuses to testify in response to probative evidence offered against him, it is proper to draw adverse inferences from his exercise of the Fifth Amendment privilege"). Indeed, "[t]he same is true regarding an invocation of the [Fifth Amendment] privilege by a non-party witness in a civil action." *Pyles v. Johnson*, 136 F.3d 986, 997 (5th Cir. 1998); *see also FDIC v. Fid. & Deposit Co.*, 45 F.3d 969, 977 (5th Cir. 1995) ("there is no constitutional bar to the admission of [a non-party's assertion of the Fifth Amendment privilege], it is admissible if it is relevant and not otherwise prohibited by the rules"). *A fortiori* Lead Plaintiff in response to Merrill's motion for judgment on the pleadings is entitled to an adverse inference arising from the facts where Merrill's former executives have refused to testify in response to probative evidence offered against them and asserted herein.

B. Merrill Settled with the DOJ and Accepts Responsibility for the Conduct of Its Employees

On September 17, 2003, Merrill entered into an agreement with the DOJ and the Enron Task Force ("DOJ Agreement").[530] The DOJ Agreement states in part:

> The Department is conducting a criminal investigation into matters relating to the collapse of the Enron Corp. ("Enron"). ***During the course of the investigation, the Department notified Merrill Lynch that, in the Department's view, Merrill Lynch personnel have violated federal criminal law***. In particular, the Department notified Merrill Lynch that certain Merrill Lynch employees: a) violated federal criminal law in connection with certain transactions initiated at year-end 1999 (the "Year-End 1999 Transactions").

Ex. 50003 at 1. Under the DOJ Agreement, the Year-End 1999 Transactions "relate to: (a) Merrill's temporary 'purchase' from Enron of Nigerian power barges (Enron Nigeria Barge Ltd.) and

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[530] Ex. 50003.

subsequent sale of the barges; and (b) offsetting energy trades involving back-to-back options (the Enron Power Marketing, Inc. energy transactions)." *Id*. at n.1.

The DOJ agreement also states:

> Merrill Lynch acknowledges that the Department has developed evidence during its investigation that one or more Merrill Lynch employees may have violated federal criminal law. ***Merrill Lynch accepts responsibility for the conduct of its employees giving rise to any violation in connection with the Year-End 1999 Transactions.***

Id. at 2.[531] Moreover, the DOJ Agreement provides:

> Merrill Lynch further agrees that it will not, through its attorneys, board of directors, agents, officers or employees make any public statements, in litigation or otherwise, contradicting Merrill Lynch's acceptance of responsibility set forth above. Any such contradictory statement by Merrill Lynch, its attorneys, board of directors, agents, officers or employees shall constitute a breach of this Agreement, and Merrill Lynch thereafter would be subject to prosecution as set forth in paragraph 3 of this Agreement.

Id. at 3. As Merrill admits, Ex. 50003 is a copy of the DOJ Agreement and the bank accepts responsibility for the conduct of its employees in connection with the year-end 1999 transactions.[532]

C. Former Merrill Executives Were Convicted for Engaging in the Sham Nigerian Barges Deal

In a Third Superseding Indictment, dated July 22, 2004, former Merrill executives Bayly, Brown, Fuhs, and Furst were each charged with conspiracy to commit wire fraud and falsify financial books and two counts of wire fraud relating to their conduct in the Nigerian Barges transaction.[533] Among other allegations, the Indictment charged:

> Daniel Bayly . . . James A. Brown, William R. Fuhs, Robert S. Furst . . . and others conspired to: (a) knowingly and intentionally devise a scheme and artifice to

531 *See also* Ex. 50004 at 2 ("Merrill Lynch admits that it accepts responsibility for the conduct of its employees giving rise to any violation in connection with the Year-End 1999 Transactions . . . .").

532 Ex. 50004 at 2 (Response to RFA Nos. 1-2).

533 Ex. 40333.

> defraud Enron and its shareholders . . . and (b) knowingly and willfully falsify books, records and accounts of Enron in violation of Title 15, United States Code, Sections 78m(b)(2)(A) & (B), 78m(b)(5) and 78ff and Title 17, Code of Federal Regulations, Section 240.13b2-1.[534]

In addition, Brown was charged with one count of perjury before the Enron Grand Jury and one count of obstruction of the Enron Grand Jury Investigation. *Id*. And Fuhs was charged with one count of making false statements and one count of obstruction of the Enron Grand Jury Investigation. *Id*.

Bayly was the head of the Global Investment Banking division. Brown was the head of Strategic Asset Lease and Finance (formerly known as Global Structured Finance) group.[535] Fuhs was a Vice President reporting to Brown, and Furst was the Enron relationship manager in the investment-banking division. Bayly, Brown and Furst were all managing directors.[536] Merrill admits Bayly, Brown, Fuhs and Furst were its employees during the period of time in which the Nigerian Barges transaction occurred.[537]

On November 3, 2004, a jury convicted Bayly, Brown, Fuhs, and Furst of ***all*** charges.[538] On August 1, 2006, the Fifth Circuit reversed the wire-fraud and conspiracy convictions of the former Merrill executives "on the ***legal*** ground that the government's theory of fraud relating to the deprivation of honest services – one of three theories of fraud charged in the Indictment – is flawed." *United States v. Brown*, 459 F.3d 509, 513 (5th Cir. 2006). The Court of Appeals held that it was not a dishonest service for employees of Enron and Merrill to work together to cook the books of a

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534 Ex. 40333, ¶30.

535 *See* Ex. 40333, ¶10.

536 *See* Ex. 40333, ¶10.

537 *See* Ex. 50004 at 3-4 (Response to RFA Nos. 4-9).

538 Ex. 40523.

public corporation when that conduct furthered management's intent to report higher profits, etc. *Id*. at 521-24. *See also id*. at 531-33. Because of the use of a unitary verdict form, the Court of Appeals did not address the government's other theories of liability. *Id*. at 523 ("the money-or-property and books-and-records charges"); *id.* ("We hold only that the alleged conduct is not a federal crime ***under the honest-services theory of fraud specifically***."). Importantly, the Fifth Circuit specifically warned: "***This opinion should not be read to suggest that no dishonest, fraudulent, wrongful, or criminal act has occurred***." *Id*.

The majority opinion in *Brown* actually expressed a view of the evidence consistent with Lead Plaintiff's allegations regarding Merrill. For example, the majority stated, "Bayly asked for a written assurance to support Enron's 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." *Id*. 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 522 n.13), indicating 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 did not pursue in the criminal case.

The concurring and dissenting opinion of Judge Reavley is also relevant to Lead Plaintiff's claims against Merrill. *Id*. at 531-33. Judge Reavley disagreed with the majority's interpretation of what might constitute the deprivation of honest services under 18 U.S.C. §1346. *See id*. at 533 ("I conclude that the behavior of [Bayly, Brown and Furst] falls squarely within the meaning of a 'scheme or artifice to deprive another of the intangible right to honest services.'"). Notably, Judge Reavley stated, "[t]he evidence at trial proved that Fastow, Glisan, Boyle, and McMahon, and other Enron personnel temporarily 'parked' the barges with Merrill Lynch so that Enron could meet its earnings." *Id*. at 532. Moreover:

> The Enron executives and managers breached their fiduciary duties by "cooking" Enron's books and engaging in the fraudulent "sale" of the barges to Merrill Lynch, withholding this information from Enron and its shareholders, and causing Enron to pay nearly $1.5 million to Merrill Lynch and LJM2 to hold the barges, along with paying compensation bonuses to [Enron] executives that depended on the completion of the barge transaction.
>
> ***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. at 533. Finally, in disagreeing with the majority, Judge Reavley stated it was "[m]ost important" that "***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*.

Even if what the Fifth Circuit did in *Brown* was inconsistent with Lead Plaintiff's factual allegations and legal theories here – which it clearly is not – that criminal case decision would have no preclusive impact on this civil case. It is "***well established that an acquittal in a criminal case does not bar a subsequent civil suit arising from the same events***." *SEC v. Dimensional Entm't Corp.*, 493 F. Supp. 1270, 1277 (S.D.N.Y. 1980) (citing *United States v. Nat'l Ass'n of Real Estate Bds.*, 339 U.S. 485, 493-94 (1950)). *Accord Neaderland v. Comm'r*, 424 F.2d 639, 641 (2d Cir. 1970); *SEC v. Everest Mgmt. Corp.*, 466 F. Supp. 167, 174 n.9 (S.D.N.Y. 1979).

D. The SEC Brought an Enforcement Action Against Merrill and Four of Its Former Executives for Their Conduct in Connection with the Nigerian Barges and Electricity Trades Transactions

In a March 17, 2003 complaint against Merrill Lynch & Co., Inc., and Merrill executives Bayly, Davis, Furst and Tilney, the SEC specifically alleged:

> ***In December 1999, at Enron's request, Merrill Lynch entered two fraudulent year-end transactions that Merrill Lynch knew were designed to improve Enron's financial picture*.**" As a result of these transactions, Enron fraudulently added $60 million to its fourth quarter 1999 income, a 30% improvement in net income. This allowed Enron to meet analysts' expectations about its performance, increase its earnings per share, improve its stock price, and boost its bonus pool for senior executives. For aiding Enron, Merrill Lynch earned millions of dollars in fees and believed Enron would continue to award it lucrative business in the future.[539]

The scheme to defraud charged by the SEC is similar to the individual conduct alleged against Merrill in this action.

On March 19, 2003, the SEC entered a Final Judgment Against Merrill Lynch & Co., Inc. ("Final Judgment") (Ex. 131), settling its claims against Merrill. *See SEC v. Merrill Lynch & Co. Inc.*, No. H-03-946, Final Judgment (S.D. Tex. Mar. 19, 2003). Under the settlement, Merrill agreed to pay a total of $80 million in disgorgement, penalties and interest. *Id*. at 5. In addition, under the Final Judgment, Merrill consented to an injunction enjoining the company from any further violations of the federal securities laws. *Id*. at 2-5.[540]

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539 Ex. 50024 at 1.

540 As it has argued in the past, Merrill will no doubt again argue that the SEC "only" charged it and its executives with "aiding and abetting" Enron's fraud. Of course, as the Court has already held, this argument does not help Merrill here because the SEC charge only means the SEC chose to pursue an easier charge against Merrill, as it is entitled to do under the law. *See Enron*, 310 F. Supp. 2d at 827 n.7 (S.D. Tex. 2004) ("The fact that the SEC is authorized to and has charged Merrill Lynch merely with aiding and abetting does not automatically mean that Lead Plaintiff cannot assert a claim that Merrill Lynch is a primary violator of §10(b).").

E. The SEC Brought an Enforcement Action Against Merrill Executive Dan Gordon for His Conduct in Connection with the Electricity Trades Transaction

According to the SEC, former Merrill executive Dan Gordon violated federal securities laws by "engaging in a risk-free energy trade designed to overstate Enron's reported 1999 income." *SEC v. Daniel Gordon*, No. H-03-05772, Complaint (S.D. Tex. 2003) ("Gordon Complaint") (Ex. 132) at 1. On December 22, 2003, the SEC entered a Final Judgment Against Daniel L. Gordon ("Gordon Final Judgment"). *SEC v. Daniel Gordon*, No. H-03-05772, Final Judgment (S.D. Tex. 2003) (Ex. 133). Under the Gordon Final Judgment, Gordon consented to an injunction enjoining him from any further violations of the federal securities laws. *Id*. at 2-5.

In its action against Gordon, the SEC alleged Gordon and others carried out the Electricity Trades – a fraudulent year-end transaction in December 1999. Gordon Complaint (Ex. 132). In this transaction, Enron agreed to pay Merrill a $17 million fee to enter into a virtually offsetting energy trade. *Id*. "***Gordon and others knew, among other things, that the transaction: (a) was essentially risk free to Merrill Lynch, and (b) had the purpose and effect of inflating Enron's reported income by approximately $50 million in 1999, and that such earnings were necessary for Enron to meet earnings targets and award bonuses to senior management***." *Id*. Accordingly, to accommodate an important client, Gordon and others knowingly carried out the fraudulent transaction. *Id*. After the transaction was completed and Enron reported its inflated earnings, Enron and Merrill unwound the transaction on June 30, 2000, and Enron received $8.5 million, half of its original fee. *Id*. The allegations that were brought by the SEC are similar to the allegations Lead Plaintiff asserts against Merrill herein.

F. A Senate Permanent Subcommittee Has Investigated Merrill's Conduct in the Enron Fraud

After reviewing the Subcommittee's findings and hearing the testimony of Kelly Martin, Senior Vice President and President of the International Private Client Division at Merrill, it was clear to the Senate that Merrill was not an innocent, passive bystander, but an active and crucial participant in Enron's nefarious deals. Furst and Tilney, the persons from Merrill most knowledgeable about the transactions in question, both invoked their Fifth Amendment right not to answer questions in fear of incriminating themselves. Merrill chose to send Kelly Martin, a person with no personal knowledge of the questionable transactions, to represent Merrill.

In his opening statement, Senator Levin made clear that he was not impressed by the testimony given by other financial institutions and made a prediction about Merrill's testimony: "Merrill Lynch will say commitment doesn't mean commitment, guarantee doesn't mean guarantee. They mean something else, maybe best efforts. And loan doesn't mean loan. It means purchase."[541]

Referring specifically to the Nigerian Barges transaction, Senator Levin stated: "Merrill Lynch assisted Enron in cooking its books by pretending to purchase an existing Enron asset when it was really engaged in a loan." *Id*. Merrill agreed to enter into the transaction only "after receiving Enron's commitment that it would find a buyer for Merrill's interest in the barges within 6 months. Merrill received assurances of a 15-percent return on its $7 million, plus an immediate payment of $250,000. This so-called sale arrangement violated elemental accounting rules which allow a seller to book sales income only for a transaction that is a real sale." *Id*. Senator Levin further opined that "***[t]he evidence is clear that Enron and Merrill Lynch were aware of this accounting problem, and in order to facilitate Enron booking the transaction as a sale, it had to keep Enron's oral guarantee a secret, omitting it from the documentation and leaving it as an oral understanding***." *Id*. at 164. "When you look at the elements of this transaction, it is obvious that it is not a real sale. Through an unwritten side agreement, Enron provided a guarantee to take Merrill out of the deal

541 Ex. 21240 at 163.

within 6 months. Merrill was guaranteed and received a specified 15-percent return on its $7 million investment." *Id*.

Referring to the LJM2 and LJM3 partnerships, Senator Levin opined that "Merrill Lynch was not blind to the conflicts of interest raised by these partnerships, but Merrill Lynch decided to go ahead and it helped raise some $390 million for LJM2. ***The money that Merrill raised for LJM2 helped Enron inflate its earnings and mislead investors and analysts in the way it did***." *Id*. at 165. Senator Collins added that "[i]n the end, the prospect of more lucrative business from Enron trumped those at Merrill who urged caution." *Id*. at 167.

Senator Collins also commented on the sudden termination of Merrill analyst John Olson after Merrill missed out on a money-making venture because Enron was displeased with Olson's coverage of Enron: "Merrill appears to have gone to extraordinary lengths to placate Enron . . . ." *Id*. at 166. Collins further commented that these allegations raise "troubling questions about conflicts of interest compromising the integrity of the ratings on which investors rely." *Id*.

Addressing the Nigerian Barges transaction once again, Senator Levin stated that "[t]he documents clearly show a commitment to Merrill Lynch that it would be bought out within 6 months." *Id*. at 178. He also pointed out that before both Furst and Tilney invoked their Fifth Amendment rights, they told the Senate staff that "***the deal would not have gone forward without the assurance from Enron***." *Id*. at 179. Further evidence that the deal was not a true sale is the fact that ***Merrill never received the scheduled cash flow payments from the operations of the barges to which they were entitled under the terms of the agreement***. *Id*. at 182. Yet Martin had no knowledge of anyone at Merrill ever sending a notice to Enron or complaining about the fact that they were not getting paid. *Id*.

Senator Levin brought his remarks to a close by summarizing his impression of the barges transaction based on the evidence he had observed: "***It is very clear, it seems to me overwhelmingly***

clear, that in fact the risks of owning Ebarge were not transferred to Merrill Lynch and indeed there was never a real sale by any of the accounting standards which have to be applied before the term 'sale' can be applied to a transaction*." *Id*. at 183. Senator Collins pointed out the inconsistency between the testimony presented by Martin about the Nigerian Barges deal and Furst's prior statements to the Subcommittee: "Mr. Furst told the Subcommittee that Merrill Lynch was very much aware that Enron needed to try to inflate it [sic] earnings and to have a better return for its African division*." *Id*. at 183.

Senators Lieberman and Levin summed up the Senate's ultimate impressions, clearly skeptical about Merrill's claims of innocence: "After reviewing the Subcommittee's findings and listening this morning to your [Martin's] testimony and answers to the questions Senator Levin and Senator Collins have posed, I must tell you that it is hard to see how an experienced, respected, sophisticated company like Merrill Lynch missed what was going on here." *Id*. at 188. Senator Levin concurred: "***[B]asically the claim that the barge deal was a purchase by Merrill Lynch is just simply unbelievable, and the documents of Merrill Lynch are just so full of references to a guarantee that is contemporaneous, that it is incredible to believe that this was a real purchase*." *Id*. at 206.

V. The Summary Judgment Standard and Lead Plaintiff's Request for Further Discovery Pursuant to Fed. R. Civ. P. 56(f)

A motion for summary judgment may only be granted where "there is ***no*** genuine issue as to any material fact ***and*** . . . the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). "The party moving for summary judgment has the initial burden of 'informing the district court of the basis for its motion, and identifying those portions of [the summary judgment record] which it believes demonstrate the absence of a genuine issue of material fact.'" *Colson v. Grohman*, 174 F.3d 498, 506 (5th Cir. 1999) (quoting *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986)); *accord Carson v. Dynegy, Inc*., 344 F.3d 446, 451 (5th Cir. 2003). "If the moving party fails to meet its initial burden, the motion must be denied, regardless of the non-movant's response." *Johnson v. Stewart & Stevenson Servs.*, No. H-03-4055, 2005 U.S. Dist. LEXIS 25593, at *3 (S.D. Tex. Oct. 20, 2005) (citing *Little v. Liquid Air Corp.*, 37 F.3d 1069, 1075 (5th Cir. 1994)).

In determining whether there is any genuine issue of material fact, the court will "view[] the evidence in the light most favorable to the nonmoving party." *Flock v. Scripto-Tokai Corp.*, 319 F.3d 231, 236 (5th Cir. 2003). As the Supreme Court has held:

> Credibility determinations, the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge . . . ruling on a motion for summary judgment . . . . The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.

Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255 (1986). *Accord Flock,* 319 F.3d at 236 ("In determining whether there is a dispute as to any material fact, we consider all of the evidence in the record, but we do not make credibility determinations or weigh evidence."); *In re Compaq Sec. Litig.*, 848 F. Supp. 1307, 1313 (S.D. Tex. 1993). "If reasonable minds could differ as to the import of the evidence," summary judgment must be denied. *Anderson*, 477 U.S. at 250-51. All "[d]oubts are to be resolved in favor of the nonmoving party." *Priester v. Lowndes County*, 354 F.3d 414, 419 (5th Cir. 2004). *Accord Rodriguez v. ConAgra Grocery Prods. Co.*, 436 F.3d 468, 473 (5th Cir. 2006).

In opposing the motion, "the non-movant does not . . . have to present its own evidence, but may point out genuine issues of fact extant in the summary judgment evidence produced by the movant, if any." *Johnson*, 2005 U.S. Dist. LEXIS 25593, at *4 (citing *Isquith ex rel. Isquith v. Middle S. Utils.*, 847 F.2d 186, 198-200 (5th Cir. 1988)). Thus the non-moving party need only "designate 'specific facts showing that there is a genuine issue for trial.'" *Celotex*, 477 U.S. at 324.

The evidence is more than sufficient to defeat Merrill's Motion. Should this Court be inclined to grant Merrill's Motion, however, Lead Plaintiff requests that it be permitted to conduct additional discovery pursuant to Rule 56(f). As discussed, this Court only ***very recently*** refined its standard for primary liability under Rule 10b-5(a) and (c). *See Enron,* 2006 U.S. Dist. LEXIS 43146, at *155-*158; *Enron*, 439 F. Supp. 2d at 713-14.[542]

VI. ARGUMENT

A. There Is More than Sufficient Evidence Demonstrating Merrill Committed Primary Violations of the Securities Laws

Merrill asserts that "assuming" Lead Plaintiff could prove all of the elements of a Rule 10b-5 violation against it, Lead Plaintiff still cannot establish primary liability as to Merrill in the scheme. Defs' Mem. at 38.[543] According to Merrill, "if the Court applies . . . consistently" the approaches of the *Parmalat* court and the SEC, it "was, at most, an aider and abettor." Defs' Mem. at 38. On the other hand, Merrill "disagrees with these tests." *Id.*

Contrary to Merrill's assertions, the Court recently identified certain transactions in which Merrill engaged that involve conduct sufficient to establish primary liability under its refined standard. The Court held "for instance," that "the allegations against Merrill Lynch relating to the

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542 This refinement comes ***after*** Lead Plaintiff was required to complete much of its discovery concerning Merrill's role in the Enron fraud. Justice requires that a litigant be informed of the legal standard under which its claims will be judged ***before*** it is required to conduct discovery, so it has fair notice ***of what facts it should seek***. Requests for additional discovery under Fed. R. Civ. P. 56(f) "are generally favored, and should be liberally granted." *Stearns Airport Equip. Co. v. FMC Corp.*, 170 F.3d 518, 534 (5th Cir. 1999). Thus, if this Court requires of Lead Plaintiff additional facts to support its claims under Rule 10b-5(a) and (c), it should deny Merrill's Motion and give Lead Plaintiff a fair opportunity to uncover such facts. *See* Declaration of Helen J. Hodges Pursuant to Rule 56(f), filed concurrently herewith.

