United States Courts
Southern District of Texas
FILED

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Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated,	§	Civil Action No. H-01-3624
	§	**(Consolidated)**
	§	
Plaintiffs,	§	CLASS ACTION
	§	
vs.	§	
	§	
ENRON CORP., et al.,	§	
	§	
Defendants.	§	

THIRD SUPPLEMENTAL BRIEF IN SUPPORT OF AMALGAMATED BANK'S *EX PARTE* APPLICATION FOR PARTICULARIZED EXPEDITED DISCOVERY FROM DEFENDANT ARTHUR ANDERSEN LLP AND ENRON EXECUTIVES, INCLUDING DEFENDANT KEN LAY TO PRESERVE EVIDENCE

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MEMORANDUM OF POINTS AND AUTHORITIES

I. THE IMPACT OF ARTHUR ANDERSEN'S ADMISSION AND THE EVIDENCE OF ENRON'S AND CEO LAY'S HYPOCRISY

In a block-buster development in the Enron meltdown – so explosive that it dominated the network newscasts, preempted coverage of the war in Afghanistan, and was featured on the front pages of major newspapers – defendant Arthur Andersen has admitted that it does not know if or when it violated its duty to preserve relevant evidence. Enron's outside auditor

> notified the U.S. Securities and Exchange Commission and the U.S. Department of Justice, and is also notifying congressional committees and other agencies investigating the Enron collapse, that ***in recent months*** individuals in the firm involved with the Enron engagement ***disposed of a significant but undetermined number of electronic and paper documents and correspondence relating to the Enron engagement.***
>
> * * *
>
> Discarding of documents occurred during the months before the SEC issued a subpoena to Andersen. After receiving the SEC subpoena, the firm issued an instruction to preserve documents. ***At this time, we have not been able to determine whether that instruction was violated.***
>
> * * *
>
> The firm is working to gather the facts and determine appropriate disciplinary actions.[1]

In mid-August 2001 Enron CEO Lay was warned by Sherron Watkins that Enron was a "crooked" company engaged in an accounting charade, which would soon "implode in a wave of accounting scandals." *See* Ex. A, attached hereto.

Enron was told by the SEC by October 22 – the date when the first class-action suit was filed – to submit requested information about former CFO Andy Fastow's related-party transactions, and the Company announced on October 31 that the SEC had opened a formal investigation to probe its off-balance-sheet partnerships. Thus, Enron's top officers were on notice to preserve all documents at least 12 weeks ago. And the Company's General Counsel, James Derrick, at least twice, notified

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[1]Arthur Andersen Press Releases, dated January 10, 2002, previously attached as Ex. 1 to plaintiff's *Ex. Parte* Application ("App."); *see also* J. Weil *et al.*, "Audit Nightmare: Arthur Andersen Says it Disposed of Documents that Related to Enron," *Wall St. J.*, Jan. 11, 2002 (App., Ex. 2); K. Eichenwald *et al.*, "Enron's Collapse: The Auditor - Enron's Auditor Says it Destroyed Documents," *N.Y. Times*, Jan. 11, 2002 (App., Ex. 3).

all employees by e-mail that ***no*** company records should be destroyed. In fact, on January 14, he sent the following e-mail update to all employees worldwide:

> This is to ***remind all employees*** that, ***as earlier instructed***, in view of the pending and threatened legal proceedings involving the company, ***no company records, either in electronic or paper form, should be destroyed.***[2]

But documents by the thousands were being shredded – and had been since November, some ***two months*** before the latest directive – and the Company knew it. A project manager observed the systematic gathering and review by support staff of boxes from all over Enron, and the subsequent shredding of documents from those boxes that filled trash cans, including those related to the off-balance-sheet JEDI II transaction, "confidential" documents, and other financial records, which are dated from at least 1994 through December 20, 2001.[3] Consequently, joining congressional committees, executive-branch criminal probes, political and legal commentators, Amalgamated Bank urges the Court to order Enron CEO Lay, as well as Enron's Chief Financial and Accounting Officers, and Andersen personnel, through plaintiff's particularized discovery, to answer questions integral to the litigation: Who shredded the documents? Which ones? When? On whose orders? And why?

The PSLRA's document-preservation provisions make it "illegal for any party who receives actual notice of the litigation to destroy or alter evidence."[4] Indeed, courts have consistently allowed discovery to commence "when faced with 'the risk of lost or destroyed evidence.'"[5] The PSLRA ordinarily stays discovery during the pendency of a motion to dismiss, but Congress specifically "included a preservation provision in the PSLRA 'in recognition that "the imposition of a stay of

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[2]*See* Amalgamated Bank's Declaration of G. Paul Howes, accompanying Amalgamated Bank's *Ex Parte* Application, ¶3 and Ex. B hereto (emphasis added).

[3]*Id.*, ¶¶2-3.

[4]*Powers v. Eichen*, 961 F. Supp. 233, 235 (S.D. Cal. 1997).

