Securities Regulation Daily Wrap Up, BROKER-DEALERS—S.D. Tex.: Enron shareholder case against brokers dismissed for failure to plead scheme liability or scienter, (Mar. 1, 2017)

Securities Regulation Daily Wrap Up

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By Joseph Arshawsky, J.D.

Several Enron shareholders' putative class action was dismissed for failure to plead scheme liability or scienter, a federal court in Texas held. The complaint also failed to pierce the corporate veil and failed to plead loss causation (*In re Enron Corporation Securities, Derivative & "ERISA" Litigation*, February 28, 2017, Harmon, M.).

The complaint alleged that brokerage firms engaged in a scheme to optimize revenue in investment banking fees from Enron Corp. at the expense and defrauding of their retail clients, a putative shareholder class that filed the suit. The suit charged violations of Securities Act Sections 11, 12(a)(2) and Exchange Act Sections 10(b) and 20(a). Defendants moved to dismiss the third amended complaint, which the court granted with prejudice.

Single entity. As a threshold matter, the shareholders were unable to make a case for disregarding the separate legal existence of both defendant corporations. At least the pleading of some facts sufficient to make a plausible claim that the defendants operated as a single entity in defrauding the shareholders was necessary but not satisfied in this case. The shareholders also failed to plead facts sufficient to support any of the seven factors in the "single entity test" of the Third Circuit (which includes Delaware) to justify piercing the corporate veil: (1) gross undercapitalization of a defendant corporation for the purposes of the corporate undertaking; (2) a failure to observe corporate formalities; (3) the non-payment of dividends; (4) the insolvency of the debtor corporation at the time; (5) the siphoning of the corporation's funds by the dominant stockholder; (6) the nonfunctioning of other officers or directors; (7) the absence of corporate records; and (8) the fact that the corporation is merely a facade for the operations of the dominant stockholders.

Holder claims. The 1933 and 1934 Acts discuss "purchase" or "sale" of a security. To the extent the shareholders raised claims that the misrepresentations forced them to "hold" onto securities, such claims are speculative, and were dismissed.

Also, because Enron's stock option plans were noncontributory and compulsory for its employees, as a matter of law there was no sale, and thus not a "purchase" or "sale" under the securities laws.

Scheme liability. Even if there had been a sale, the United States Supreme Court has rejected the scheme liability theory under section 10(b). There is no private right of action under section 10(b) for aiding and abetting. Rather a primary claim must be established. Here, neither broker made a public statement nor did either have a duty to disclose material information to the shareholders.

Scienter. Even if there had been a "sale," the shareholders failed to allege facts establishing that the brokers had acted with scienter. Where the defendant is a corporation, the plaintiff must plead specific facts giving rise to a strong inference that a particular defendant's employee acted with scienter as to each alleged omission. The knowledge necessary to form the requisite fraudulent intent cannot be inferred and imputed to a corporation based on disconnected facts known by different agents. Given that, the shareholders failed to adequately allege scienter.

There were no allegations about statements that caused the stock to plummet, as required to plead loss causation. Having failed to allege a primary violation, control person liability under section 20(a) also failed.

The case is No. 4:02-cv-00851.

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Companies: UBS Financial Services Inc.; UBS Painewebber, Inc.

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