543 Merrill contends that plaintiffs' "scheme" allegations are nothing more than aiding and abetting liability barred by the Supreme Court's holding in *Central Bank*. *See* Defs' Mem. at 50-53. As indicated by this Court's repeated rejection of this argument by bank defendants in this case and the Supreme Court's ruling in *Central Bank*, Merrill is exactly the kind of "secondary actor" that can be subject to primary liability. In *Central Bank* the Court held: "The absence of §10(b) aiding and abetting liability does not mean that secondary actors in securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or ***bank***, . . . may be liable as a primary violator under 10b-5, assuming ***all*** of the requirements for primary liability under Rule 10b-5 are met. ***In any complex securities fraud, moreover, there are likely to be multiple violators*** . . . ." *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994) (emphasis in original and added).

Nigerian barge 'sales' . . . satisfy the requirements for pleading primary violations of the statutes." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *170. The Court has also repeatedly recognized, for pleading purposes, that Merrill committed primary violations of Rule 10b-5(a) and (c) by engaging in the Electricity Trades and the Nigerian Barges shams. *See Enron*, 235 F. Supp. 2d at 703 (the Nigerian Barges sham and bogus Electricity Trades deal "fit the patterns of the scheme alleged by Lead Plaintiff throughout the complaint"); *Enron*, 310 F. Supp. 2d at 830 (same). This Court further recognized that Lead Plaintiff properly alleged "an ongoing scheme in which Merrill Lynch participated in a substantial way over years," including "early in the Class Period when it participated in establishing and funding LJM2 at a critical accounting time, despite red flags identified in the complaint and known to Merrill Lynch." *Enron*, 310 F. Supp. 3d at 830. The evidence now more fully developed supports a finding as to primary liability against Merrill Lynch.

Merrill suggests a very narrow reading of the statute and case law defining primary liability, basically limited to manipulation or in the misrepresentation/omission context. The SEC and other courts considering primary liability in the scheme context reject Merrill's interpretation of the proper scope of primary liability for participation in a fraudulent scheme under Rule 10b-5(a) and (c). The SEC's "principal purpose and effect" test for culpable participation in a scheme is amply supported by Supreme Court precedent and was applied by this Court in identifying the alleged Nigerian Barges transaction as an example of conduct constituting a primary violation. *See Enron*, 2006 U.S. Dist. LEXIS 43146, at *161-*164, *170. As the Court had previously held, the SEC's interpretation of §10(b) and Rule 10b-5 is entitled to significant deference.[544]

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[544] *See Enron*, 235 F. Supp. 2d at 588 ("Because §10(b) expressly delegated rule-making authority to the agency, which it exercised *inter alia* in promulgating Rule 10b-5, this Court accords considerable weight to the SEC's construction of the statute since the Court finds that construction is not arbitrary, capricious or manifestly contrary to the statute."). The SEC's test is reasoned and practical and should be followed by the Court. *See* SEC Brief (Ex. 14) at 12-23.

Boiled down, Merrill's argument is that *Central Bank* bars a finding of primary liability for a scheme, unless a defendant made fraudulent public statements or omitted facts for which they had a legal duty to disclose.

Merrill's argument is without legal basis. Such a hyper-restrictive interpretation of §10(b) has been rejected by the Supreme Court, numerous circuit and district courts, as well as the SEC. Rule 10b-5(c) makes it unlawful for "any person," "***directly or indirectly***," to "engage in ***any*** act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. §240.10b-5(c). No court has ever held that Rule 10b-5(c) – or Rule 10b-5(a) for that matter – is beyond the scope of §10(b). Notably, the Supreme Court has held that the text of Rule 10b-5 "is coextensive with the coverage of §10(b)." *Zandford*, 535 U.S. at 816 n.1. Nor has any court held that Rule 10b-5(a) and (c) are limited to manipulative, rather than deceptive, conduct. Indeed, the SEC has argued, and courts have routinely held, that both §10(b) and Rule 10b-5 cover (among other things) deceptive conduct, acts, and practices beyond mere false statements or market manipulation:

> It has long been accepted that Section 10(b), and Rule 10b-5(a) and (c) thereunder, ***cover conduct beyond the making of false statements and misleading omissions***, which are covered by Rule 10b-5(b). The Supreme Court has stated that Section 10(b) encompasses deceptive "practices," *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977), deceptive "conduct," *id.* at 475 n.15; *O'Hagan*, 521 U.S. 659, and deceptive "acts," *Central Bank*, 511 U.S. at 173; *see Bankers Life*, 404 U.S. 6.

SEC Brief (Ex. 14) at 13-14.

Indeed, in *Zandford* the Supreme Court rejected the precise argument raised here. In *Zandford*, the SEC alleged that defendant engaged in a scheme to defraud by selling his customer's securities and using the proceeds for his own benefit without the customer's knowledge or consent. The Supreme Court analyzed whether the alleged fraudulent conduct was "'in connection with the purchase or sale of any security' within the meaning of the statute and the rule." 535 U.S. at 815.

Stressing that "the statute should be 'construed "not technically and restrictively, but flexibly to effectuate its remedial purposes,"'" the Supreme Court reversed. *Id*. at 819. The Court held that defendant engaged in "deceptive" conduct "'in connection with the . . . sale of any security'" sufficient for scheme liability under Rule 10b-5, despite the fact that he did not make false statements or omissions: "***neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act***." *Id*. at 819-20.

Similarly, the Supreme Court in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), did not restrict the interpretation of what constitutes deceptive conduct solely to those who make false statements or engage in manipulative securities transactions. There, the Supreme Court again reiterated that "'[§]10(b) must be read flexibly, not technically and restrictively' and that the statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities.'" *Id*. at 475-76.

Numerous courts have confirmed the viability of scheme liability for conduct that is not limited simply to making a false statement or engaging in a manipulative securities transaction. Most recently, the Ninth Circuit in *Homestore* substantially adopted the SEC's test for determining what constitutes a manipulative or deceptive act sufficient to render a defendant a "primary violator":

> The SEC defines "a deceptive act" as "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues." We agree with the SEC that engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a "deceptive act." Participation in a fraudulent transaction by itself, however, is insufficient to qualify the defendant as a "primary violator" if the deceptive nature of the transaction or scheme was not an intended result, at least in part, of the defendant's own conduct. ***We hold that to be liable as a primary violator of §10(b) for participation in a "scheme to defraud," the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme***. It is not enough that a ***transaction*** in which a defendant was involved had a deceptive

> purpose and effect; the defendant's own ***conduct*** contributing to the transaction or overall scheme must have had a deceptive purpose and effect.

452 F.3d at 1048 (emphasis added and in original). Later, in its opinion, the Ninth Circuit stated:

> ***Conduct by the defendant that does not have a principal legitimate business purpose, such as the invention of sham corporate entities to misrepresent the flow of income, may have a principal purpose of creating a false appearance***. . . .
>
> If a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of §10(b). . . . Thus, when determining whether a defendant is a "primary violator," the conduct of each defendant, while evaluated in its context, must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in the furtherance of an overall scheme to defraud.

Id. at 1050.

This fundamental approach to scheme liability has been affirmed by this Court, which adopted the SEC's standard for scheme liability:

> "Where a wrongdoer, intending to deceive investors, engages in a deceptive act as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the market regardless of whether he designed the scheme. . . . Liability should be available against any person who engages in a deceptive act within the meaning of Section 10(b) as part of a scheme to defraud, regardless of who designed the scheme.
>
> [D]eceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available."

Enron, 2006 U.S. Dist. LEXIS 43146, at *164-*165, *173-*174.[545]

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545 Numerous courts are in accord. *Hopper*, 2006 U.S. Dist. LEXIS 17772, at *37; *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003); *SEC v. Santos*, No. 02c 8236, 2003 U.S. Dist. LEXIS 19806 (N.D. Ill. Nov. 3, 2003), at *5; *IPO*, 241 F. Supp. 2d at 381-82; *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004).

In addition, a defendant like Merrill is not immunized from liability in a scheme to defraud by claiming simply that the deception did not occur until the issuer of the financial statements fraudulently accounted for the transactions.[546] In *Parmalat I*, Judge Kaplan held:

> The defendants' argument that they were at most aiders and abettors of a program pursuant to which Parmalat made misrepresentations on its financial statements misses the mark. The transactions in which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value. It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors. Neither the statute nor the rule requires such a distinction.

376 F. Supp. 2d at 504. Similarly, in *Enron*, this Court held:

> Although Merrill Lynch argues its actions were not unlawful and that they were merely business transactions later misrepresented by Enron in its financial statements, the factual allegations suggest knowingly deceptive conduct . . . . Sham business transactions with no legitimate business purpose that are actually guaranteed "loans" employed to inflate Enron's financial image are not above-board business practices. This Court disagrees with Merrill Lynch's contention that the alleged "'deception' did not occur until Enron allegedly misreported" the transactions.

310 F. Supp. 2d at 830.

The SEC agrees:

> Thus, a prior deceptive act, from which the making of the false statements follows as a natural consequence, can constitute a sufficient step in the causal chain to support a finding of reliance. Certainly where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation.

SEC Brief (Ex. 14) at 22.

The above-discussed case law rejects Merrill's argument that no liability lies because Enron, not Merrill, falsified its financials. In doing so, these cases logically embrace the following premise: Of necessity, in any public-company fraud involving a scheme with multiple participants, the

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[546] Nor is a special relationship required. According to the SEC, "[T]o require a special relationship with the corporation . . . would allow a person who is not in such a relationship to accomplish the same fraud, with the same state of mind, and the same effect on investors as a person in such a relationship, and nonetheless escape liability." SEC Brief (Ex. 14) at 7.

financial statements ultimately issued to investors remain those of the issuer, primarily created by it. Seldom will a third party involved in the scheme have the ability or the responsibility to formally account for any transaction on the issuer's financial statements. But perfecting the ultimate deceit on investors by issuing false financial statements is not the only point at which acts of deception are important in a complex securities fraud. Earlier acts of deception in the chain of conduct must occur. In short, the issuer will not be able to misaccount for the transaction unless, earlier, the third party acts deceptively – *i.e.*, designs or structures transactions that were by their nature inherently deceptive – so that other actors that participate in the transactions without knowledge of their deceptive nature (as well as investors) will see a fiction, not reality, if and when they look. *See Homestore*, 452 F.3d at 1049 ("We see no justification to limit liability under §10(b) to only those who draft or edit the statements released to the public.").

There will never be scheme liability if the issuer's ultimate misaccounting, without more, is enough to shield those actors who engaged in deceit in the underlying fraudulent financial transactions by creating or funding transactions designed to perpetrate a fraud and/or structuring illegitimate deals and the like that deprive the transactions of economic substance or risk or cause them to be non-GAAP compliant. Each actor, no matter how manipulative, deceptive or contrived its conduct may be, will be shielded because it will always be the issuer that later formally misaccounts for the bogus deal. Thus, it cannot be the rule that the mere fact that the issuer ultimately misaccounts for the transaction shields from liability sophisticated banks, like Merrill, who engaged in the fraud with scienter, using manipulation, deception or contrivances with the principal purpose and effect of deceiving investors under Rule 10b-5(a) or (c).

This Court relied heavily on Judge Kaplan's decision in *Parmalat I*, but Merrill disagrees with *Parmalat I*. The Court's decision in *Parmalat I* demonstrates Merrill is subject to primary liability. Thus, Merrill's interpretation of *Parmalat I* is strained and flawed. According to Merrill, under *Parmalat I* and the position of the SEC, ***no*** side agreement can "transform a real transaction into a primary violation." Defs' Mem. at 42. Contrary to what Merrill suggests at page 39 of its Motion, in *Parmalat I* the court held only that the particular side agreements alleged there "'that required Parmalat to pay additional interest on its loans'" did not support a primary violation. *Parmalat I*, 376 F. Supp. 2d at 487. But the side agreement to pay "additional interest" in *Parmalat I* is hardly the sort of side agreement that transforms the nature of a transaction.

By contrast, the oral side agreements between Enron and Merrill ***did*** transform the nature of the transactions, because (unlike *Parmalat I*) they eliminated the transfer of any significant risk. Further, unlike the dismissed claims in *Parmalat I*, the year-end 1999 transactions here "depend[ed] on . . . fictions" and had the purpose and effect of deceiving Enron's auditors rather than intending the "auditors would misrepresent the nature of the arrangements." *Id.* at 505. *See also* Defs' Mem. at 39-40. In the words of the Ninth Circuit, Merrill Lynch's transactions were ***not*** "legitimate transactions that became 'deceptive' ***only*** when distorted by the willful or intentional fraud of another party." *Homestore*, 452 F.3d at 1053 (citing *Parmalat I*, 376 F. Supp. 2d at 505).

Merrill says that under *Parmalat I* it is immunized because "real entities" entered the Electricity Trades contracts and the Nigerian Barges transaction. Defs' Mem. at 40-41. If a defendant uses a "real" entity to commit deceptive conduct, the fact that the entity is not a sham does not negate primary liability. *See, e.g., Homestore*, 452 F.3d at 1052 (creating "sham business entities ***or*** engag[ing] in deceptive conduct"); *In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428, 435, 437 (S.D.N.Y. 2006) ("*Parmalat III*") (bank – real entity – committed deceptive conduct); *Parmalat I*, 376 F. Supp. 2d at 504 (each bank – a real entity – "disguise[d] its loan to Parmalat," committing deceptive conduct); *Enron*, 2006 U.S. Dist. LEXIS 43146, at *170 (parking of barges supports primary liability).

Merrill Lynch also suggests that its conduct in the Nigerian Barges transaction should be immunized because that transaction "involved the transfer of real assets." Defs' Mem. at 40. The use of a deceptive device or contrivance in a transaction involving "real assets" does not negate liability for the deceptive conduct. In *In re Parmalat Sec. Litig.*, 383 F. Supp. 2d 616 (S.D.N.Y. 2005) ("*Parmalat II*"), Parmalat engaged in a transaction disguised as a "'conventional' sale" of trademarks to Newlat. *Id.* at 625-26. It was not alleged the trademarks were anything less than real assets, nor did Judge Kaplan base his ruling on any such allegation. *Id.* at 620, 625-26. Regardless of whether the Nigerian Barges were real assets, their "sale" constituted a fiction.

As demonstrated by the citations above, *Parmalat I* did not announce a *per se* rule. Subsequent *Parmalat* decisions – not cited by Merrill – upheld scheme allegations. In *Parmalat II*, Judge Kaplan upheld allegations against lawyers who were involved in fictional sale of assets disguised as a "conventional sale" and a payment "disguised" "as a loan rather than an outright transfer":

> The complaint alleges in substance that Parmalat sold assets and lent money to Newlat and Web Holdings . . . . In the case of Newlat, the sale was a fiction designed to allow Parmalat to book as receivables obligations that it knew would not be paid. In the case of Web Holdings, the loan from Parmalat was not a loan at all, but rather a payment to the Tanzi family. Depicting the payment as a loan rather than an outright transfer presumably served a dual function – it disguised the embezzlement, and it made Parmalat appear healthier than it was.
>
> Like the factoring and securitization of worthless invoices reviewed in the Banks Opinion, these transactions were "inventions, projects, or schemes with the tendency to deceive because they created the appearance of a conventional" sale and loan "when, in fact, the reality was quite different."

383 F. Supp. 2d 616, 625-26. In *Parmalat III*, Judge Kaplan upheld allegations against a defendant who was party to a transaction that created the false appearance of fact that it was legitimate when the defendant who was party to it knew it was not legitimate and "was willing to invest only because [the defendant was] guaranteed that [it] would be repaid at a premium." 414 F. Supp. 2d at 435.

Merrill's conduct – analyzed in light of the SEC's principal-purpose-and-effect test, Judge Kaplan's rulings in *Parmalat*, and *Homestore* – constitutes primary violations of the federal securities laws, as explained below.

1. LJM2

This Court previously held that Merrill Lynch's alleged "establishing and funding LJM2 at a critical accounting time, despite red flags identified in the complaint and known to Merrill Lynch" demonstrates for pleading purposes Merrill Lynch's involvement in the scheme. *Enron*, 310 F. Supp. 2d at 830. The evidence now establishes that Merrill Lynch's conduct in connection with LJM2 was deceptive and constitutes a primary violation. Merrill Lynch "engage[d] in the creation of a sham entity," LJM2, ***and*** through LJM2 authorized and funded deceptive transactions with Enron. SEC Brief (Ex. 14) at 20. *See also Homestore*, 452 F.3d at 1050 ("the invention of sham corporate entities to misrepresent the flow of income, may have a principal purpose of creating a false appearance"); *Parmalat II*, 383 F. Supp. 2d at 626 n.43 (engaging in deceptive acts "through" another entity constitutes a primary violation).

As demonstrated here and in §III.A. above, the principal purpose and effect of Merrill Lynch's conduct in connection with LJM2 was to create a false appearance of fact, namely that LJM2 was a partnership independent from Enron and transactions between LJM2 and Enron were arm's length.

LJM2 was not a legitimate entity independent from Enron, rather it constituted a conduit through which deceptive transactions were completed. Fastow stated in his declaration:

> ***Merrill understood*** that in conjunction with some of the [year-end 1999] transactions, LJM2 received certain assurances from Enron management or structural

> features attendant to the transactions that caused the equity holders – ***LJM2 – to have less risk in their investment than a true arms-length third party would have had***.[547]

Fastow also stated:

> ***I explained to Merrill how the Raptor vehicle would be used by Enron to increase its current period earnings, and the fact that LJM2 would receive the return of and on its investment before any hedging would begin. . . . As I stated in my plea agreement, I and others knew that the Raptors were not sufficiently independent from Enron and should not have been deconsolidated***.[548]

As shown above and indicated by internal documents and testimony, Merrill Lynch engaged in creating an entity that was not independent of Enron, contrary to LJM2's partnership agreement and other documentation. *See supra* §III.A.3. Merrill understood from the inception of LJM2 that "LJM2 would be used to manage Enron's earnings and balance sheet," which meant and was understood by Merrill to mean "making the numbers what Enron desired them to be.[549] Indeed, as of the time Merrill Lynch funded and syndicated LJM2, it knew Fastow and Enron were controlling LJM2 through side agreements with Merrill and others. Thus, Merrill Lynch's creation of LJM2 and authorization and funding of loans and asset-parking transactions disguised as conventional asset sales constitute deceptive conduct.

Fastow's ability to abusively control LJM2 as a general partner ***appeared*** to be substantially contained by the governance provisions of the LJM2 partnership agreements and internal controls. *See supra* §III.A.3.a. This was simply not so because the side agreements with Merrill and others actually controlled the operation of LJM2.

Omitted from the LJM2 partnership agreement and internal controls were the oral side agreements. The purpose of the oral side agreements and of Merrill Lynch's undocumented

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547 Fastow Decl., ¶44.

548 Fastow Decl., ¶46.

549 *See* Fastow Decl., ¶¶41-42.

understanding was that Enron would use LJM2 to manage earnings, which was deceptive. These secret understandings destroyed the false appearance of fact that LJM2 was a partnership independent from Enron, when in fact LJM2 was a stooge for Enron and LJM2 transactions were rigged by side agreements between Fastow, Merrill Lynch and others. In other words, LJM2 depended on a fiction, namely that it was independent from Enron.

In addition, Merrill, Fastow and Enron used LJM2 to park or "warehouse" Enron assets and fund loans to Enron in transactions disguised as conventional asset sales or equity investments. *See supra* §§III.A.2.-3., III.C. LJM2 was a deceptive device used by Merrill, Enron and Fastow to manipulate Enron's financial statements. The evidence shows quite clearly that Merrill knew, in advance, the nature and purpose of each of these transactions[550] and that these deceptive transactions were consistent with the "earnings management" and "balance sheet management" twin purposes of the LJM2 scheme. *See supra* §III.A.1.-2. As Fastow's March 30, 2000 notes reflect, Merrill and the other limited partners "approved 5 out of 6 [of the year-end] deals"[551] that closed in December 1999. Merrill knowingly provided its proportionate share of the funding that was necessary to close these deals.

The funds Merrill and others provided for these deals appeared to be earnings from asset sales or equity investments, when in fact they were loans. As Fastow stated in his declaration: "Merrill understood that in conjunction with some of the transactions, LJM2 received certain assurances from Enron management or structural features attendant to the transactions that caused

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550 *See, e.g.,* Fastow Decl., ¶44; Ex. 44 at MLNBY0238974-81.

551 Ex. 2 at ASF_CIV_000001904.

the equity holders – LJM2 – to have less risk in their investment than a true arms-length third party would have had."[552]

For example, in the Raptors transactions, as Merrill knew, there was an undocumented agreement that "LJM2 would receive the return of and on its investment before any hedging would begin."[553] The Raptors transactions depended on the fiction LJM2 was making true arm's-length equity investments. But Merrill and LJM2 received huge returns on these transactions without their purported equity investments ever being exposed to risk by the hedging. *See supra* §III.A.3.b.-c. That Merrill engaged in bogus transactions through LJM2 is not an impediment to its primary liability. Like the lawyers who engaged in transactions "through Newlat and Web Holdings" in *Parmalat II*, through LJM2, Merrill Lynch "used or employed" devices or contrivances. 383 F. Supp. 2d at 626 n.43.

Merrill insists that it cannot be held liable for the LJM2 fraud because it did not have any "role in the operation of LJM2 or its investment decisions." Defs' Mem. at 37. This argument is based on the Court's language in its ruling on the LJM2 allegations concerning Deutsche Bank: "The key fact is that Lead Plaintiff does not allege facts demonstrating that they were involved in the operation of LJM2 and in where and how its monies were being used by Enron and Fastow."[554] The Court's order with respect to Merrill was different, as is Merrill's role in structuring LJM2 and preparing the PPM. *Enron*, 310 F. Supp. 2d at 830. In any event, aside from structuring, preparing the PPM and marketing LJM2, the evidence shows that Merrill Lynch was in fact "involved . . . in where and how [its] monies were being used." This is much more than Deutsche Bank's

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552 Fastow Decl., ¶44.

553 Fastow Decl., ¶46. *See also supra* §III.A.3.b.-c.

554 *Enron*, 2006 U.S. Dist. LEXIS 43146, at *388.

engagement. LJM2 was not, and was never designed to be, an "operating company."[555] Merrill Lynch knows that, whatever "day-to-day operations" were conducted by LJM2 were administrative in character. The substance of LJM2 was the funding, usually on short notice, of deceptive transactions with Enron. Merrill Lynch was fully informed about and knowingly engaged in these fundings. Contrary to what Merrill Lynch suggests, whether or not it had a ministerial role in the operations of LJM2 is besides the point. Rule 10b-5 provides explicitly that a person violates the law by engaging "directly or indirectly" in a fraudulent or deceptive act or course of business. One who knowingly structures, markets, approves and funds a deceptive structure that undertakes deceptive transactions must surely be said to have "engaged" in a scheme to defraud.

Merrill's conduct in connection with LJM2 had a deceptive effect because it caused Enron's accounting to be false, and it contributed to the overall scheme by (among other things) falsifying Enron's financial statements for 1999-2001.[556] It is clear the transactions between LJM2 and Enron were not legitimate transactions that became deceptive ***only*** when reported. LJM2 was a sham and transactions it engaged in were governed by secret side agreements unknown to Enron's auditors, Andersen. This deception had a huge impact on the accounting and financial reporting for LJM2 transactions with Enron. *See supra* §III.A.3.b.-d.

For example, former Andersen auditor Carl Bass testified that the side agreements between LJM2 and Enron in the Raptors transactions meant that the transactions did not involve an "outside

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555 Ex. 134 at MLNBY0218899.

556 *See supra* §§III.A.3.c.-d.; Ex. A; Solomon Report at 101-09 (finding LJM2 transactions should have been consolidated onto Enron's financial statements because LJM2 was not independent from Enron); Solomon Supp. Report, Schedules 3-6, 8; 4/13/06 Expert Rebuttal Report of Saul Solomon ("Solomon Rebuttal Report") at 88-89 (finding given revelations since Enron's bankruptcy, including the Global Galactic, Enron and Fastow controlled LJM2); Foster Report at 69-70 ("any purported sales by Enron to entities with which LJM2 was involved . . . were not sales because of the likely existence of side agreements between Enron and LJM2" concealed from Andersen).

party" and therefore "the accounting that [Enron] achieved in the financial statements would not have been appropriate."[557] Solomon found that given the revelations since Enron's bankruptcy, LJM2 transactions should have been consolidated onto Enron's financial statements because LJM2 was not independent from Enron.[558] Foster found that "any purported sales by Enron to entities with which LJM2 was involved . . . were not sales because of the likely existence of side agreements between Enron and LJM2" concealed from Andersen.[559] For the same reason, Foster found that investments made by LJM2 in Enron-sponsored SPEs were not at risk "and, therefore, should not be counted as independent equity for purposes of applying the 3 percent independent equity at risk test for any Enron-sponsored SPE."[560]

The jury will be asked whether Merrill "directly or indirectly" either "employed" a "device, scheme, or artifice to defraud" or "engaged" in a deceptive or fraudulent "act, practice, or course of business" in connection with LJM2. The evidence in this case will permit the jury to respond in the affirmative.

2. The Nigerian Barges Transaction

This Court previously held the alleged conduct of Merrill in "purchasing Nigerian barges from Enron to create sham earnings of over $12 million in return for a secret, oral side agreement with Andrew Fastow that Enron would repurchase them within six months so there would be no risk, but only a lucrative profit for Merrill Lynch," to be "deceptive." *Enron*, 310 F. Supp. 2d at 829.

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557 7/18/06 Bass Depo. Tr. at 414:13-415:1.

558 Solomon Report at 100-01; *see also* Solomon Rebuttal Report at 88-89 (finding given revelations since Enron's bankruptcy, including the Global Galactic, Enron and Fastow controlled LJM2).

559 Foster Report, ¶¶69-70.

560 Foster Report, ¶172.

The Court further held "[s]uch allegations support a strong inference that Merrill knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return." *Id*. The same conclusion is reached under the SEC's principal-purpose-and-effect test, *Parmalat* and *Homestore*. As demonstrated here and in §II.C. above, the principal purpose and effect of Merrill's conduct in the Nigerian Barges transaction was to create a false appearance of fact, namely an asset sale.

The Nigerian Barges transaction was not a legitimate sale of assets, rather it constituted a disguised loan and the parking of assets. As internal documents and testimony indicate, and Merrill now all but concedes, "***Merrill Lynch is not in the business of owning barges***."[561] And Merrill did not conduct any due diligence before entering into the Nigerian Barges transaction, nor did it engage in any negotiations with Enron regarding the purchase price for the barges.[562] The reason for this is simple – Merrill received from Enron an oral guarantee that it would get back its purported investment, and a return on the investment, plus fees, within a defined period of time. As Andy Fastow testified: "***I let [Bayly] know that Merrill Lynch would be out of the deal in six months. That means by June 30, 2000, they'd get their specified rate of return and the fee as – we had agreed on a fee as well***."[563]

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[561] Ex. 87 at MLNBY0303952. *See also* Ex. 87 at MLNBY0303954 ("Merrill Lynch is not in the business of owning barges"); *id*. at MLNBY0303983 (same); *id*. at MLNBY0303958 ("***It's not a deal we would do in the normal course of our business***.").

[562] Ex. 12 at MLNBY0303191, MLNBY0303261; 9/23/04 Barges Trial Tr. at 1051:1-3 (Trinkle testimony) ("Was there any discussion about due diligence to be done with the barges themselves? No."); 10/11/04 Barges Trial Tr. at 4119:9-10 (Zrike testimony) ("***there had been no due diligence done***"); *id*. at 4120:10 ("no diligence"); Government Ex. 965D (9/25/02 Grand Jury testimony of James Brown) at 98:11-18 (Merrill did not do any due diligence before it agreed to do the barges deal).

[563] 3/7/06 Lay/Skilling Trial Tr. at 6492:11-6493:11. *See also supra* §III.B.

Merrill's oral side agreement with Enron was not accidental. It had the principal purpose and effect of creating the false appearance that the risks and rewards of ownership in the barges sale passed to Merrill when in fact that was not so. Merrill's early draft "sales" agreement for the Nigerian Barges transaction[564] made reference to the 15% rate of return[565] to be paid to Merrill on the $7 million investment and stated that Merrill's equity interest would be subsequently sold to third-party equity investors or purchased by Enron or an Enron affiliate.[566] These terms, however, were ***omitted*** from the final letter agreement between Merrill and Enron dated December 29, 1999.[567] As Merrill knew, its agreement with Enron could not be disclosed in writing because Enron would not be able to get the accounting treatment to inflate its profits as intended.[568] Making the guarantee orally was, in itself, intentionally deceptive. It created the false appearance that there was an asset sale when in fact the transaction constituted a disguised loan and asset parking. In other words, the transaction depended on a fiction, that there was a true asset sale – which there was not.

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564 *See* Ex. 97 at MLBE0294423-26 (Draft Letter Agreement).

565 *See id.* at MLBE0294423 (Draft Letter Agreement). When coupled with the $250,000 up-front fee to be paid by Enron to Merrill, the total rate of return to Merrill on its investment for the expected six-month life of the transaction was 22.14%. Ex. 13 at MLBE0296773 (Toone/Valenti email).

566 Ex. 97 at MLBE0294423 (Draft Letter Agreement).

567 *See* Ex. 95 at MLBE0049945-49 (12/29/99 Letter Agreement); *see also* Ex. 100 at MLBE0050388-407 (12/29/99 Share Purchase Agreement between Enron Nigeria Barge Holdings Ltd. and Ebarge, LLC); Ex. 96 at MLBE0050409-27 (12/29/99 Barge Loan Agreement; Pledge Agreement between Enron Nigeria Power Holding, Ltd. and Ebarge, LLC); Ex. 101 at MLBE0050529-32 (12/30/99 Confirmation Letter from Dan Boyle, Enron, to Ebarge).

568 9/23/04 Barges Trial Tr. at 1047:23-24 (Trinkle testimony) (Trinkle testified Merrill executives communicated to one another "***No, they can't [put it in writing] because, otherwise, they won't get the right accounting treatment***."). *See also* Fastow Decl., ¶34 ("Based upon my discussions with senior Merrill executives, I believe that Merrill understood the impact this transaction would have on Enron's financial statements, that the guarantee provided by me would likely change the accounting treatment of the transaction, and that the only reason for the transaction was to receive the desired accounting . . . treatment.").

Merrill's conduct in connection with the Nigerian Barges transactions had a deceptive effect because it caused Enron's accounting to be false, and it contributed to the overall scheme by (among other things) falsifying Enron's financial statements for fourth quarter and year-end 1999. *See supra* §III.B.4. The Nigerian Barges transaction was not a legitimate transaction that became deceptive ***only*** when it was reported. Fastow stated in his declaration: "***Arthur Andersen, had it known of the guarantee, would not have treated the transaction as a true sale***."[569] Andersen accountants and auditors and experts testified that Andersen was misled by the oral guarantee Enron gave Merrill, and Merrill engaged in highly deceptive conduct. *See supra* §III.B.4.-5. John Stewart testified, for example: "Had Andersen known about the oral side agreements . . . the appropriate accounting would have been it would not have been a sale at all because of the retention by Enron of the risks and rewards of ownership." *See supra* §III.B.4. Contrary to Merrill's benign portrayal, oral guarantees are so inherently deceptive that the SEC has warned financial institutions oral guarantees cause "improprieties" in financial statements and can lead to the issuer of the oral guarantee "fil[ing] false and misleading statements with the Securities and Exchange Commission." *See supra* at 78 & n.299.

Although there should be no question here, there certainly is a material issue of fact whether Merrill's conduct in the Nigerian Barges transaction was deceptive.

3. The Electricity Trades

This Court previously held the factual allegations concerning the Electricity Trades "with a clandestine agreement to cancel the transactions after Enron's 1999 earnings report" "suggest knowingly deceptive conduct." *Enron*, 310 F. Supp. 2d at 830. The same conclusion is reached under the SEC's principal-purpose-and-effect test, *Parmalat*, and *Homestore*. As demonstrated here

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569 Fastow Decl., ¶34.

and in §II.D. above, the principal purpose and effect of Merrill's conduct in the Electricity Trades transaction was to create a false appearance of fact, namely a physical power trade.

The Electricity Trades transaction did not involve a legitimate power purchase, rather it constituted a sham transaction with no transfer of significant risk. Internal documents and testimony demonstrate Merrill had not done such a transaction before and did not even have the ability to operationally schedule the delivery of power as indicated in the contracts. *See supra* §II.D.1. Nonetheless Merrill entered contracts indicating it would take delivery of power. Why? It was promised a huge fee and had an oral side agreement the transaction would be unwound and reversed after Enron reported nearly $50 million in earnings. As Fastow stated in his declaration, "***at the time the transaction closed in December 1999, there was a verbal agreement between Mr. Baxter and Mr. Tilney to unwind the transactions in 2000 in exchange for a predetermined fee to be paid by Enron to Merrill. I do not believe Merrill would have entered into these transactions absent the agreement to unwind the transactions and to pay the predetermined fee***."[570] The oral side agreement was not accidental.

Merrill's oral side agreement with Enron had the principal purpose and effect of creating the false appearance that significant risk had transferred to Merrill by the purchase of power, when that was not true. The contracts for the transaction falsely indicated on their face that Enron intended to deliver power to Merrill and Merrill intended to take delivery of that power. *See supra* §§III.D, III.D.8. The Power Purchase Agreement contained additional false representations and warranties that no assurances or guarantees had been made, no representations outside the contracts were being relied upon, there were no contemporaneous agreements, and the contracts constituted the entire agreement of Enron and Merrill. *See supra* §III.D.8. The contemporaneous oral side agreement to

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570 Fastow Decl., ¶36.

unwind and reverse the transaction for a fee to Merrill was ***omitted*** from the written documentation.[571] The purpose of the oral side agreement was deception. It created the false appearance that there was a power trade when in fact the transaction would be unwound and reversed. In other words, the transaction depended on a fiction, that there would be the delivery of power. But no power was delivered nor intended to be delivered.

According to Merrill, when the contracts were entered there was no power plant to deliver the electricity, construction of the plants was "completed in the Summer of 2000." Defs' Mem. at 40-41. This misses the point. The parties had an oral side agreement to unwind and reverse the transaction and did so before power could even be delivered. The transaction was bogus and neither the SEC nor any court has found that bogus commodity contracts get a pass just because the contracts are associated with "real" power plants or entered by "real" entities.

Merrill's conduct in connection with the Electricity Trades had a deceptive effect because it caused Enron's accounting to be false, and it contributed to the overall scheme by (among other things) falsifying Enron's financial statements for fourth quarter and year-end 1999. *See supra* §III.D.8. The Electricity Trades transaction was not a legitimate transaction that became deceptive ***only*** when it was reported. Fastow stated in his declaration the Electricity Trades "had the effect of increasing Enron's reported income by $40 million or more and contributed to causing Enron to report higher income at year end than it would otherwise have been able to report."[572]

Andersen accountants and auditors and experts testified Andersen was misled by the oral side agreement between Enron and Merrill, and Merrill engaged in deceptive conduct. For example, Bauer, who audited the transaction, testified he was deceived by collusion between Enron and

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571 *Compare* Fastow Decl., ¶36 *with* Foster Ex. 6A, Foster Report Ex. 79, Ex. 44349.

572 Fastow Decl., ¶36.

Merrill in this transaction, and had he discovered the oral side agreement alarm bells would have gone off at Andersen. *See supra* §III.D.8. He further testified such an oral side agreement would have negated the accounting treatment and the booking of any profits by the transaction. *See supra* §III.D.8. Foster testified "the fact that there . . . was no risk in the transaction which was concealed from Andersen . . . and/or the fact that the transaction unwound early would cause the accounting to be materially different."[573] *See supra* §III.D.8. Again, it is well recognized oral side agreements of this nature are inherently deceptive. *See supra* §III.B.4.-5.

Applying Judge Kaplan's decision in *Parmalat* to transactions very much like the Merrill Electricity Trades, Judge Werlein of this District held that engaging in circular, riskless commodities trades states a claim for primary violations of Rule 10b-5(a)-(c). In *Hopper*, the SEC alleged the defendants participated in "certain 'round-trip' energy trades" that "were sham transactions, bogus trades portrayed as legitimate sales, that were improperly accounted for and reported." 2006 U.S. Dist. LEXIS 17772, at *3. Like the Merrill electricity trades here, the SEC alleged the defendants had engaged in risk-less trades "with no contemplation of delivery." *Id*. at *5. Judge Werlein held:

> [I]t could be inferred that the round-trip trading scheme was fraudulent apart from the manner in which the trades were characterized in the SEC filings, given that the trades themselves were sham transactions . . . . ***Because the round-trip trades were sham transactions, and therefore had an inherent tendency to deceive, it cannot be said that the alleged fraud or deception only occurred when the trades were misreported in the companies' SEC filings***. Thus, the SEC has adequately alleged that [the defendant's] round-trip trading scheme was a "device" or "scheme" to defraud, or at least a "practice" or "course of business" which operated as a fraud or deceit upon the investing public, that encompassed conduct beyond mere misstatements.

Id. at *37-*38.

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573 5/15/06 Foster Depo. Tr. at 256:24-257:3.

Although there should be no question here, certainly there is a material issue of fact as to whether Merrill's conduct in the Electricity trades was deceptive.

B. Lead Plaintiff Is Entitled to a Presumption of Reliance as to Merrill

1. The *Affiliated Ute* Presumption of Reliance Applies

Merrill contends that the presumption of reliance afforded plaintiffs in certain securities cases under *Affiliated Ute* does not apply to this case. Defs' Mem. at 9. But Merrill concedes that this Court in the 6/5/06 Order "provisionally accepted" the applicability of the *Affiliated Ute* presumption here. Defs' Mem. at 9. In addition, shortly after Merrill's filing of its Motion, this Court issued an Opinion and Order of Class Certification ("7/5/06 Order"), which granted Lead Plaintiff's amended motion for class certification.

Thus, it is clear this Court has ruled that the *Affiliated Ute* presumption applies to this case, rejecting the argument by the Financial Institution Defendants that the presumption is supposedly inapplicable. *See Enron*, 2006 U.S. Dist. LEXIS 43146, at *101 ("Financial Defendants have argued that *Affiliated Ute* is inapplicable here . . . ."). This Court rejects this argument.[574]

For the same reasons this Court rejected Merrill's previous challenges, the Court should reject Merrill's third swing at the *Affiliated Ute* presumption and adhere to its previous rulings that the presumption applies, consistent with Fifth Circuit law.

[574] This Court also rejected Merrill's earlier challenge to the applicability of *Affiliated Ute*. *See In re Enron Corp. Sec. Litig.*, 236 F.R.D. 313, 316 (S.D. Tex. 2006) ("the Court here . . . will not address a number of arguments raised by objectors to Plaintiff's Trial Plan that are rehashings of issues of law upon which this Court has recently ruled").

a. Sufficient Omissions Are Present to Trigger the *Affiliated Ute* Presumption

Because Lead Plaintiff's case against Merrill alleges the existence of an undisclosed fraudulent scheme to conceal the true financial condition of Enron in violation of Rule 10b-5(a) and (c), the *Affiliated Ute* presumption of reliance is available.

This Court ruled in the 6/5/06 Order (and reiterated by reference in the 7/5/06 Order) that the *Affiliated Ute* presumption of reliance is available to plaintiffs in cases involving allegations "primarily of omissions." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *101 (citing *Affiliated Ute*, 406 U.S. at 153; *Finkel v. Docutel/Olivetti Corp*., 817 F.2d 356, 359 (5th Cir. 1987)). Use of the "primarily" qualifier allows application of the presumption despite the presence of affirmative false statements which produce a "mixed context" of misstatements and omissions. *Enron,* 2006 U.S. Dist. LEXIS 43146, at *101-*103, *112 ("The case need only be primarily one of nondisclosure, not a case of pure nondisclosure, for the *Ute* presumption of reliance to apply for scheme or course of business liability under Rule 10b-5(a) and (c)."). The Court's ruling explicitly and correctly relies on Supreme Court and Fifth Circuit law. *See id.* at *96-*103.

Merrill nevertheless urges reconsideration of this ruling because, purportedly, this is "not" "an omissions case." Defs' Mem. at §I.A.2. Merrill's argument on this point rests on the assertion that for *Affiliated Ute* to apply, the case must be one of so-called pure omissions. *See* Defs' Mem. at 11-13. Yet, as indicated by the Court's analysis above, this is clearly contrary to Supreme Court and Fifth Circuit law which finds the presumption applicable in cases "***primarily*** of omissions." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *101-*103. Merrill here attempts an end-run around Fifth Circuit law. Its motion ***does not even discuss or cite Finkel***, a Fifth Circuit decision on which this Court relied in holding the presumption applicable to this case. In *Finkel*, the Fifth Circuit recognized there are no "pure" omissions cases:

> 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*. The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the market place; if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3).

Finkel, 817 F.2d at 363-64. *See also* Lead Plaintiff's Response to the Bank Defendants' Supplemental Briefing in Opposition to Lead Plaintiff's Amended Motion for Class Certification (Docket No. 1445) (Docket No. 4529) at 56-57.[575]

Merrill's instant argument – its third such argument – presents the Court with nothing new. Indeed, Merrill relies on three cases whose holdings were ***already examined by this Court*** in concluding that *Affiliated Ute* nevertheless applies to this case. *Compare* Defs' Mem. at 11-12 *with Enron*, 2006 U.S. Dist. LEXIS 43146, at *91-*96. This Court should again reject the suggestion that these decisions require a contrary result. *See LeClerc v. Webb*, 419 F.3d 405, 412 (5th Cir. 2005).[576]

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575 Moreover, even assuming arguendo that Lead Plaintiff is required to show that there were no affirmative statements regarding the relevant conduct, Lead Plaintiff can do so. In fact, neither Merrill nor Enron made any affirmative statements to the market discussing, or addressing the financial impact of, the Nigerian Barges or the Electricity Trades transactions, much less the true nature of the manipulative LJM2 transactions.

576 Lead Plaintiff notes that this Court has already rejected the Financial Institution Defendants' argument that Lead Plaintiff's invocation of the presumption is defective as unpled. *See Enron*, 2006 U.S. Dist. LEXIS 43146, at *103-*104 ("At the Class Certification hearing the Financial Institution Defendants complained and demonstrated that Lead Plaintiff did not plead the *Affiliated Ute* presumption of reliance and contended that it therefore could not assert that theory now. . . . [T]he Court rejects Defendants' failure-to-plead argument."). Merrill's claim that Lead Plaintiff first argued for application of the *Affiliated Ute* presumption "for the first time at oral argument on class certification" (Defs' Mem. at 9) is simply untrue. This Court recognized the application of the *Affilited Ute* presumption in the case in 2002. *See* 235 F. Supp. 2d at 577. And Lead Plaintiff has continued to rely on it prior to Class Certification as recently as October 2005 – six months prior to the Class Certification hearing in March 2006. *See* Lead Plaintiff's Reply in Support of Corrected Motion for Leave to File an Amended Complaint as to Deutsche Bank (Docket No. 3903) (Docket

b. Merrill's Duty-to-Disclose Argument Does Not Deprive Lead Plaintiff of the Benefit of the *Affiliated Ute* Presumption

Merrill also contends that *Affiliated Ute* is inapplicable because Merrill purportedly had no "duty to disclose." Defs' Mem. at §I.a.1. But Merrill again ignores this Court's previous rulings and other controlling law misconstruing the duty at issue.

(1) This Court Has Already Ruled that Merrill Had the Requisite Duty – A Duty Not to Engage in Acts Proscribed in Section 10b-5(a) and (c)

This Court has rejected the Financial Institution Defendants' argument that an absence of a duty to disclose bars application of the *Affiliated Ute* presumption of reliance.[577] After careful analysis of Fifth Circuit law, this Court ruled that Merrill and other Financial Institution Defendants, in the scheme context, had a duty – a duty not to engage in conduct proscribed by Rule 10b-5(a) and (c):

> [T]he Fifth Circuit has ruled that for a presumption of reliance, a duty to disclose is relevant only to Rule 10b-5(b) claims of statements that are either false or misleading; in a scheme case brought under Rule 10b-5(a) and (c)("employ any device, scheme or artifice to defraud" or "engage in any act, practice or course of business that operates or would operate as a fraud"), the Fifth Circuit has indicated that the requisite duty is not a duty to disclose, but . . . "the duty not to engage in a fraudulent 'scheme' or 'course of conduct' [that] could be based primarily on an omission."

No. 4065) at 27-30. *See also* Lead Plaintiff's Opposition to the Deutsche Bank Entities' Motion to File a Sur-Reply in Opposition to Lead Plaintiff's Corrected Motion to File an Amended Complaint (Docket No. 3903) (Docket No. 4159) at 2; Lead Plaintiff's Opposition to the Deutsche Bank Entities' Supplemental Filing in Support of their Motion for Reconsideration (Docket No. 3791) and in Opposition to Lead Plaintiff's Motion to Amend (Docket No. 3903) in Light of the Court's December 5, 2005 Opinion (Docket No. 4388) at 10-11.

[577] *See Enron*, 2006 U.S. Dist. LEXIS 43146, at *101 (stating: "Financial Defendants have argued that *Affiliated Ute* is inapplicable here because one of its requirements is that the defendant have a duty to disclose to the plaintiff, and they maintain they do not owe such a duty to the *Newby* plaintiffs under the circumstances alleged"; yet holding presumption applicable).

Enron, 2006 U.S. Dist. LEXIS 43146, at *102. Accordingly, Merrill's argument that it had no "duty to disclose" is of no import.[578] *Affiliated Ute* remains applicable by virtue of Merrill's duty not to engage in deceitful conduct, the principal purpose and effect of which was to distort Enron's financials.

The Court's holding on this point is thoroughly grounded in Fifth Circuit law. In *Ayres*, 845 F.2d at 1363, relied upon by the Court, the Fifth Circuit extensively analyzed the proper application of the *Affiliated Ute* presumption, concluding that it applies where defendants breach "the duty not to engage in a fraudulent 'scheme' or 'course of conduct'" under Rule 10b-5(a) and (c).[579] Contrary to what Merrill proclaims at footnote 6 of its Motion, this is not a "massive loophole in the securities

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[578] Generally, duty and reliance are separate elements of a claim for deceit, whether common law or statutory. Merrill is trying to conflate the two. Merrill would require, in cases like this one, the existence and violation of two separate duties – the duty not to engage in scheme conduct prohibited by 10b-5(a) or (c), and a separate duty to disclose that is somehow part of the reliance element. Merrill's argument boils down to this: if a person violates sub-sections (a) or (c) through affirmative conduct which does not involve non-disclosure or a duty to disclose, there can be no *Affiliated Ute*-style presumption of reliance unless the person also has (and violates) a separate duty to disclose. There is no logic to the argument. There is no reason why a separate duty to disclose should be a prerequisite for presumed reliance; there is no logical connection between a duty to disclose and the decision by the hypothetical reasonable investor to buy Enron stock. But there is a logical connection between that hypothetical investment decision and manipulation of the issuer's financial statements.

[579] *See also Finkel*, 817 F.2d at 359-60 (the *Affiliated Ute* presumption applies regardless of the existence vel non of any duty to disclose); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185-89 (3d Cir. 1981) (without any discussion of a purported duty to disclose, the Third Circuit upheld the jury's finding of primary liability for defendants' acts in furtherance of a Ponzi scheme and ruled the district court properly instructed the jury on the *Affiliated Ute* presumption of reliance on omissions even though the defendants had "misrepresented certain crucial facts"); *Fogarazzo v. Lehman Bros.*, 232 F.R.D. 176, 186 (S.D.N.Y. 2005) (applying *Affiliated Ute* presumption of reliance without any discussion of purported need of duty of disclosure); *CFTC v. Marquis Fin. Mgmt. Sys.*, No. 03-74206, 2005 U.S. Dist. LEXIS 41438, at *23-*24 (E.D. Mich. June 8, 2005) (same); *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 105 (S.D.N.Y. 2004) (same); *Walco Invs. v. Thenen*, 168 F.R.D. 315, 331-32 (S.D. Fla. 1996) (applying the *Affiliated Ute* presumption of reliance without any discussion of a purported need for duty of disclosure, where plaintiffs alleged the existence of a fraudulent Ponzi scheme).

laws." The Court's previous rejection of Merrill's arguments rested on an eminently sound application of Fifth Circuit law and there is no reason for the Court to reverse that decision.

This very issue was addressed by the court in *Parmalat I*. There the court noted that the bank defendants "made no representations in connection with those schemes, at least none relevant here." 376 F. Supp. 2d at 509. The banks in *Parmalat I* argued that plaintiffs therefore cannot be said to have relied on the banks.

The court in *Parmalat I,* however, noted that the Supreme Court had explained there is more than one way to prove transaction causation. *Id*. And while it is often said that reliance is an element of a private cause of action under Rule 10b-5, that formulation typically arises in the context of Rule 10b-5(b) actions based on misstatements and omissions – in other words, conduct in violation of Rule 10b-5(b), not (a) and (c). *Id*. The court in *Parmalat I* stated that the reliance requirement in that context has a very specific foundation to provide the requisite causal connection between a defendant's misrepresentation and plaintiff's injury or in the Second Circuit's formulation, to certify that the conduct of the defendant actually caused the injury. *Id*. Because a Rule 10b-5 cause of action does not precisely track the common law tort of fraud and there is more than one way to prove transaction causation, in the scheme context if the defendant's (the bank's) actions were a substantial cause of the harm, *i.e.*, a foreseeable cause and the defendant (bank) itself as well as the issuer both committed acts in violation of the rule, both may be liable. *Id*. Specifically, the court in *Parmalat I* noted:

> 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.
>
> 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.

Id. at 509-10.

However, even if Merrill were correct and there is a disclosure duty,[580] this Court noted that to the extent a duty to disclose arises, it arises as to one that engages in a scheme. *Enron*, 2006 U.S. Dist. LEXIS 43146, at *102. *See also IPO*, 241 F. Supp. 2d at 381-82 ("Where a defendant has engaged in conduct that amounts to 'market manipulation' under Rule 10b-5(a) or (c), that misconduct creates an independent duty to disclose. . . . [P]articipants in the securities markets are entitled to presume that all of the actors are behaving legally; silence that conceals illegal activity is therefore intrinsically misleading and (presuming the illegality is also material) is always violative of Rule 10b-5(b)."); *Santos*, 355 F. Supp. 2d at 920 (relying on initial public offering and holding that violations of subsections (a) and (c) of Rule 10b-5 create an independent duty to disclose that is not limited to market manipulation). Having pled and now supplied the evidence supporting the scheme

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580 Merrill's duty-to-disclose argument is based upon a misreading of the *Affiliated Ute* decision. Merrill reads *Affiliated Ute* as requiring a duty to disclose as an absolute prerequisite for the presumption of reliance. The better reading is that the *Affiliated Ute* opinion recognized that, under the facts of that case, a duty to disclose was necessary to a finding that the defendants had engaged in a prohibited scheme. But, once the scheme was established, the presumption of reliance flowed from the fact that the forbidden conduct was hidden, not from the fact that the defendants had a duty to disclose. As noted in the Supreme Court's opinion in *Affiliated Ute*, because the individual defendants had engaged in a scheme that created a market, they could be liable not only for their own purchases consisting of 81.3% of the sales, but for other sales their activities produced. In other words, sales that their scheme caused, but not ones in which the defendants made an independent misrepresentation to be relied upon. *Affiliated Ute*, 406 U.S. at 153. In the end it was the scheme, not the duty to disclose, that created the presumption of reliance. In this case, Merrill's violation of Rule 10b-5(a) and (c) does not depend upon a duty to disclose. In other words, the basis for liability here is affirmative conduct, not (as in *Affiliated Ute*) non-disclosure. Here, liability flows from Merrill's affirmative acts in violation of the law, not (as in *Affiliated Ute*) from inaction (silence) that violates the law only because of the duty to disclose that was a part of a scheme.

and Merrill's involvement in it, Lead Plaintiff is entitled to the *Affiliated Ute* presumption of reliance.

Furthermore, to the extent necessary, Lead Plaintiff can easily demonstrate that Merrill indeed had a duty to disclose in this case for two alternative reasons.

(2) Merrill Had a Duty to Disclose Because It Sold Enron Securities

During the Class Period, Merrill acted as both an underwriter and market-maker in Enron securities.[581] By trading Enron securities with the investing public, Merrill assumed a duty to disclose all material facts known to it about Enron's true financial condition – such as the ways in which Merrill distorted that reported financial condition through the conduct described *infra* at §III.D.[582] *Enron*, 235 F. Supp. 2d at 612 ("An underwriter of a public offering risks exposure to such liability under §11, ***as well as to liability under §10(b)*** for any material misstatements or omissions in the registration statement made with scienter, and thus has a duty to investigate an issuer and the securities that the underwriter offers to investors."). Both this Court and the Supreme

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581 *See* Ex. 135 at Attachment A (Merrill Lynch Co., Inc.'s & Merrill Lynch, Pierce, Fenner & Smith Incorporated's Responses and Objections to Plaintiffs' First Set of Interrogatories ("Merrill Rog. Resp."); Ex. 113 at 4-5 ("An affiliate of Merrill Lynch serves as a specialist in this stock in its primary market. Such specialist may have a long or short position in this stock or in options on this stock, and may be on the opposite side of public orders."); Ex. 115 at 4 ("An affiliate of MLPF&S serves as a specialist in this stock in its primary market. Such specialist may have a long or short position in this stock or in options on this stock, and may be on the opposite side of public orders."); Ex. 121 at 3 ("MLPF&S and its affiliates may trade for their own accounts as odd-lot dealer, market maker, block positioner, specialist and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders."); Ex. 124 at 10 ("MLPF&S and its affiliates may trade for their own accounts as odd-lot dealer, market maker, block positioner, specialist and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders."); Ex. 125 at 2 ("MLPF&S and its affiliates may trade for their own accounts as odd-lot dealer, market maker, block positioner, specialist and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders.").

582 *See, e.g.*, 5/17/06 Deposition Transcript of Robert Haft ("5/17/06 Haft Depo. Tr.") at 406 (testimony of Deutsche Bank's expert on due diligence).

Court recognize that underwriters take on a fiduciary relationship with shareholders of a company imposing certain duties of disclosure.[583]

Merrill sold hundreds of millions of dollars worth of Enron securities during the Class Period. Those offerings included a $752 million offering of Enron common stock in February 1999 and over 150 billion Yen denominated notes between November 1999 and June 2001. *See* Ex. 135 at Attachment A (Merrill Rog. Resp.). In addition, Merrill arranged a program to sell $500 million of Enron notes in May 2000. *See* Ex. 136 (5/19/00 Prospectus).

In addition, Enron served as a market-maker and therefore had a duty to disclose the truth. *See Affiliated Ute*, 406 U.S. at 153.

(3) Merrill Had a Duty to Disclose Because It Published Analyst Reports on Enron

The Court's previous rulings dealing with analyst's reports as non-actionable unless plaintiff establishes scienter as to the analyst or those controlling the reports are satisfied here. As noted above, Merrill fired its analyst after speaking with Enron and then assured Enron that Enron could expect "some good coverage."[584] The new analyst's first report upgraded Merrill's rating on Enron

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583 *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an ***underwriter***, accountant, lawyer, or consultant working for the corporation, these outsiders may become ***fiduciaries of the shareholders***. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."); February 18, 2005 Memorandum and Order (Docket No. 30 in Case No. H-03-4359) at 24 ("Because an underwriter has access to information not generally available to the public and because the public relies on the expertise, integrity, and independent analysis of the underwriter, ***there is a relationship of confidence and trust with the investing public, and the underwriter is charged with a high standard of professional conduct*** and reasonable investigatory responsibility.").

584 10/24/06 Fastow Depo. Tr. at 520:1-9.

from neutral to accumulate.[585] These deliberate actions undertaken by those involved (Tilney) in LJM2 and the Nigerian Barges and Electricity Trades transactions supply the necessary scienter behind the false Merrill reports. *See supra* §III.E. Thus, Merrill's publicly issued analyst reports discussing Enron's reported financial condition are actionable.[586] Merrill's Tilney knew they were false and misleading and orchestrated the issuance of the positive, but false reports.[587] The issuance of the reports was part of the overall scheme because without the positive reports, Merrill was unable to engage in certain other transactions (*see supra* §III.E.) as part of the scheme.[588] Because Merrill chose to speak on the subject of Enron's financial condition, it had a duty to disclose all material facts known to it concerning that financial condition. *See Rubinstein v. Collins*, 20 F.3d 160, 170 (5th Cir. 1994) ("As we have long held under Rule 10b-5, 'a duty to speak the full truth arises when a defendant undertakes a duty to say anything.'"); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977) (same); *Kunzweiler v. Zero.net, Inc*., No. 3:00-CV-2553-P, 2002 U.S. Dist. LEXIS 12080, at *30 (N.D. Tex. July 3, 2002) (same); *Kurtzman v. Compaq Computer Corp*., No. H-99-779, 2000 U.S. Dist. LEXIS 22476, at *189 (S.D. Tex. Dec. 12, 2000) ("The duty to

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585 Ex. 112 at ELIB00000631-00001-04 (1/20/99 Donato J. Eassey, Merrill Lynch, Comment: "Enron Corp. – Solid Results in A Difficult Environment"); Ex. 120 at 27-28; *see also* Ex. 18 at 22.

586 *See* Exs. 137-138.

587 Thus "'[t]he knowledge necessary to form the requisite fraudulent intent must be possessed by at least one agent and cannot be inferred and imputed to a corporation based on disconnected facts known by different agents.'" February 18, 2005 Memorandum and Order (Docket No. 30 in Case No. H-03-4359) at 40.

588 *See* Ex. 121 at 1 ("Intermediate Term: Accumulate") ("Enron Corp. – Solid Results In a Difficult Environment"); Exs. 122, 123 at 1 ("Intermediate Term: Accumulate"); Ex. 124 at 1 ("Intermediate Term: Accumulate"); Ex. 125 at 1 ("Intermediate Term: Buy") ("Enron Corp. – Strength In Numbers and Then Some"); Ex. 126 at 1 ("Raising the Bar – Again") ("We reiterate our Buy opinions").

disclose information exists when such disclosure is necessary to make defendants' statements, whether mandatory or volunteered, not misleading.").

2. *Greenberg* Does Not Appear to Apply Directly to Scheme Allegations

This Court has noted that *Greenberg v. Crossroads Sys.*, 364 F.3d 657 (5th Cir. 2004), does ***not*** appear to apply to non-representational claims under Rule 10b-5(a) and (c). *Enron*, 236 F.R.D. at 316. Merrill seeks reconsideration of this recent ruling in its Motion. Again, this Court should not entertain Merrill's efforts to endlessly "rehash" and resubmit failed legal arguments. *See LeClerc*, 419 F.3d at 412. Moreover, it must be noted that Merrill's argument here relies on a misreading of *Greenberg*, a misinterpretation of this Court's previous rulings, and a fundamental misunderstanding of what conduct is actionable under the securities laws.

Merrill argues that *Greenberg* applies to scheme cases because the "plaintiffs in *Greenberg* alleged a scheme." Defs' Mem. at 16. But in *Greenberg*, the plaintiffs used the term "scheme" to describe their case in which the gravamen was false and misleading statements under Rule 10b-5(b), and on the appeal the Fifth Circuit clearly found so. "The action is based on several ***statements*** made by defendants relating to the capabilities of Crossroads's products and financial results for the first three quarters of Fiscal Year 2000." *Greenberg*, 364 F.3d at 659-60. According to the Fifth Circuit, the "***pertinent*** part" of Rule 10b-5 was subsection "(b)" – the only subsection quoted by the panel. *Id*. at 662 n.5. Merrill is flat wrong that *Greenberg* concerned scheme liability claims under Rule 10b-5(a) and (c). This Court was completely correct in concluding that reliance regarding "conduct charged under Rule 10b-5(a) and (c)" was simply "not addressed by *Greenberg*." *Enron*, 236 F.R.D. at 316.

The same conclusion is required with regard to *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir. 2001). In that case, the Fifth Circuit used the generic "scheme" label but clarified that the case concerned "issuing a series of public misrepresentations about two of Zonagen's potential products" (*id*. at 404), and again, identified the only "relevant part" of Rule 10b-5 as subsection "(b)" (*id.* at 406 n.5). Thus, neither did *Zonagen* address conduct alleged to violate Rule 10b-5(a) and (c).

In arguing that even in a scheme case, reliance must supposedly "derive[]" only from misrepresentations (Defs' Mem. at 15), Merrill speculates that "[t]his Court has placed heavy reliance on Judge Kaplan in *Parmalat*." Defs' Mem. at 14. Merrill then claims the Court's holding that *Greenberg* does not apply in this scheme liability case "is at odds with both *Parmalat* and the SEC's *Homestore.com* Amicus Brief." Defs' Mem. at 16. This is incorrect. As these cases make clear, the focus is on conduct not the ultimate misrepresentation which the issuer may publish which flows from the conduct.

Thus, Merrill is also incorrect in claiming *Parmalat* and its adoption of the position of the SEC in *Homestore* means that the reliance inquiry must focus only on misstatements, and not conduct. *See* Defs' Mem. at 15-18. While both *Parmalat* and the SEC envision that deception from conduct ***can*** flow through a misstatement, the analysis of each is of the conduct violative of Rule 10b-5(a) and (c). Indeed, this Court quoted *Parmalat I* as holding that scheme conduct is actionable "'***even if*** a material misstatement by another person creates the nexus between the scheme and the securities market.'" *Enron*, 439 F. Supp. 2d at 715 (quoting *Parmalat I*, 376 F. Supp. 2d at 502).

As to the SEC, the Court observed that "The SEC argues, 'The reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception ***flowing from*** a deceptive act . . . ..'" *Enron*, 439 F. Supp. 2d at 718. The SEC did not conclude that deception flows through ***only*** misstatements. In fact, in the 6/5/06 Order, this Court observed that the SEC faulted the *Homestore* District Court's conclusion "that the plaintiffs relied on Homestore's misrepresentations about its revenue and not on the ***business partners' conduct***." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *172. Thus, Merrill's assertion that *Parmalat* and the SEC require adoption of Merrill's argument on reliance is unfounded.

Merrill makes the sweeping assertion that "every deceptive act, to qualify as securities fraud ***must result in a misrepresentation*** upon which an investor relies." Defs' Mem. at 17. This is unquestionably wrong. For one thing, it is indisputable that securities fraud can be perpetrated by omissions and nondisclosure, not just misrepresentations. Furthermore, in *Affiliated Ute* and *Zandford*, the Supreme Court confirmed that claims under subsections (a) and (c) do ***not*** require the making of a false or misleading statement. *Accord Enron*, 2006 U.S. Dist. LEXIS 43146, at *288 ("The Supreme Court has not limited §10(b)/Rule 10b-5 violations to misrepresentations, but has recognized scheme and course-of-business liability under the Rule's subsections (a) and (c))."

Equally faulty is Merrill's claim that conduct supposedly cannot be relied upon if it was "unknown" to the market. Defs' Mem. at 17. The most salient feature of the Supreme Court's decision in *Affiliated Ute* is that precisely because the defendants' status as market-makers in the relevant securities was ***unknown*** to the plaintiffs, reliance would not only nevertheless be possible, but so virtually certain that it would be ***presumed***.

3. Lead Plaintiff's Evidence Nevertheless Satisfies *Greenberg*

Even if *Greenberg* were applied in the manner Merrill argues (Defs' Mem. at §I.C.), it would ***not*** invalidate Lead Plaintiff's evidence regarding Merrill for two, separate and independent reasons.

a. The *Greenberg* Facts

Merrill argues that under *Greenberg* the fraud-on-the-market presumption cannot be applied in this case. According to Merrill, the claims against it must be dismissed because the reliance element cannot be met. But Merrill presents no evidence to disprove reliance by Lead Plaintiff. It only attempts yet again to assert that the Court erred in its prior rulings on the reliance presumption.

Merrill's view of *Greenberg* is far too expansive. The practical effect of Merrill's argument would be to immunize fraudulent end-of-quarter transactions that have the purpose and effect of artificially boosting earnings or cash flow to meet prior analysts' estimates. But *Greenberg* did not involve hidden and fraudulent end-of-quarter transactions, as this case does. Under Merrill's view of *Greenberg*, issuers, as well as secondary actors, would be immunized from liability for hidden end-of-quarter fraud that enables the issuer to falsely report that it had met Wall Street's expectations.

Merrill focuses principally on *Greenberg*'s so-called "non-confirmatory test." *Greenberg* held the release of "confirmatory information" that has been previously digested by the market and that does not cause a company's stock price to move is not actionable. The court defined confirmatory information as "***information*** [that] has already been digested by the market" which, as a result, "will not cause a change in stock price." *Greenberg*, 364 F.3d at 666.

At issue in *Greenberg* was a series of announcements about the company's new product line and its earnings based on sale of those products. *See id*. The Court viewed the second or third announcement of the same fact as merely "confirmatory" of the initial announcement of that fact, where that old news did not move the market. *See id*. ("a market will not double-count the same information"). Under those circumstances, the Court held, plaintiffs could not use the "special circumstances" language contained in *Nathenson*, 267 F.3d at 419, to explain the non-movement of the stock price. *Greenberg*, 364 F.3d at 663.

Here, in contrast, there is no recycled old news. Merrill stands *Greenberg*'s language on its head, claiming that ***new information*** that has ***not*** been disclosed to or digested by the market in the first place, *i.e.*, the sham LJM2, Nigerian Barges transactions and Electricity Trades, can nevertheless be deemed "confirmatory" in nature and accordingly be deemed ineligible for fraud-on-the-market treatment.

Merrill confuses the meaning of "information" as used in *Greenberg*. In that case, the "information" was what had been announced about the new product line and earnings based on product sales. Merrill erroneously assumes that the relevant "information" was only the expected earnings number, without regard to product or other announcements that might inform the expectations. So, according to Merrill, the principal test in a case involving hidden, end-of-quarter fraud is whether it was effective, *i.e*., did the fraudulent acts or transactions in fact permit the company to announce – falsely – that it had met earnings expectations? If, according to Merrill, the fraud was effective in that sense and the company did announce earnings in line with expectations, the earnings announcement would be deemed "confirmatory" and any claim based on that fraud would be ineligible for treatment as a class action. That is absurd.

The proposed "Merrill Rule" thus would also preclude class action treatment of cases such as the *Worldcom* fraud, where the Company insiders cooked the books through fraudulent end-of-quarter reductions to various expense items so as to meet Wall Street's earnings expectations. Under the Merrill Rule, such fraud could not be pursued on a class action basis – and indeed probably not at all – because the result of the fraud was that Worldcom's announced (but fraudulent) earnings met Wall Street's expectations. Therefore, according to Merrill, the earnings announcements were merely "confirmatory," and no presumption of reliance could properly be utilized.

Put another way, Merrill's argument is essentially:

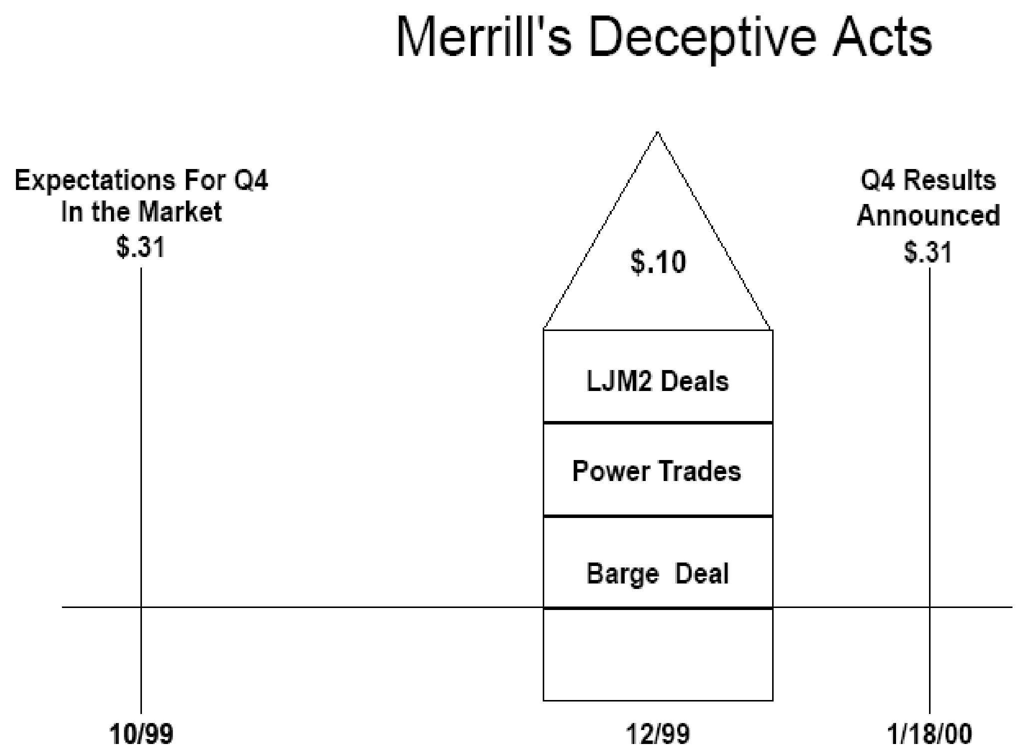
- Merrill's deceptive transactions (which took place in the last days of December 1999) affected Enron's fourth quarter 1999 earnings.

- Therefore, the reliance element with respect to these transactions must derive from the January 18, 2000, public announcement of Enron's fourth quarter earnings.

- But (according to Merrill) the January 18, 2000 announcement of fourth quarter earnings was "confirmatory" in nature, since the earnings were in line with earnings estimates that were already "in the market" – and had been since at least October 1999.

- Since (according to Merrill) the earnings announcement was "confirmatory" and therefore cannot provide the basis for a fraud-on-the-market presumption, claims arising from the end-of-quarter fraud engineered by Merrill – fraud that accounted for 30% or more of Enron's reported "earnings" for the period – cannot benefit from a presumption of reliance and therefore must fail.

Merrill's argument is depicted below:



As the graphic depicts, the $0.31 of "earnings" announced on January 18, 2000, included $.10 of "earnings" created as a result of the Merrill end-of-quarter transactions. Merrill does not (and cannot) demonstrate that "information" concerning these transactions was "digested by the market" in any form or fashion prior to the January 18, 2000 earnings release. Indeed, Merrill's transactions were ultimately structured, funded and executed in late December 1999 (well after Enron's October earnings forecast) and booked internally just prior to the earnings release. It is equally impossible for Merrill to call this information "confirmatory," because the crucial facts were concealed, not affirmatively misrepresented.

Furthermore, in many cases achieving a forecast is ***new*** information – and does impact the stock price. Here, for example, when Enron said it ***met*** its projections, it conveyed actual ***achievement*** of earnings – which is new and different information from a ***projection*** made three months earlier. Had Enron failed to meet market expectations, its price would have declined. Indeed, expert testimony developed in discovery concluded as much: Enron's stock price would have declined sharply "if it ***did not*** report financial earnings or other financial metric ***in line with its projections*** during the period between 1997 and the second quarter of 2001."[589] Barclays' expert agreed: "I would expect the price of the stock to obviously go down, and maybe by a substantial amount."[590]

Greenberg stands for the proposition that follow-on announcements of the same ***fact*** with no price change – whether standing alone or incorporated in an earnings expectation or earnings release – will not support the fraud-on-the-market presumption. Merrill's argument contradicts that proposition and far from justifies the absurd holding in this case Merrill requests.

b. Even if *Greenberg* Applied, this Case Satisfies *Greenberg*'s Requirements

Merrill argues that Lead Plaintiff's case against it fails *Greenberg*'s "actual movement test." *See* Defs' Mem. at 23-24.[591] But this is not so. Merrill states that this test is satisfied if,

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589 11/9/04 Deposition Transcript of David Fleischer ("11/9/04 Fleischer Depo. Tr.") at 55-56.

590 5/23/06 Deposition Transcript of Michael Gibbons ("5/23/06 Gibbons Depo. Tr.") at 127:24-128:10. *See also infra* at 184-185, 189-198 (demonstrating inflationary effect of Merrill transactions on Enron's stock price).

591 The *Greenberg* test, even if applied in the absurd way Merrill would apply it, would not preclude reliance on the January 18, 2000 announcement because in fact that announcement was ***not*** confirmatory of what the markets expected of Enron, *i.e.*, that Enron beat expectations. Because Enron did not beat expectations, its stock dropped nearly 2% from the previous day, as Merrill concedes in its Motion.

> when ***the falsity of the non-confirmatory misrepresentation later is revealed***, there occurred a "related" ***decrease in stock price*** "and that it was this negative statement, and not other unrelated negative statements, that caused a significant amount of the decline."

Id. at 20 (quoting *Greenberg*, 364 F.3d at 665-66). This is precisely what happened in this case.[592] As discussed in detail herein, Lead Plaintiff has ample evidence establishing that Merrill's conduct in structuring LJM2 and the Nigerian Barges and Electricity Trades transactions operated to falsify Enron's year-end 1999 reported financial results, and thus the January 18, 2000 announcement of those results. No information about the transactions at issue was released prior to January 18, 2000, so the numbers announced were not confirmatory as to the falsity alleged.

Furthermore, Merrill Lynch's conduct in connection with LJM2 continued to significantly impact Enron's reported financial condition into 2000 and 2001. For example, the LJM2-Raptors transactions alone in fourth quarter 2000 and first quarter 2001 falsely inflated earnings by $532 million and $253 million, respectively.[593] On January 22, 2001, Enron announced fourth quarter and year-end 2000 financial results artificially inflated by LJM2-Raptors. The results ***exceeded*** many analyst estimates and Merrill Lynch issued "BUY" rating analyst reports on January 22-23, 2001,

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592 Merrill was approached in August 1999 by Enron to structure LJM2. On October 12, 1999, Merrill's estimate was $0.24 a share. *See* Ex. 122 at 1 (ML 10/12/99 report at 12p.m.). At the close of business, Merrill raised its estimate to $0.29 a share. *See* Ex. 123 at 1 (ML 10/12/99 report at 16:48p.m.). The raise in estimate by Merrill caused the stock to rise 2.39% the next day, a statistically significant rise under any expert's view. *See* Nye Report, Ex. 11 at 6 (entry for 10/13/99). Of course, the stock continued to rise based, at least in part, on expectations that Enron would meet or exceed fourth quarter and year-end 1999 estimates. The "false" and "deceptive" December 1999 transactions were not confirmatory of anything in the market.

593 *See* Ex. A; Solomon Supp. Report at Schedules 3-4; *supra* §III.A.3.b.-d.

calling the results "impressive," increasing 2001 and 2002 EPS estimates, and stating "ENE's operating growth is what legends are made from."[594] Enron's stock price increased significantly.[595] On April 17, 2001, Enron announced financial results for first quarter 2001 artificially inflated by LJM2-Raptors. The results ***exceeded*** consensus estimates and Merrill Lynch issued "BUY" rating analyst reports on April 17-18, 2001, stating "ENE's operating growth continues to soar/scream," and "once again raising EPS expectations in '01 and '02."[596] Enron's stock price increased significantly.[597]

The falsity, the strength of Enron's operations and financials, was revealed as information in the Spring of 2001 hit the market as well as on November 8, 2001, when, as Lead Plaintiff's Expert witness discusses, Enron admitted the falsity of its financial statements, prompting a precipitous decline in the price of Enron stock:

> On November 8 . . . Enron's share price fell significantly yet again. The 7.1% decline in share price from $9.05 to $8.41 was statistically significant net of market and industry effects (a net decline of 7.8%). Enron's share price fell on confirmation from the Company that Enron had ***misstated its financial results and financial condition for years*** and very likely on the prospect of a deal with Dynegy that could significantly dilute shareholders' interests. . . . At 10:06 am EST, First Call carried an Enron press release announcing the filing of a Form 8-K with the SEC in which Enron declared its intent ***to restate its financial statements for years 1997 through 2000***, and for year 2001 through the second quarter, *i.e.*, all the quarterly financial statements released for 2001.[598]

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594 Ex. B. *See also* Ex. 125; Ex. 151; Nye Report, ¶¶90-91.

595 *See* Nye Report, ¶¶90-91; Nye Report, Ex. 11 at 13 (entries for 1/22-1/23/01).

596 Ex. 152; Ex. 126. *See also* Ex. B; Nye Report, ¶¶106-07.

597 *See* Nye Report, ¶¶106-07; Nye Report, Ex. 11 at 18 (entries for 4/17-4/18/01).

598 Nye Report, ¶158. *See also* 4/13/06 Rebuttal Report of Blaine F. Nye, Ph.D. ("Nye Rebuttal Report"), ¶7.

Accordingly, *Greenberg*'s so-called "actual movement" test is in fact satisfied under the facts of this case.

C. The Evidence Establishes Loss Causation

Merrill contends Lead Plaintiff cannot demonstrate that it caused Enron investors to suffer losses. Defs' Mem. at §II. This argument fails in every respect.[599]

In an opinion late last year, this Court established a legal framework for the analysis of loss causation in this case. *See Enron*, 2005 U.S. Dist. LEXIS 41240, at *45-*74 (denying motion to dismiss filed by defendant Royal Bank of Canada and six of its subsidiaries). And in a very recent opinion, the Court reaffirmed this loss causation framework, adding some refinements. *See Enron*, 439 F. Supp. 2d 692 (concerning Barclays PLC, Barclays Bank PLC, and Barclays Capital, Inc.'s motion for partial judgment on the pleadings). The Court's Opinions present the following framework:

- This Court adopts the loss causation analysis of *Lentell*, 396 F.3d at 171 (*Enron*, 2005 U.S. Dist. LEXIS 41240, at *69-*71; *Enron*, 439 F. Supp. 2d at 705).
- Accordingly, the requisite causal connection is established when the loss was "foreseeable" and caused by the "***materialization of the concealed risk***" (*Enron*, 2005 U.S. Dist. LEXIS 41240, at *63).
- Thus, "'the loss causation requirement will be satisfied if [the defendant's] conduct had ***the effect of concealing the circumstances*** that bore on the ultimate loss,'" *e.g.*, it "'created the appearance of assets or revenue where there was none and therefore concealed, among other things, the risks that [Enron] would be unable ***to service its debt and consequently suffer financial collapse***,'" and "that risk materialized" (*Enron*, 439 F. Supp. 2d at 712).

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599 At the outset, Lead Plaintiff notes that this issue is particularly ill-suited for resolution on a motion for summary judgment. As many Circuit Courts have concluded, the issue of loss causation is better left for trial. *See EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 884 (3d Cir. 2000) ("Whether the plaintiff has proven causation is usually reserved for the trier of fact.") (citing *Huddleston v. Herman & MacLean,* 640 F.2d 534, 549-50 (5th Cir. 1981)).

- Loss causation does ***not*** require "a formal corrective disclosure by a defendant followed by a steep drop in the price of stock" (*Enron*, 439 F. Supp. 2d at 701; *see also Enron*, 2005 U.S. Dist. LEXIS 41240, at *63-*64).

- Disclosure of the relevant truth can be "gradual and partial" (*Enron*, 439 F. Supp. 2d at 724).

- ***These disclosures need not identify the specific defendant's conduct*** (*Enron*, 439 F. Supp. 2d at 720). Instead, if the subject defendant is alleged to have participated in a securities fraud scheme, it is sufficient that the disclosures regarded the ***similar conduct of others in the scheme***, and harmed investors (*id*. at 724).

- "[T]he plaintiff's loss need ***not*** be caused ***exclusively*** by the defendant's fraud" (*Enron*, 2005 U.S. Dist. LEXIS 41240, at *60; *Enron*, 439 F. Supp. 2d at 702).

- If the defendant asserts that causation was supposedly broken by "an intervening event," "the issue becomes a 'matter of proof at trial'" (*Enron*, 2005 U.S. Dist. LEXIS 41240, at *65; *Enron*, 439 F. Supp. 2d at 703-04).

In the 7/20/06 Order, the Court stated that its loss causation analysis was applicable not just for the defendant there, but was offered "to guide other Defendants whose alleged acts might constitute primary violations of §10(b)." 439 F. Supp. 2d at 723. Thus, the analysis controls the resolution of loss causation issues raised by Merrill's Motion.

That we are now concerned with issues of proof does not detract from the Court's analysis, which is largely grounded in the Supreme Court's decision in *Dura*. In *Dura*, the Court spoke not only "in respect to what the plaintiffs' complaint [] must allege," but also with "respect to what a plaintiff must prove." 544 U.S. at 338. In discussing what plaintiffs ultimately must prove in order to establish loss causation, the *Dura* Court concluded "that a plaintiff [must] prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." *Id*. at 346.

Proof of loss causation may take a variety of forms, and the Supreme Court in *Dura* did not (and likely could not) set forth specific parameters on what must be proven. Instead, as this Court has recognized, the *Dura* court held:

> Plaintiff's economic loss may occur as "relevant truth begins to leak out" or "after the truth makes its way into the market place," and the plaintiff need only give "some indication" of the causal link between that leaked truth and his economic loss. 125 S. Ct. at 1631-32, 34. The pleading of a single formal corrective measure is not necessary.

Enron, 439 F. Supp. 2d at 701.[600] The Court cited significant support for its interpretation of *Dura* and found that a "majority" of cases after *Dura* "appear to have concluded that methods other than corrective disclosures satisfy *Dura*[]." *Id*. at 701 n.10. For example, the Court cited *In re Bradley Pharms., Inc. Sec. Litig.*, 421 F. Supp. 2d 822, 828 (D.N.J. 2006), where Judge Hochberg rejected defendants' "rigid and dogmatic interpretation" that there must be a "true corrective disclosure" and concluded "*Dura* did not address what type of events or disclosures may reveal the truth" or "how specific such a disclosure must be" or "set forth any requirements as to who may serve as the source of the information" or "that the disclosure take a particular form or be of a particular quality."

In *Dura* the Court recognized that fraud-induced inflation of a stock's price can be removed in any number of ways in addition to a corrective disclosure. *See Enron*, 439 F. Supp. 2d at 701 n.10. As this Court stated when it interpreted *Dura*, "the market may learn of possible fraud through a number of sources: *e.g.*, from whistleblowers, analysts' questioning of financial results, resignations of CFOs or auditors, announcements by the company of changes in accounting treatment going forward, newspapers and journals, etc." *Id*. at 701. *See also Enron*, 2005 U.S. Dist. LEXIS 41240, at *63-*64. Lead Plaintiff avails itself of all these forms of proof, and more, to demonstrate loss causation.

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[600] As further support for this proposition, the Court cited Patrick J. Coughlin, Eric Alan Isaacson, and Joseph D. Daley, *What's Brewing in Dura v. Broudo? The Plaintiffs' Attorneys Review The Supreme Court's Opinion and Its Import for Securities Fraud Litigation*, 37 Loy. U. Chi. L.J. 1 (Fall 2005) (Ex. 139).

Merrill's analysis of the loss causation issue, however, completely disregards this Court's framework identified above. For example, despite this Court's conclusion that it will "appl[y]" *Lentell*, Merrill never even discusses that case in its loss causation argument. *See* Defs' Mem. at §II.

1. Lead Plaintiff's Theory of Loss Causation Concerning Merrill

Lead Plaintiff's losses were a foreseeable result of, and caused by, Merrill's conduct, which helped conceal – and falsify – Enron's true financial condition and the material risk Enron would suffer a liquidity crisis – a financial meltdown – causing the Company to become insolvent and its stock worthless. Merrill's conduct and concealment caused Enron's securities to trade at artificially inflated prices. When the true financial condition of Enron could no longer be concealed and the truth entered the market, the prices for its publicly traded securities collapsed, and plaintiffs were damaged. On facts substantially similar to these, the Court endorsed plaintiffs' theory of damages as to Barclays, holding causation is pleaded where "plaintiff's loss was foreseeable and was caused by the materialization of the concealed risk." *Enron*, 439 F. Supp. 2d at 714.

Lead Plaintiff's evidence establishes Merrill's conduct inflated the price of Enron's securities as part of the larger Ponzi scheme, and numerous revelations of the concealed negative information caused economic losses suffered by Enron's investors.

a. Sufficient Evidence Establishes Merrill's Conduct Inflated the Price of Enron's Securities

As described above, Lead Plaintiff's claims against Merrill concern the latter's conduct related to LJM2, the Nigerian Barges and Electricity Trades transactions, among other things. Merrill concedes that the Nigerian Barges Transaction and Electricity Trades had some "impact" on Enron's year-end 1999 financial results. Defs' Mem. at 4. But Merrill nevertheless argues Lead Plaintiff "cannot establish [that these transactions] artificially inflated Enron's stock price." Defs' Mem. at 28. Merrill is flat wrong.

At the time of the January 18, 2000 earnings announcement, Enron had a track record of ***exceeding*** analysts' profit estimates. *See* Nye Report, ¶48 ("For each quarter of the Class Period through the second quarter of 2001, Enron purported to meet or, more often, exceed security analysts' consensus forecast for the Company's quarterly earnings per share . . . .").[601] In fact, for five of the previous six quarters alone, Enron had exceeded then-current EPS consensus estimates.

Market familiarity with this track record – and the expectations engendered by it – can be seen in the fact that, on January 18, 2000, when Enron announced that it merely ***met*** analyst expectations for its financial results, the price of Enron common stock actually declined slightly.[602] These facts entitle a reasonable jury to infer that, had Enron's year-end 1999 financial results not benefited from Merrill's Nigerian Barges transactions and the Electricity Trades, Enron's stock would certainly have declined steeply on announcement of the resultant earnings miss.

Merrill's own investment bankers recognized in contemporaneous admissions that Merrill's year-end 1999 transactions gave Enron's stock price an artificial boost: "we were clearly helping them make earnings for the quarter and year (***which had great value in their stock, not to mention personal compensation***)."[603] In fact, the Electricity Trades were the precise cause of Enron making its earnings, as they were likely the last transaction booked – close to midnight on the last day of the year. There is substantial documentary evidence, testimony and expert analysis demonstrating that

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601 Dr. Nye is Lead Plaintiff's expert witness in this case concerning the issues of loss causation, materiality, and the damages incurred by acquirers of certain publicly traded securities of Enron.

602 *See* Nye Report, ¶74.

603 Ex. 50028.

the Nigerian Barges, Electricity Trades and LJM2 transactions in which Merrill Lynch engaged created the false appearance of earnings and cash flow, and concealed debt.[604]

As Enron's former CFO Fastow states in his declaration, the Electricity Trades:

> ***had the effect of increasing Enron's reported income by $40 million or more and contributed to causing Enron to report higher income at year end than it would otherwise have been able to report***.[605]

Fastow also states with respect to the Nigerian Barges transaction that

> ***the guarantee from me reduced the risk to Merrill in a manner sufficient so that Arthur Andersen, had it known of the guarantee, would not have treated the transaction as a true sale. As a result of the true sale treatment, Enron recorded higher income and funds flow at year-end than it otherwise would have***.[606]

As to the year-end 1999 LJM2 transactions, Fastow declares:

> ***Based 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***.[607]

And Merrill Lynch internally admitted that "[s]ham deals with partnerships [such as LJM2] distorted Enron's true financial picture – inflated earnings and understated on balance sheet debt."[608] Similarly, Fastow testified, "My opinion is that many of the transactions that LJM2 did with Enron

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604 *See, e.g.*, Ex. A; Solomon Report at 101-09; Solomon Supp. Report at Schedules 3-6, 8; 10/24/06 Fastow Depo. Tr. at 359:18-20, 529:3-11; *supra* §§III.A.3.c.-d., III.B.4.-5., III.D.8.

605 Fastow Decl., ¶36.

606 Fastow Decl., ¶34.

607 Fastow Decl., ¶41. *See also* 10/24/06 Fastow Depo. Tr. at 371:23-372:23.

608 Ex. 19 at MLNBY0919625.

caused Enron's financials to be misleading and deceptive."[609] There should be no doubt this buoyed and artificially inflated Enron's stock price.

David Fleischer, an equity analyst from Goldman Sachs who covered Enron during the Class Period, testified the price of Enron stock would have declined sharply if the Company failed to meet earnings estimates:

> Q. "Do you have any opinion as to what would have happened to Enron's stock price if it ***did not*** report financial earnings or other financial metrics ***in line with its projections*** during the period between 1997 and the second quarter of 2001?"
>
> * * *
>
> A. "I believe the stock would have been punished."[610]

And as testified by Michael Gibbons, Barclays' expert witness concerning damages:

> Q. When you have a company that quarter after quarter announces that it has met or beaten expectations, and that year after year it announces that it has grown and expects to grow at a significant pace, in your experience, looking to that 1999-2000 time frame, what would the effect be of a, say, a 50 percent earnings miss that surprised the market?
>
> A. I would expect the price of the stock to obviously go down, and maybe by a substantial amount.[611]

That Merrill falsely inflated Enron's stock price is confirmed by plaintiffs' experts.[612] Lead Plaintiff's experts have opined that Merrill's falsification of Enron's year-end 1999 financial results was critical in causing Enron's stock price to be inflated in at least three ways.

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609 10/24/06 Fastow Depo. Tr. at 359:18-20.

610 11/9/04 Fleischer Depo. Tr. at 55:20-56:10.

611 5/23/06 Gibbons Depo. Tr. at 127:24-128:10.

612 *See* Hakala Decl., ¶¶2, 8; Nye Report, ¶¶27-29, 43; Solomon Report at 133.

First, if Merrill had not falsified Enron's reported financial results at year-end 1999 via either the Nigerian Barges transactions, the Electricity Trades, or the LJM2 transactions, there "would almost certainly have precipitated a dramatic drop in Enron's stock price."[613] Dr. Hakala explains:

> [H]ad Enron's true fourth-quarter 1999 financial results been disclosed – absent either the purported earnings derived from the two Merrill year-end transactions or its engagement in LJM2 – the Company would have missed earnings expectations substantially. Consequently, investors would have begun to substantially discount Enron's inflated earnings guidance and such an earnings shortfall would have substantially altered the market's perception that the Company could reliably deliver current earnings and future earnings growth. This would have led to compound negative effects that would have substantially reduced earnings expectations **and** reduced the earnings multiple applied to expected future earnings.[614]

As a result, had Merrill not done the fraudulent 1999 transactions, Enron's "stock price would have fallen dramatically."[615]

Second, by falsifying Enron's 1999 financial results, Merrill contributed substantially to the strong increase in Enron's stock price leading up to and after Enron released its full-year 1999 financial results. Enron reported its full-year 1999 financial results on January 18, 2000. On December 15, 1999, Enron's stock traded as low as $36.25. During the period from December 15, 1999 to January 18, 2000, when Enron reported its 1999 results and hit the forecasts, several analyst reports on Enron were issued – forecasting fourth quarter 1999 and year-end 1999 earnings of $.31 and $1.15-$1.18, respectively.[616] By January 18, 2000 – the date Enron reported – it had hit its 1999

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613 Hakala Decl., ¶2; Nye Report, ¶43. *See also* Arthur Levitt, The "Numbers Game," N.Y.U. Center for Law and Business, September 28, 1998, (Ex. 15) at 3; Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio*, July 1999, (Ex. 16) at 2; Jennifer Conrad, Bradford Cornell & Wayne Landsman, *When Is Bad News Really Bad News?* (June 1999) (Ex. 17) at 2-3, 20.

614 Hakala Decl., ¶7 (emphasis in original).

615 Hakala Decl., ¶8.

616 *See* Ex. 140 (12/17/99 Goldman Sachs Analyst Report: "ENE Action – Enron Corp"); Ex. 141 (1/6/00 CIBC World Markets Analyst Report: "Enron Corp. – Broadband Communications

earnings forecasts of $1.17, in just 22 trading days, the stock reached $56.56 – a huge increase. After Enron hit its 1999 numbers and held a very successful analysts' conference – Enron's stock continued to climb. In the month of January alone, Enron's stock price jumped from $44.375 to $67.875 – an increase of 38.8% versus industry indices.[617]

This increase in Enron's stock price throughout the month of January is attributable to Enron "meeting . . . earnings expectations and using that positive earnings information to guide upward analysts' forecasts of earnings and future earnings growth within its wholesale operations."[618] The increase in Enron's stock price throughout the month of January is also attributable to Enron's announcements concerning its broadband business.[619]

As Dr. Hakala concludes, had Merrill not falsified Enron's 1999 year-end results, management would not have had the necessary credibility with investors to sell its aggressive valuations of the broadband business and Enron's stock price would not have responded as favorably as it did.[620] Dr. Hakala's opinion is strongly supported by the testimony of Goldman Sachs' equity analyst who followed Enron and, based on management's perceived credible guidance, valued its broadband business at a conservative $30 billion in January 2000:

Strategy Unfolding"); Ex. 142 (1/12/00 Banc of America Securities Analyst Report: "Enron Corp. – Strong Buy"); Ex. 143 (1/14/00 Credit Suisse First Boston First Call Report: "ENE: Analyst Conference to be Held January 20"); Ex. 144 (1/18/00 Credit Suisse First Boston First Call Report: "ENE: 4Q99 and FY99 Earnings In-Line W/Expectations"); Ex. 145 (1/18/00 Merrill Lynch Analyst Report: "Enron Corp. – Telecom Driving Valuation, Reason for Report: Quarterly earnings"); Ex. 146 (1/18/00 Banc of America Securities Analyst Report: "Enron Corp. – Strong Buy").

617 Hakala Decl., ¶5.

618 *Id.*, ¶6.

619 *Id.*, ¶8.

620 *Id.*

Q. Was your assessment of Enron's broadband business in early 2000 based in part on Enron's management's representations?

A. Yes.

Q. Did you believe Enron management to be credible in this regard?

A. Yes.

Q. In part, did you think Enron's management to be credible because Enron usually performed in line with the expectations it fostered in the market?

* * *

A. ***Yes, they did perform and that was part – yes***.

Q. Had Enron failed to meet earnings expectations for year 2000 by a material amount, would management have lost some of that credibility?

* * *

A. Yes.[621]

Third, Merrill hid Enron's true financial condition from the rating agencies, causing investors to misperceive Enron's true creditworthiness. As discussed by Dr. Nye, "[m]aintaining an investment-grade credit rating was essential to Enron," primarily to allow the Company's Wholesale segment to maintain credit with, and confidence of, its trading counterparties.[622] Andrew Fastow's testimony helps demonstrate that Merrill Lynch transactions that created the false appearance of funds flow and earnings, and that concealed debt, contributed to maintaining Enron's investment-grade credit rating:

Q. Did creating the false appearance of funds flow contribute to Enron maintaining its investment investment-grade credit rating?

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621 11/10/04 Deposition Transcript of David Fleischer ("11/10/04 Fleischer Depo. Tr.") at 523:14-524:10.

622 Nye Report, ¶51.

> A. Yes.[623]

> * * *

> Q. Did the creating of – creation of false appearance of earnings through structured-finance transactions contribute to Enron maintaining its investment-grade credit rating?

> * * *

> A. Yes, and to – to meet earnings expectations of Wall Street.[624]

> * * *

> Q. Did reducing and concealing debt through structured-finance transactions contribute to Enron maintaining its investment-grade credit rating?

> * * *

> A. I believe so, yes.[625]

As demonstrated herein, the transactions for which Merrill Lynch is responsible contributed to artificially maintaining Enron's investment-grade credit rating by causing one or more of each of the financial statement manipulations described by Fastow.[626]

Moreover, the loss of such a credit rating was one event that could potentially trigger an Enron "death spiral" – *i.e.*, the unraveling of the Ponzi scheme that concealed Enron's true financial condition.[627] As explained by former Enron risk management employee David J. Port in his deposition, losing the investment-grade credit rating by, for example, Enron's loss of ability to continue to hide its ***debt***, would rapidly lead to the end of Enron:

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623 10/24/06 Fastow Depo. Tr. at 525:8-11.

624 10/24/06 Fastow Depo. Tr. at 527:20-528:1.

625 10/24/06 Fastow Depo. Tr. at 529:13-17.

626 *See, e.g.*, Ex. A; Solomon Report at 101-09; Solomon Supp. Report at Schedules 3-6, 8; *supra* §§III.A.3.c.-d., III.B.4.-5., III.D.8.

627 *See id*.

> "Q. Okay. The next step in this death spiral is a credit downgrade . . . What would cause that?
>
> A. Well, when the rating agencies see the profit warning, the stock selloff, read the earnings release that talks about suddenly all this ***debt coming back on to the balance sheet***, inevitably they would have to think about downgrading the company's bonds.
>
> Q. The next step in this death spiral is headed "positions unwind." It says "Trading losses realized. Margin calls." What do those items refer to?
>
> A. That refers to the trading business which if there was a credit downgrade that means that we would suddenly have to post more collateral against our positions because our counterparties would be unwilling to accept our credit. . . .
>
> Q. . . . The next step in this death spiral is headed, 'Liquidity dries up,' 'banks call lines, refinance necessary, for example, Xerox.' What do those items refer to?
>
> A. That simply refers to the process of trying to recapitalize the company because the banks would cut off the lines and you'd have to try and find other ways of raising finance. . . ."[628]

With regard to the conduct of Merrill in, for example, the Nigerian Barges transaction, Port's testimony forcefully establishes that such conduct operated to inflate Enron's stock price. This is because, as Lead Plaintiff's expert witness on accounting matters concluded, this transaction permitted Enron to understate its debt – thus protecting (through fraudulent concealment) Enron's investment-grade credit rating.[629]

In fact, from mid-year 1999 to March 2000, Moody's was reviewing and reassessing Enron's creditworthiness in consideration of upgrading its credit rating after CFO Fastow approached the agency about an upgrade.[630] After careful consideration and analysis of Enron's 1999 financial

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628 *See* Nye Report, ¶51.

629 *See* Solomon Report at 133 (Table 9).

630 2/17/05 Deposition Transcript of John Diaz ("2/17/05 Diaz Depo. Tr.") at 1198:21-22 ("Enron at some point in mid 1999 asked that we consider upgrading the rating.").

results, on March 22, 2000, Moody's did upgrade Enron's credit rating, recognizing, among other things, "Enron's rising earnings potential."[631]

But had Enron ***not*** met its 1999 earnings forecasts, Moody's likely would ***not*** have upgraded Enron and, indeed, would have taken a closer look at what was going on at the Company. As Moody's senior analyst John Diaz testified, the Nigerian Barges had "important ramifications on Enron's financial statements," which should have, but were not, disclosed to Moody's.[632]

And the year-end 1999 electricity trades had an even larger impact on Enron's financial statements (and thus were likewise relevant to investors and the credit rating agencies).[633] Simply booking "earnings" from these bogus trades operated to fool investors into believing that Enron possessed a viable business model, thus again concealing Enron's true financial and operational condition.[634] Plaintiffs' expert concerning the credit rating agencies, Professor Claire Hill, has opined that the rating agencies would have downgraded Enron to below investment grade had they known of Enron's financial machinations at the end of 1999, including the Nigerian Barges transaction.[635]

Furthermore, had Merrill's conduct in connection with either LJM2, the Nigerian Barges transactions or the Electricity Trades been revealed in January 2000, it likely would have led to the withdrawal of Andersen's audit opinion. As Andersen audit partners have testified, revelation of

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631 2/17/05 Diaz Depo. Tr. at 1198-1202, 1255-57; Ex. 147 at ANARPT009042.

632 2/17/05 Diaz Depo. Tr. at 1256:17-18.

633 Solomon Report at 133; Hakala Decl., ¶4.

634 *See* Black Report, ¶11 (describing that, in reality, Enron's "trading" activities (among others) were "consistently unprofitable"). Professor Black is Lead Plaintiff's expert witness concerning the true nature of Enron's financial condition and results of operations, and other topics.

635 *See* 4/13/06 Expert Rebuttal Report of Claire A. Hill at 10-11.

such collusion between Enron and Merrill would have caused a formal investigation, ceased Andersen approval of interim financial statements, and likely led to the withdrawal of Andersen's audit opinions and the resignation of Andersen. *See supra* §§III.B.4.-5., III.D.8. One need only look to the withdrawal of Andersen's audit opinions upon discovery of the Chewco side letter as a proxy for what would have happened if Merrill's fraud was revealed in January 2000.[636] Disclosure that Andersen's audit opinions could no longer be relied upon occurred in Enron's Report on Form 8-K filed November 8, 2001. Along with other disclosures, this triggered a precipitous decline in Enron's stock price in November despite buoyancy generated by investor expectations Dynegy would bail out Enron.[637]

This all demonstrates that Merrill's conduct in the year-end 1999 transactions played an important role in concealing Enron's true financial condition – causing the artificial inflation of Enron's stock price. Not only did Merrill cause Enron to appear far more profitable than it was, it also caused Enron to appear far more creditworthy than it was. This concealment staved off an immediate decline in the price of Enron's securities and also staved off the "death spiral" that would have imploded Enron. Meanwhile, investors continued to purchase the Company's inflated securities. There could be no more a prototypical – and egregious – instance of causing price inflation than what Merrill did here.[638]

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[636] *See* 7/6/06 Odom Depo. Tr. at 321:17-323:19; 8/22/06 Bauer Depo. Tr. at 382:1-7; 8/25/06 Bauer Depo. Tr. at 1427:12-1428:14.

[637] *See* Nye Report, ¶158; Nye Rebuttal Report, ¶7.

[638] Furthermore, Merrill's conduct in connection with LJM2 continued to inflate the price of Enron's securities into 2000 and 2001. *See supra* at 184-185; Ex. A.

b. Sufficient Evidence Demonstrates the Risk Concealed by Merrill Caused Plaintiffs' Losses

This Court has ruled that "[p]laintiff's economic loss may occur as "'relevant truth begins to leak out'" or 'after the truth makes its way into the market place.'" *Enron*, 439 F. Supp. 2d at 701. This truth may emerge partially and over time, and may come through different types of revelations and disclosures. *See id*. at 719-24; *id.* at 701; *Enron*, 2005 U.S. Dist. LEXIS 41240, at *63-*64. This Court also stated that under *Lentell*, and in the context of this case, these revelations of Enron's true condition need not specifically identify Merrill's conduct. *Enron*, 439 F. Supp. 2d at 720. Because Merrill is alleged to have participated in the larger Enron Ponzi scheme, it is sufficient that the leakage of information and partial disclosures revealed Enron's true conditions concealed by the scheme and some of the wrongful conduct engaged in by co-schemers, and harmed investors:

> [T]his Court concludes a disclosure of the wrongful conduct in an alleged securities fraud scheme with the same purpose, *i.e.*, overstating revenue and concealing debt, committed by some defendants in the alleged securities fraud scheme that is a substantial cause of plaintiffs' loss is sufficient to plead loss causation; ***the identity of a particular participant/defendant's primary [violation] need not have been revealed*** if the same type of primary violations by other defendants with the same purpose, here of creating a picture of financial success when the reality was the opposite to defraud investors, is leaked or disclosed to the market and causes a steep decline in the price of Enron's stock, injuring plaintiff investors.

Id. at 724.

Lead Plaintiff's loss causation evidence against Merrill includes numerous such releases of information and partial disclosures that revealed that Enron's "picture of financial success" was false, fabricated by "primary violations by other defendants with the same purpose" as Merrill. Moreover, these revelations are sufficient because they represent a "materializ[ation]" of the "risk" that "'[Enron] would be unable to service its debt and consequently suffer financial collapse'" – that which Merrill's conduct "concealed." *Id*.

As explained by Dr. Nye:

> Defendants' misrepresentations and omissions caused Enron securities to be overpriced because investors were led to believe: that Enron and Enron-related debt had less credit risk than it actually had in the Class Period and that Enron could repay the debt it had assumed; that Enron's common stock represented shares in a Company which generated much more operating cash flow than it actually generated; that Enron's earnings had repeatedly met or exceeded investor expectations; and that Enron's economic earnings would grow at a rapid rate. This was the fraud: the inflation of Enron's financial health and prospects to make the Company appear a far better and less risky investment than it was. When in the latter part of the Class Period, a series of events and disclosures revealed the true risk of investing in Enron and a more accurate picture of its finances, operations, and prospects, the prices of Enron securities declined on those events and disclosures, and finally on November 28, 2001, reached a level which represented their true value. The cause of investors' economic losses was the inflation caused by the concealment of Enron's true risk, financial condition, performance, and prospects, resulting in inflated prices of Enron securities, followed by the disclosure of the truth about these subjects, events and disclosures which caused the prices of Enron's securities to decline precipitously.[639]

Dr. Nye identified numerous leaks of information and partial disclosures in 2001 that began to reveal Enron's true financial condition – *i.e.*, the reality that its ostensible financial condition was the product of accounting manipulations and sham transactions, the pertinent details which were hidden from investors – leading to the eventual collapse of the Company.[640]

For example, as detailed in the Nye Report, on Sunday, May 6, 2001, the Off Wall Street Consulting Group issued a report (the "OWS Report") concerning Enron featuring a new "sell" recommendation on the Company's stock, citing concerns with Enron's financial condition and reporting. The OWS Report also expressed concerns about Enron's "transactions with related parties" and "mark-to-market" accounting, as well as the Company's "securitization of financial

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[639] Nye Rebuttal Report, ¶7.

[640] *See* Nye Report, ¶¶95-170.

assets."[641] Thus, the OWS Report "anticipated the major aspects of Defendants' scheme," revealing negative information about the reality of Enron's financial condition:[642]

> [D]eceptive reported earnings (achieved through transactions with Defendant banks and through transactions with related parties); inadequate cash flow as well as rising debt; management predictions of improvement in apparent capital structure to be achieved with substantial proceeds of asset sales.[643]

Following publication of the OWS Report, on May 7 and 10, 2001, Dr. Nye determined that Enron's share price experienced statistically significant price drops (net of market and industry factors) of 2.42% and 2.74%, respectively.[644]

This one revelation is sufficient to establish the requisite causal link between Merrill's conduct in the Nigerian Barges transaction, the Electricity Trades and LJM2 and economic loss by Enron investors. The OWS Report released negative information concerning Enron's true financial condition – thus, the "risk" concealed by Merrill's conduct partially "materialized" – and at a minimum revealed the effects of "primary violations by other defendants with the same purpose" as Merrill. *Enron*, 439 F. Supp. 2d at 724. And because this caused economic harm to Enron investors in the form of a declining stock price, it alone establishes causation under the Court's well supported framework.

But the Nye Report discusses numerous other revelations and partial disclosures which began to show Enron's true but concealed financial condition, and resultant economic injury to Enron investors – *i.e.*, causal links between Merrill's conduct and harm to Enron investors. For example:

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641 Nye Report, ¶¶108-19l; *see also* ¶110.

642 Nye Report, ¶111.

643 *Id.*

644 Nye Report, ¶¶111-112.

- After Enron announced the resignation of CEO Skilling, it "caused Enron stock to decline sharply on both August 15 and 16, 2001, because it aroused speculation that there were ***undisclosed problems*** at Enron." Nye Report, ¶119; *see also* ¶¶118-122. The share price declines on August 15 and 16, net of market and industry, were statistically significant, amounting to 6.7% and 8.8%. *Id.*, ¶119.[645]

- On the morning of Tuesday, October 16, 2001, Enron released its results for the third quarter of 2001, reporting a one-time charge of $1 billion or $1.11/share, for a loss of ($0.84)/share. Some of the charge was attributed to "'early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity.'" Nye Report, ¶127;

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[645] That Skilling's departure revealed significant negative information about the scheme is supported by (among other things) evidence garnered from those inside the Company. Andrew Fastow testified:

> Q. How did you view the company's prospects and performance after Jeff Skilling left in mid-August of 2001?
>
> A. I thought it was a dire situation when Mr. Skilling left.
>
> Q Why?
>
> A. My personal view was that if the CEO – president and CEO of a company steps down without preparing the market for it, that it would send a very bad signal to the market that there were big problems at the company.
>
> Q. Within the company, were there discussions about how Mr. Skilling's departure would be viewed in the market?
>
> A. Well, after he left there were discussions about how the market was viewing it, what we – what we could perceive the market view was.
>
> Q. And what was it?
>
> A. That the market was very skittish, very concerned. That the market didn't believe that Mr. Skilling left for personal reasons. They thought that there was other bad news coming.

10/24/06 Fastow Depo. Tr. at 454:11-455:7. As Sherron Watkins (Enron) noted internally, "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues." Ex. 31536 at VEL00680. It did. Equity analysts such as those at Bear Stearns noted that the resignation continues to raise "numerous questions regarding the aggressiveness of both the operational and financial aspects of Enron. Ex. 148 (8/15/01 Bear Stearns Analyst Report).

- On Monday, October 22, 2001, "Enron announced that the SEC had 'requested that Enron voluntarily provide information regarding certain related party transactions.'" *Id*., ¶142. As Dr. Nye determined: "News of the SEC inquiry . . . continued to fuel market suspicions about ***Enron's condition*** and ***the validity of its financial reporting***. Enron's share price fell from the prior closing price of $26.05 to $20.65 at close, a decline of 20.7%, or 21.3% net of market and industry, a statistically significant decline." *Id*.

- On November 8, 2001, Enron's share price fell again, representing a statistically significant 7.1% decline (net of market and industry effects) from $9.05 to $8.41. *Id*., ¶158. This decline was caused in part by confirmation from the Company that ***Enron had misstated its financial results and financial condition*** for years. *Id*. This disclosure is directly tied to Merrill's conduct, as again, even ***Merrill concedes*** that the Nigerian Barges transaction and the Energy Trades had some "impact" on Enron's 1999 financial statements. Defs' Mem. at 4.

- On Wednesday, November 28, 2001, among other relevant events, credit rating agencies Moody's, S&P, and Fitch all downgraded Enron debt to ***non-investment grade***, *i.e*., junk, status. Nye Report, ¶169. Dr. Nye determined that Enron stock closed at $0.61, down from $4.011 at close on November 27, 2001, a total decline of 85.2% which was statistically significant after excluding market and industry effects (83.9% residual decline). *Id*.

These partial disclosures and leaks of negative information (among others – *see infra* at 211-213) gradually revealed Enron's true financial condition and the reality that Enron's reported financial condition was the product of fraud – the very "risk" "concealed" by Merrill's conduct. *Lentell*, 396 F.3d at 173. Because these revelations caused economic harm to Enron investors by occasioning the decline in Enron share prices, the requisite causal link between Merrill's conduct and economic loss is established under this Court's legal framework. As this Court held, "Plaintiff's economic loss may occur as "'relevant truth begins to leak out'" or "'after the truth makes its way into the market place.'"" *Enron*, 439 F. Supp. 2d at 701 (quoting *Dura*, 544 U.S. at 343). Merrill does not address these disclosures in its Motion, and indeed cannot do so without conceding there is a triable issue.

2. Merrill's Contentions that Loss Causation Is Purportedly Absent Are Meritless

Merrill's arguments are based on its selective view of the factual record and misplaced attempts to avoid this Court's legal framework for loss causation in this case. Merrill fails to adhere to the summary judgment standard that the facts must be viewed in the light most favorable to the non-movant, Lead Plaintiff. *See Anderson*, 477 U.S. at 255.

Merrill claims that Lead Plaintiff has purportedly offered "no loss causation evidence" against it. Defs' Mem. at §II.A. Yet, as described above, Lead Plaintiff proffers a large body of evidence establishing that Merrill caused economic loss to Enron investors. It is in fact Merrill that has "no . . . evidence" to demonstrate a triable issue of fact.

Similarly hollow is Merrill's claim that Lead Plaintiff's experts (such as Dr. Nye) are "silent" as to Merrill's responsibility for economic loss. Defs' Mem. at 27. This assertion simply ignores the conclusions of Dr. Nye described above, which present fraud disclosures establishing the requisite causal connection between Merrill's conduct and Class members' economic loss.

These observations in turn dispose of Merrill's contention that the PSLRA's requirement that the jury consider the conduct of "each such person" claimed liable requires summary judgment. Defs' Mem. at 27. Merrill's assertion here is again based on its faulty claim that Lead Plaintiff lacks "any proof" of causation regarding Merrill. *Id*. As established above, this is not the case. The jury in this case, in considering the evidence against Merrill along with that establishing loss causation concerning all defendants, will necessarily consider the conduct of "each such person" claimed liable. 15 U.S.C. §78u-4(f)(3)(C)(ii).

Merrill's assertion that Lead Plaintiff's expert has not sought to show a "'relationship'" between "'the barge and energy transactions'" to "'corrective disclosures'" is unavailing. Defs' Mem. at 28. Again, this Court has already ruled that "***the identity of a particular participant/ defendant's primary [violation] need not have been revealed*** if the same type of primary violations by other defendants with the same purpose . . . is leaked or disclosed to the market and causes a steep decline in the price of Enron's stock." *Enron*, 439 F. Supp. 2d at 724. As established above, this test is satisfied as to Merrill.

Unwilling and unable to deal with the revelations discussed herein (*see supra* §IV.B.2.b), Merrill focuses instead on two disclosures in 2002 concerning the Nigerian Barges transaction and the Electricity Trades, claiming that no loss causation can be established concerning them. *See* Defs' Mem. at 28-29. But Merrill's contention here simply ignores this Court's ruling in the 7/20/06 Order establishing that causation follows from the 2001 leaks and partial disclosures of Enron's true financial condition which preceded the financial collapse and bankruptcy of the Company:

> Questioning of Enron as a "black box" with "impenetrable financial statements" commenced ***early in 2001***, and began to peak on ***October 16, 2001***, when Enron revealed a $1 billion charge, surged by its disclosure a few weeks later that it was restating its financial results for 1997, 1998, 1999, and 2000 to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity, succeeded next by Dynegy's rejection of a "saving" merger with Enron after it performed a due diligence review of Enron's finances, and ultimately Enron's filing for bankruptcy on December 2, 2001. Disclosure of the roles of some primary violators in a multi-defendant scheme to defraud investors by creating the appearance of assets or revenue that did not exist and concealing debt and increasing risks of financial collapse, reflected in "cooking the books," ***should be viewed as sufficient to show loss causation for later-disclosed actions*** constituting primary violations of §10(b) of other defendants substantially contributing to that fabrication of Enron assets and that hiding of debt in the same scheme.

Enron, 439 F. Supp. 2d at 724. *See also id.* at 720 (discussing loss causation holding of *Parmalat I*, 376 F. Supp. 2d at 510, and stating: "This Court notes that there is no mention in the opinion of any disclosure specifically of Citigroup's worthless invoice scheme prior to Parmalat's financial collapse").

Significantly, the Court arrived at this conclusion after noting Barclays' claim that "Plaintiffs do not allege that any of the Barclays' purported transactions were disclosed or unwound before the collapse of Enron stock's price and thus do not show that the disclosure or realization of some risk caused Plaintiffs' loss." *Enron*, 439 F. Supp. 2d at 711. This is the ***same argument*** made by Merrill here concerning the two 2002 disclosures. Thus, this Court's 7/20/06 Order squarely disposes of Merrill's contention here. The 2001 leaks and partial disclosures identified in Dr. Nye's report and discussed herein are sufficient to establish loss causation as to Merrill.

Furthermore, Merrill's claim here is one of intervening causation – an issue not suitable for resolution by summary judgment. Because "Enron was in bankruptcy and its stock was trading at $0.29" (Defs' Mem. at 29), Merrill contends that an intervening cause – the bankruptcy and events leading to it – broke the chain of causation. But summary judgment is not warranted on this point because, as this Court has correctly ruled, questions concerning intervening causes are disputed issues of fact properly reserved for trial. *See Enron*, 2005 U.S. Dist. LEXIS 41240, at *64-*65; *Enron*, 439 F. Supp. 2d at 704 ("If there was an intervening event . . . the issue becomes 'a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss.'") (quoting *Lentell*, 396 F.3d at 174).

Merrill attempts to disprove loss causation by citing comments of Judge Werlein from the Nigerian Barges criminal trial of Merrill's bankers. Defs' Mem. at 29-30. Merrill, however, is misleading in its selection of excerpts from the sentencing transcript in the criminal case. First, it has been proven beyond a reasonable doubt that Merrill's bankers "caused Enron and its shareholders to suffer a loss" in connection with the Nigerian Barges transaction. Judge Werlein gave this jury instruction:

> The Government alleges that the defendants' commission of the offenses charged in Counts 1 through 3 of the third superseding indictment caused Enron and its shareholders to suffer a loss.
>
> The Government must therefore prove beyond a reasonable doubt: One, that the defendants' fraudulent conduct caused Enron and its shareholders to suffer a loss;

> and, if so, two, the amount of loss attributable to the defendants' fraudulent conduct.[646]

The jury returned a guilty verdict as to each of the Merrill bankers, finding beyond a reasonable doubt (a much higher burden than required here) that they caused plaintiffs to suffer a loss.[647]

Second, contrary to what Merrill suggests, Judge Werlein did indeed find Merrill bankers caused Enron and its shareholders losses.[648] Finally, the theory under which Judge Werlein determined the amount of losses is different from that used to determine damages in this private securities class action. Thus, although they are not binding here, insofar as the statements made by Judge Werlein at the sentencing of Merrill's bankers are relevant, they in fact support plaintiffs' loss causation theories against Merrill.

Merrill's citation to *Ray v. Citigroup Global Mkts., Inc.*, No. 03 C 3157, 2005 U.S. Dist. LEXIS 24419 (N.D. Ill. Oct. 18, 2005), where loss causation was found absent because the fraud was revealed only after the stock has already collapsed (*see* Defs' Mem. at 30), is unavailing. *Ray* is factually distinguishable from this case because, as described in detail above, Lead Plaintiff's expert Dr. Nye has identified numerous revelations of negative information occurring ***before*** Enron's stock collapsed. *See supra* §VI.C.1.b. These pre-bankruptcy leaks and partial disclosures sufficiently establish loss causation as to Merrill.

Merrill then again claims that *Dura* requires a corrective disclosure preceding a significant drop in stock price. Defs' Mem. at 30-31. This Court has already ruled that *Dura* imposes no such requirement. *See Enron*, 439 F. Supp. 2d at 701 ("The Supreme Court did not affirmatively adopt

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646 *United States v. Bayly*, No. H-03-363, Trial Transcript (S.D. Tex. Nov. 5, 2004) at 6894:13-22.

647 *See* Ex. 40523.

648 *United States v. Bayly*, No. H-03-363, Sentencing Transcript (S.D. Tex. Apr. 21, 2005) at 20:21-23 ("the Court is satisfied that there was some loss by Enron and its shareholders").

Dura Pharmaceuticals' argument that a plaintiff must allege and ultimately prove that the defendant made a corrective disclosure of the fraud that was followed by a related price drop . . . ."). And in any event, as also discussed above, Lead Plaintiff's expert Dr. Nye has identified numerous revelations precipitating declines in Enron's stock price. *See supra* §VI.C.1.b.[649]

Merrill also contends that Lead Plaintiff purportedly "cannot rely on a 'scheme' theory of loss causation." Defs' Mem. at §II.C. That is, Merrill argues that Lead Plaintiff should not be able to rely on disclosures of manipulations caused by the acts of other scheme defendants to demonstrate loss causation. Defs' Mem. at 32. But this assertion directly contradicts the recent ruling of this Court that Lead Plaintiff may indeed use disclosures concerning the conduct of other scheme participants to demonstrate loss causation for only later-revealed acts of a subject defendant:

> Disclosure of the roles of some primary violators in a multi-defendant scheme to defraud investors . . . ***should be viewed as sufficient to show loss causation for later-disclosed actions*** . . . .
>
> * * *
>
> ***[T]he identity of a particular participant/ defendant's primary [violation] need not have been revealed*** if the same type of primary violations by other defendants with the same purpose . . . is leaked or disclosed to the market and causes a steep decline in the price of Enron's stock.

[649] In support of its argument that *Dura* purportedly requires a corrective disclosure and subsequent price drop, Merrill claims that the loss causation decisions of *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), *Robbins v. Koger Props.*, 116 F.3d 1441, 1448-49 (11th Cir. 1997), and *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990), were all "cited with approval by the Supreme Court in *Dura*." Defs' Mem. at 30-31 & n.10. Merrill's claim here, however, is highly misleading, if not straightforwardly inaccurate. In *Dura*, the Supreme Court cited these three cases merely as examples of courts that ***rejected the Ninth Circuit's approach*** to pleading loss causation. *See* 544 U.S. at 340, 344. *Dura* did ***not*** adopt these courts' purported rule that "revelation of the truth misstated or concealed by the conduct of the defendant must precede and cause a significant stock drop." Defs' Mem. at 30-31. Again, *Dura* itself does not impose such an unwarranted rule, as this Court has correctly ruled. Thus, *Robbins* is ***not*** "the law in the Fifth Circuit" (Defs' Mem. at 31 n.10), as Merrill falsely claims.

Enron, 439 F. Supp. 2d at 724. This Court's ruling here is alone sufficient to dispose of Merrill's contention.

Merrill also argues that Lead Plaintiff must first establish that Merrill's acts caused losses before it can "treat Merrill Lynch as part of the alleged Ponzi-scheme." Defs' Mem. at 34. Otherwise, according to Merrill, Lead Plaintiff "puts the cart before the horse." *Id.* at 33.

But it is Merrill which has things turned around here. The proper analysis focuses first on whether Merrill's acts (and not the losses caused by them) were part of the scheme. A reasonable jury can conclude that Merrill's acts were part of the alleged Ponzi scheme because those acts were perpetrated in furtherance of the larger manipulative and deceptive goal of the scheme, to wit, to conceal Enron's true financial condition. And a jury could also conclude that those acts caused harm to Enron investors, pursuant to the Lead Plaintiff's theory of loss causation concerning Merrill. *See supra* §VI.C.1.b Both of these points are well-illustrated in this Court's recognition that:

> These newly alleged [Merrill] transactions are not to be viewed in isolation. Lead Plaintiff's complaint has alleged an ongoing scheme ***in which Merrill Lynch participated in a substantial way over years***. . . . [T]he success of the alleged deceptive scheme, buttressed by purported misrepresentations about Enron in Defendants' analysts' reports and recommendations, attracted investors ***and caused their loss when the bubble burst*** and the fraudulent scheme was exposed.

Enron, 310 F. Supp. 2d at 830. There is ample evidence that Merrill committed the acts in question and that those acts harmed Enron investors.

Here Merrill Lynch has simply cloaked in different garb its proximate causation argument made in support of its motion for judgment on the pleadings. *Compare* Defs' Mem. at 33-34 & n.12 ("plaintiffs must establish proximate cause as to each defendant's own acts") *with* Merrill Lynch, Pierce, Fenner & Smith, Incorporated's and Merrill Lynch & Co., Inc.'s Motions for Judgment on the Pleadings (Docket No. 3734) at 21-22 ("plaintiff's loss is attributable to intervening events or by factors not foreseeable by" Merrill Lynch). As this Court has recognized, Lead Plaintiff advances a proper theory of proximate causation:

> [T]here is no showing that the plaintiffs' loss was the result of external market forces such as recession, a volatile market, a fall in prices in energy trading generally or any "***intervening***" factor. Instead the plaintiffs have adequately pleaded that their loss was directly and ***foreseeably*** caused by Defendants' alleged fraudulent practices at Enron, including Merrill Lynch's Nigerian barge transaction and bogus power trades involving Enron North America . . . .

Enron, 310 F. Supp. 2d at 832. Lead Plaintiff demonstrates loss causation according to Merrill Lynch's own culpable acts. And the notion that Merrill Lynch did not foresee the results of fraudulently manipulating Enron's financial statements is unbelievable. The cases that Merrill Lynch cites in support of its argument show the poverty of Merrill Lynch's position.

For example, at page 34 of its Motion, Merrill Lynch cites *Miller v. Schweickart*, 413 F. Supp. 1062 (S.D.N.Y. 1976), as a "prime example" of a case that shows Lead Plaintiff has not adequately attributed loss causation to it. In *Miller*, however, the plaintiff tried to hold liable a defendant who had "no relationship" with the company for two years prior to its demise. *Id*. at 1067. As most easily demonstrated by viewing the chart filed herewith (*see* Ex. B) Merrill Lynch had an extensive relationship with Enron right up to the collapse in the price of Enron's securities. The LJM2 transactions alone in which Merrill engaged (and their financial statement effect) extended into 2000 and 2001. *See id*; Ex. A; Solomon Report at 101-09; Solomon Supp. Report at Schedules 3-6, 8.

And (as opposed to *Miller*) this is not a case where an isolated transaction or category of transactions (*e.g.* FAS 125-140) alone caused Enron's stock price to plummet. Over time, a series of leaks and partial disclosures of negative information revealed Enron's financial condition was not as it appeared because of broad scale financial manipulation.[650] Merrill Lynch engaged in that manipulation. Although one need not search long for causation in this case, this Court has

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[650] Nye Report, ¶¶96-169.

recognized that "'[w]henever the rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also.'" *Enron*, 2006 U.S. Dist. LEXIS 43146, at *109 (quoting *Shores v. Sklar*, 647 F.2d 462, 472 (5th Cir. 1981) (en banc)).

Not only did Merrill Lynch engage in the broad scale fraud that was revealed in this case, but a number of transactions for which Merrill Lynch is responsible were disclosed to the market and caused Enron's stock price to decline. Merrill Lynch engaged in Enron's related-party transactions that were the subject of partial disclosures in Fall 2001. For example, on October 16, 2001, Enron disclosed a $1 billion charge related in part to losses that were concealed by the LJM-Raptors transactions for which Merrill is a responsible actor. *See supra* §III.A.2.-3. Enron's stock price significantly decreased thereafter, as the market learned that some of those losses were related to LJM2.[651] On October 17, 2001, Enron's share price declined over 4.5 percent.[652] On October 19, 2001, the decline was over 10%.[653] And when it was disclosed a few days later that the SEC had made an inquiry into Enron's related-party transactions (*e.g.*, LJM2) Enron's stock price plunged 20 percent.[654]

Indeed, on November 8, 2001, Enron's Report on Form 8-K disclosed that the accounting basis for the $1 billion charge and $1.2 billion reduction in shareholders' equity previously disclosed was in part attributable to transactions involving "four SPEs known as Raptor I-IV."[655] That report further disclosed LJM2 transactions for which Merrill Lynch is responsible, and revealed facts

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651 Nye Report, ¶¶128-41. *See also* Ex. B.

652 Nye Report, ¶138.

653 *Id.*, ¶141.

654 *Id.*, ¶142.

655 Ex. 149 at 7-8. *See also id.* at 11-12, 15-16 (describing the Raptors transactions and their financial statement effect).

indicating Enron was engaging in asset parking transactions with LJM2 and specifically with respect to the Nigerian Barges.[656] Enron's stock price dropped over 7% even though it was buoyed by news that Enron might be bailed out by Dynegy.[657] In contrast to *Miller* and the other cases cited by Merrill Lynch, here there is a plethora of evidence demonstrating proximate cause.

Finally, it should be noted that contrary to Merrill Lynch's claim that *Miller* is "a case that plaintiff cites with approval" (Defs' Mem. at 34), in fact Lead Plaintiff ***distinguished*** *Miller* in the brief to which Merrill Lynch refers. *See* Lead Plaintiff's Opposition to Defendant Alliance Capital Management L.P.'s Motion for Summary Judgment and for Attorneys' Fees and Costs (Docket No. 4734) at 25 & n.9.

3. Opposing Expert Reports Creating a Triable Issue of Fact Preclude Summary Judgment on the Issue of Loss Causation

Dr. Nye's conclusions, when considered under this Court's loss causation framework, demonstrate a legally sound and factually supported theory of loss causation concerning Merrill. Merrill, however, claims that its expert witness on loss causation has opined that Merrill's "alleged conduct caused no losses." Defs' Mem. at 27 (citing to Report of Frederick C. Dunbar, Ph.D.).

The presence of opposing expert reports creates a triable issue of fact precluding summary judgment. In *In re Worldcom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472 (S.D.N.Y. 2005), the court held:

> [A] jury will have to determine which expert's analysis is more compelling and reliable.

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656 *See* Ex. 149 at 12-13 (disclosing that in a number of transactions where LJM2 purchased equity or debt in Enron assets "Enron repurchased all or a portion of the equity and debt initially purchased by LJM"); Ex. 149 at 17 ("In December 1999, Enron sold an equity investment in Enron Nigeria Barge Ltd. to an investment bank and provided seller financing. In June of 2000, LJM2 purchased this equity investment directly from the investment bank for $7.5 million and the assumption of the seller-financed note from Enron.").

657 Nye Report, ¶158.

> Fact finding and credibility determinations are the function of the jury and are not appropriately resolved on a motion for summary judgment. *See* [*Anderson v. Liberty Lobby, Inc*., 477 U.S. 242, 255 (1986)]. Indeed, "where, as here, there are ***conflicting expert reports*** presented, courts are wary of granting summary judgment." *Harris v. Provident Life & Accident Ins. Co.*, 310 F.3d 73, 79 (2d Cir. 2002) (collecting cases).

Id. at 500. *Accord Bieghler v. Kleppe*, 633 F.2d 531, 534 (9th Cir. 1980); *Sightsound.com, Inc. v. N2K, Inc*., 391 F. Supp. 2d 321, 354 (W.D. Pa. 2003) ("Conflicts in the evidence on factual issues are not to be resolved on summary judgment, particularly where those conflicts arise from ***competing expert opinions***, the resolution of which is a matter reserved to the jury.") *Real v. Bunn-O-Matic Corp*., 119 F. Supp. 2d 807, 811 (N.D. Ill. 2000) ("Bunn-O-Matic now asks this Court to find that, despite the conflicting opinions of expert witnesses, there is no genuine issue of material fact, and to rule as a matter of law . . . . It asks too much. This is an issue for trial."); *Provenz v. Miller*, 102 F.3d 1478, 1490 (9th Cir. 1996) ("'As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case.'"); *Owens v. Ford Motor Co.*, 297 F. Supp. 2d 1099, 1110 (S.D. Ind. 2003) ("The court's role on summary judgment is not to choose the better expert . . . .").

These authorities also dispose of Merrill's suggestion that the damages calculation method of Lead Plaintiff's expert witness is purportedly flawed. *See* Defs' Mem. at 31 n.11. Again, having refused to actually argue the point, Merrill has failed to properly move for summary judgment on it. Yet even if Merrill's suggestion is considered, it consists simply of noting that both Merrill and Lead Plaintiff have conflicting expert opinions on the subject (*id.*) – rendering summary judgment improper under the authorities discussed above.

D. There Is a Triable Issue of Fact that Merrill Is Subject to Joint and Several Liability for Its Ongoing Engagement in Enron's Ponzi Scheme

1. This Court Has Already Decided This Issue in Lead Plaintiff's Favor

Merrill raises its oft-repeated (and rejected) claim that the Court should rule as a matter of law that it cannot be subject to joint and several liability.[658] According to Merrill it "at most had knowledge of and participated in an inactionable hub-and-spoke conspiracy, not a mega-scheme" (Defs' Mem. at 43), "was not a knowing participate beyond its own acts" (Defs' Mem. at 44), and should not be held "jointly and severally liable for all damages resulting from . . . acts as to which Merrill Lynch did not participate and lacked knowledge" (Defs' Mem. at 45), and for plaintiffs to seek joint and several liability against it "violates the PSLRA" (Defs' Mem. at 49).

Merrill made the same argument to the Court in its briefing opposing class certification ***and*** at oral argument:

> My client, Your Honor, has been involved in two of those 66 transactions. Yet, if you listen to the Plaintiffs, under their hub-and-spoke conspiracy theory, my client is jointly and severally liable for the 64 transactions they didn't know about, they had no involvement with.

3/8/06 Class Certification Tr. (Ex. 150) at 394:15-19. And the Court rejected Merrill's argument. *See Enron*, 2006 U.S. Dist. LEXIS 43146, at *222-*223. The Court phrased the issue thusly: "[I]s a defendant liable only for the loss suffered by plaintiff that was caused by that defendant's own

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[658] *See, e.g.*, Memorandum of Law of Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch & Co., Inc. in Opposition to Lead Plaintiff's Motion for Partial Summary Judgment (Docket No. 3937) at 4 ("Merrill Lynch can be legally responsible for its 'own acts or omissions,' but not for those committed by others as to which it was unaware and uninvolved."); Reply Memorandum of Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch & Co., Inc. in Support of Their Motion for Judgment on the Pleadings (Docket No. 4008) at 2 ("Plaintiff's baseline position is that . . . Merrill Lynch is jointly and severally liable for causing all of plaintiff's alleged losses, regardless of whether Merrill Lynch participated in – or even knew about – the conduct underlying those losses. . . . [P]laintiff's theory . . . is unprecedented, and would lead to an unfair, and indeed absurd, result.").

primary violation or is a defendant liable for the loss caused by all primary violators participating in the scheme as a whole?" *Id*. at *222. The Court chose the latter. Defendants may be held "jointly and severally liable for the loss caused by the entire overarching scheme, ***including conduct of other scheme participants about which it knew nothing***." *Id*. Amazingly, in its entire section disputing joint and several liability, Merrill hardly acknowledges that the Court already decided this issue. *See* Defs' Mem. at 43-53. As demonstrated here – and in Lead Plaintiff's numerous other submissions on this topic[659] – the Court's decision is well-founded and correct.

2. Lead Plaintiff Need Not Prove Merrill Knew the Conduct of All Scheme Participants to Demonstrate a Triable Issue as to Joint and Several Liability

Merrill asserts it cannot be held jointly and severally liable in the scheme unless it knowingly committed deceptive acts in each and every transaction that was part of the Ponzi scheme. *See* Defs' Mem. at 49 (there "are 64 other transactions unknown to Merrill Lynch," and it "violates the PSLRA" to "claim . . . liability flowing from transactions [Merrill Lynch] had no knowledge of or involvement in"). Merrill's arguments overstate what is required for Lead Plaintiff to prevail on this Motion. Moreover, as this Court has recognized, Merrill need not have committed or had knowledge of every deceptive act in the Ponzi scheme to be liable for ongoing substantial participation in the unified scheme to defraud.

Lead Plaintiff more than sufficiently demonstrates Merrill knowingly committed deceptive acts in furtherance of a scheme to defraud. Lead Plaintiff need not prove the entire scheme in this case to prevail on this Motion which is solely directed at certain issues of proof related to Merrill's

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[659] *See* Lead Plaintiff's Opposition to Merrill Lynch's Motion for Judgment on the Pleadings (Docket No. 3820) at 25-27; Lead Plaintiff's Response to Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated's and Merrill Lynch & Co., Inc.'s Sur-Reply in Further Opposition to Lead Plaintiff's Motion for Partial Summary Judgment (Docket No. 4571) at 11-20.

involvement in the scheme. Nor need we prove Merrill's "knowledge of or involvement in" "64 other transactions" (*see* Defs' Mem. at 49) to demonstrate a triable issue of fact that Merrill may be subject to joint and several liability at trial. The purpose of the year-end 1999 transactions (well known to Merrill) implies the deception of Enron's investors. Here it is enough that Lead Plaintiff has demonstrated Merrill knew the purpose of its deceptive acts and that those acts fit the pattern of the broader scheme. The full extent of Merrill's knowledge and involvement in the broader scheme need not be proven here.

As this Court has recognized, the Nigerian Barges transaction and the power swaps "fit the pattern" of a "deliberate, unified scheme to defraud." *Enron*, 310 F. Supp. 2d at 830. And this Court has recognized Lead Plaintiff properly alleged "an ongoing scheme in which Merrill Lynch participated in a substantial way over years," including "early in the Class Period when it participated in establishing and funding LJM2 at a critical accounting time, despite red flags identified in the complaint and known to Merrill Lynch." *Id*.

Therefore, contrary to what Merrill suggests, the year-end 1999 transactions are not to be viewed as isolated for purposes of determining whether its deceptive acts were made in furtherance of a scheme to defraud. Indeed, Lead Plaintiff has more than sufficiently demonstrated Merrill's conduct in the year-end 1999 transactions was intended to deceive Enron's auditors, manipulate Enron's financial statements and thereby deceive Enron's investors. Indeed, Merrill does not dispute that was the very purpose of its secret side agreements with Enron.

As shown herein, this is not the first time Merrill has asked the Court to absolve it from liability because it purportedly only participated in "isolated" or "discrete" acts in the Enron fraud. In its motion to dismiss Lead Plaintiff's amended allegations concerning the Nigerian Barges transaction and the power swaps, Merrill argued Lead Plaintiff had not alleged that it "'committed a manipulative or deceptive act in furtherance of the scheme.'" Memorandum of Law of Merrill

Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith, Inc. in Support of Their Motion to Dismiss Amended Complaint (Docket No. 1501) at 13. *See also supra* n.__.

This Court rejected Merrill's claims that its "isolated" conduct in connection with the Nigerian Barges transaction did not indicate Merrill Lynch committed deceptive acts in furtherance of a scheme:

> These newly alleged transactions are not to be viewed in isolation. Lead Plaintiff's complaint has alleged an ongoing scheme in which Merrill Lynch participated in a substantial way over years. Not only do the particularities of alleged Nigerian barge deal . . . and the power swaps in 1999 imply deception of Wall Street and the public at large by Merrill Lynch and give rise to a strong inference of scienter, they also cast a long shadow over Merrill Lynch's ongoing, substantial participation in the alleged Ponzi scheme. . . . The concealed pattern of manipulation (including unlawful SPEs, off-the-books transactions without any legitimate economic purpose to inflate Enron's earnings and conceal its debts, sham hedging, guaranteed "loans" or disguised sales, etc.,) that characterized the alleged Ponzi scheme, repeated in the Nigerian barge and sham power swaps transactions, created a highly inaccurate public picture of Enron's financial condition . . . . Indeed, when this Court ordered Lead Plaintiff to replead its claims against Merrill Lynch, it did so because the Nigerian barge transaction and the power swaps fit the pattern that the original consolidated complaint had alleged; such parallels imply a deliberate, unified scheme to defraud.

Enron, 310 F. Supp. 2d at 830. Thus, as this Court has recognized, Merrill need not have committed or had knowledge of every deceptive act in the Ponzi scheme to be liable for ongoing substantial participation in that scheme to defraud.

Even assuming any one of the year-end 1999 transactions was the only trick Merrill had up its sleeve (obviously this is not so), the significance of committing deceptive acts in connection with that transaction cannot be understated. As this Court recognized in its order denying the motions to dismiss filed by a number of bank defendants:

> Where Lead Plaintiff has once adequately alleged that a party took such an affirmative step with scienter, not only that immediate act or material misrepresentation or omission, which without adequate public disclosure directly or indirectly manipulated the financial picture of Enron or the value of its securities, any alleged subsequent activity by that party, such as continuing to lend funds to Enron-controlled SPEs or soliciting or selling Enron securities or even silence, necessarily

> becomes suspect as further complicity in, expansion of, and perpetuation of the alleged Ponzi scheme.

Enron, 235 F. Supp. 2d at 695. Thus, Lead Plaintiff need not prove the entire scheme to establish Merrill committed deceptive acts in furtherance of the scheme. But, establishing Merrill knowingly committed deceptive acts in connection with either the Nigerian Barges transaction or the Electricity Trades will, to use this Court's words, "cast a long shadow over" its other conduct. *Enron*, 310 F. Supp. 2d at 830.

Merrill offers nothing new in support of its oft-repeated condemnation of the purported unfairness joint and several liability would impose upon it. Congress passed the PSLRA with its joint and several liability provisions. Merrill's concern about the fairness of joint and several liability should be directed to Congress, not this Court.

3. The Issue of Joint and Several Liability Is Not Properly Decided on Motion for Summary Judgment

Just like it argued the issue of joint and several liability at class certification (and lost), Merrill again raises the issue but without explanation of why the matter is appropriately decided on motion for summary judgment, and not by the trier of fact. The PSLRA clearly states: "Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only ***if the trier of fact specifically determines*** that such covered person knowingly committed a violation of the securities laws." 15 U.S.C. §78u-4(f)(2)(A). Thus, the requisite factual determination for the imposition of joint and several liability is a question for the jury, and should not be decided presently.

4. Should the Court Revisit Its Ruling on Joint and Several Liability Presently, Which It Need Not Do, It Is Clear Merrill's Arguments Are Contrary to the PSLRA

The PSLRA is unequivocal in providing that knowing violators of Rule 10b-5 are jointly and severally liable for all of a plaintiff's damages regardless of the violator's degree of fault as compared with others in the scheme. The PSLRA states: "Any covered person against whom a final judgment is entered in a private action ***shall be liable for damages jointly and severally*** only if the trier of fact specifically determines that such covered person ***knowingly committed a violation*** of the securities laws." 15 U.S.C. §78u-4(f)(2)(A). There need only be "a" violation by the defendant; one is enough. The statute plainly states there "shall be" joint and several liability for damages under the final judgment if the trier of fact finds one "knowingly committed a violation." *Id*. There is no exception, or reduction, or apportionment of liability for knowing violators who claim lack of responsibility for all the damages found. There simply is no ambiguity as to the clear text of the statute or to congressional intent that knowing violators should bear the entire brunt of plaintiffs' damages.

To impose joint and several liability against a scheme participant such as Merrill, Lead Plaintiff need only show Merrill acted with actual knowledge of "the facts and circumstances" that made Merrill's conduct "a violation of the securities laws." 15 U.S.C. §78u-4(f)(10)(A)(ii) ("if that covered person engages in that conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws"). Under the PSLRA, the level of intent is the sole criterion for determining whether a violator should be held jointly and severally liable for the judgment. 15 U.S.C. §78u-4(f)(2)(A). Indeed, the statute contemplates securities actions with multiple violators and provides "knowing" violators will have a "percentage of responsibility" less than the "total fault of all persons who caused or contributed to the loss" based on the "nature of conduct" and "causal relationship between the conduct . . . and the damages." 15 U.S.C. §78u-4(f)(3). Nonetheless, each knowing violator is jointly and severally liable. Just as the statute makes that clear, so does the Congressional record:

> Under joint and several liability, each defendant is liable for all the damages awarded to the plaintiff. Thus a defendant found responsible for only 1% of the harm could be required to pay 100% of the damages.

S. Rep. No. 104-98, at 20 (1995), *reprinted* 1995 U.S.C.C.A.N. 679, 699.

Furthermore, knowing violators are responsible for the damages of all other violators – both knowing and non-knowing – including the damages caused by any violator whose share of the damages is uncollectible. 15 U.S.C. §78u-4(f)(4). In the latter case, if "after a final judgment is entered in any private action," the court finds that "all or part of the share of the judgment of the covered person is not collectible against that covered person," it may be collected from a knowing violator. *Id*. Thus, Congress expressly provided in the PSLRA that knowing violators are responsible for the entire judgment, regardless of their degree of responsibility for particular parts of the fraud and, in fact, even if they were not responsible at all for certain parts.

Merrill argues that the imposition of joint and several liability here would be contrary to the loss causation requirement set forth in 15 U.S.C. §78u-4(b)(4). Defs' Mem. at 48. This is incorrect. As set forth by Lead Plaintiff, it is sufficient that plaintiffs show Merrill was a cause of plaintiffs' single, indivisible injuries. Plaintiffs have done so. *See supra* §III.A.3.b.-d., III.B.4.-5., III.D.8., VI.C. Merrill also argues that the Court should adopt "the approach followed by Judge Kaplan in *Parmalat*" and address each of the transactions as dealing with "individual schemes" for the purposes of joint and several liability. Defs' Mem. at 47 (citing *Parmalat I*, 376 F. Supp. 2d at 505, 510). Judge Kaplan's opinion, however, does not once address the issue of joint and several liability and is simply inapposite here. Moreover, it is contrary to the clear text of the PSLRA.

5. Joint and Several Liability Is Perfectly Consistent with Lead Plaintiff's Experts' Testimony and Does Not Raise "Constitutional Due Process Issues"

Merrill contends that joint and several liability cannot be imposed because it is supposedly inconsistent with the testimony of Lead Plaintiff's own experts. Defs' Mem. at 46 ("Not even plaintiff's own loss causation/damages experts are prepared to opine that it is rational to hold Merrill Lynch jointly and severally liable . . . ."). Yet Merrill misconstrues the relevant testimony and the purpose for which these experts were called. The quoted testimony merely reveals that Lead Plaintiff's experts, as economists, have no opinion as to whether it would be "fair and rational" to impose joint and several liability. *See* Defs' Mem. at 46. But it should hardly be surprising to Merrill that Lead Plaintiffs' experts will not opine on the law governing the imposition of joint and several liability. As the Court is well aware, there is only one expert on the law in Your Honor's Courtroom. *See*, *e.g.*, *In re Initial Pub. Offering Sec. Litig*., 174 F. Supp. 2d 61, 64 (S.D.N.Y. 2001) ("The rule prohibiting experts from providing their legal opinions or conclusions is 'so well-established that it is often deemed a basic premise or assumption of evidence law – a kind of axiomatic principle.'").

Finally, Merrill also contends the imposition of joint and several liability could be unconstitutional. This is a red herring. Merrill does not cite one case finding joint and several liability is unconstitutional in any context, let alone where it has been sanctioned by Congress. Moreover, the only case Merrill cites for its proposition, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003), states: "In sum, courts must ensure that the measure of punishment is both reasonable and ***proportionate to the amount of harm to the plaintiff and to the general damages recovered***." *Id*. at 426. Here, Merrill could not be liable for any more than plaintiffs' damages. Thus, Merrill's potential liability would be "proportionate to the amount of harm to the plaintiff" and could not violate the standards set forth by the Supreme Court. Accordingly, all of Merrill's arguments against the application of joint and several liability are without basis and should not cause the Court to reverse its prior holding on this matter.

DATED: November 13, 2006

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing LEAD PLAINTIFF'S OPPOSITION TO MOTION FOR SUMMARY JUDGMENT FILED BY DEFENDANTS MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND MERRILL LYNCH CO., INC. (DOCKET NO. 4816) document has been served by sending a copy via electronic mail to serve@ESL3624.com on November 13, 2006.

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 November 13, 2006.

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