[5]*See, e.g.*, *Vezzetti v. Remec, Inc.*, No. 99CV0796-L (JAH), 2001 U.S. Dist. LEXIS 10462, at *5 (S.D. Cal. July 20, 2001) (citation omitted).

discovery may increase the likelihood that relevant evidence may be lost.""[6] Further, the "statute provides for the possibility of court-ordered sanctions for a party's 'willful failure' to comply with the duty to preserve relevant evidence."[7] The discovery-stay provisions and the concomitant duty to preserve relevant evidence "reflect a careful balance between Congress's efforts to shield defendants facing frivolous claims from the burdens of discovery, on the one hand, and its desire to ensure the preservation of evidence relevant to legally cognizable claims, on the other."[8]

In the wake of these recent revelations and admissions, coupled with their violation of the PSLRA's mandate to preserve evidence, Andersen and Enron's top officers have breached a basic civil-litigation precept: "[F]undamental to the duty of production of information is the threshold duty to preserve documents and other information that may be relevant in a case."[9] In *Danis*, a case where defendants were charged with destroying crucial documents in violation of the PSLRA and the Federal Rules of Civil Procedure, the court noted that "[i]mmediately upon the filing of the ... lawsuit [defendant] was required to preserve for possible production in the lawsuit documents (whether in hard copy or electronic form) that might be discoverable. That duty flowed from both the [PSLRA] and from a common law duty not to spoil documents that might be discoverable in the litigation."[10]

Without question, Enron's CEO Lay, as well as its CFO, CAO, and its auditor, had no less of a duty here: Enron, since October 22, when the first class-action suit was filed, and also October 31, when the SEC's formal probe was disclosed; and Andersen, from at least December 4, when it was named in Amalgamated Bank's Complaint – if not before, since the auditor disclosed

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[6]*In re Tyco Int'l Ltd. Sec. Litig.*, No. 00-MD-1335, 2000 U.S. Dist. LEXIS 11659, at *4 (D.N.H. July 27, 2000) (citing *In re Grand Casinos Sec. Litig.*, 988 F. Supp. 1270, 1271 (D. Minn. 1997)).

[7]*Id.* at *4-*5 (citing 15 U.S.C. §78u-4(b)(3)(C)(ii)).

[8]*Id.* at *5.

[9]*Danis v. USN Communs., Inc.*, No. 98 C 7482, 2000 U.S. Dist. LEXIS 16900, at *5 (N.D. Ill. Oct. 20, 2000).

[10]*Id.* at *37.

on November 30 that it had received a subpoena from the SEC, but has refused to say when.[11] Further, earlier in 2001 Chicago headquarters personnel had questioned the Company's accounting – so much so that the potential to drop the $52-million client was discussed.[12]

Moreover, in the aftermath of this colossal collapse, Andersen is accountable to the profession and to the public:

> A distinguishing mark of a profession is acceptance of its responsibility to the public.... This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.... In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.[13]

Indeed, the Auditor's document destruction may well establish another significant failure: "Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; ***it cannot accommodate deceit*** or subordination of principle."[14]

In sum, Enron's and CEO Lay's hypocrisy speaks volumes about its purported credibility and promised cooperation. Taken together with Andersen's damning admissions, plus the existence of the box of shredded Company documents from the corporate accounting area, these shocking revelations establish that Enron and Andersen failed their statutory, professional, and common-law duties to preserve evidence. The indisputable fact that documents were destroyed during the pendency of this litigation shows that the willfulness element required by the statute has been met. Consequently, pursuant to PSLRA §21D(b)(3)(B), Amalgamated Bank requests that the Court order

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[11]*See* D. Alexander, "SEC Subpoenas Andersen Records in Enron Collapse," *Chicago Tribune*, Dec. 1, 2001 (App., Ex. 4).

[12]*See* Second Supplemental Brief for Expedited Discovery.

[13]AICPA Code of Professional Conduct §53.01-02 (App., Ex. 5).

[14]*Id.* at §54.02 (emphasis added).

Enron's CEO Lay, CFO, and CAO, and Andersen personnel to answer particularized discovery aimed at preserving and recovering evidence, and that the Court take control of their documents.

II. DISCRETE DISCOVERY IS WARRANTED

Amalgamated Bank seeks discovery from Enron's CEO Lay, CFO, CAO and Andersen personnel with personal knowledge on the following topics, a limited number of documents, and preservation of electronic data. Plaintiff reserves the right to videotape the examinations and the discovery sought is without prejudice to its rights to formal discovery.

A. Deposition Topics

(1) The identity of each individual who was responsible for, directed, executed, or assisted in the destruction of any electronic and paper documents and correspondence relating to Enron's business or Andersen's Enron engagement.

(2) The identity of each document and category of documents Andersen and Enron's CEO, CFO, and CAO believe, or have reason to believe, has or may have been destroyed.

(3) The identity of the individual(s) who discovered the evidence destruction identified in Andersen's releases, including when and how it was discovered and the auditor's response to the discovery of the destruction.

(4) All information gathered by or for Andersen concerning the reasons for the evidence destruction.

(5) All facts concerning how all Enron-related electronic and paper documents and correspondence were destroyed, including the manner in which the documents were destroyed and the location where such destruction took place.

(6) The current location of all electronic and paper documents and correspondence relating to the Amalgamated class-action suit and Enron engagement that were once destroyed, Andersen's and those that since have been recovered, reconstituted, or recreated.

(7) Enron's and Andersen's past and current document-preservation policies.

(8) The steps taken by Enron CEO Lay, and its CFO and CAO, and Andersen personnel, at any time to ensure that Enron-related evidence or evidence related to the class-action suit in the auditor's or the Company's possession, custody or control was preserved.

(9) The facts and results of all efforts to find, identify, recreate or reconstitute any destroyed evidence.

(10) The preservation or destruction of evidence responsive to any request for production (formal or informal) or subpoena issued by the staff of the United States Securities and Exchange Commission, the United States Department of Justice or the United States Congress (including any committee or

subcommittee) concerning Enron or any services Andersen performed for Enron, including auditing and accounting services.

B. Documents

(1) All documents concerning Andersen's investigation of the destruction or spoliation of Enron-related evidence.

(2) All documents concerning the success or failure of Andersen's recovery of destroyed Enron-related evidence.

C. Preservation of Electronic Evidence

Andersen has admitted that critical electronic evidence has been destroyed and based on a project manager's observations over several weeks, we know now that Enron personnel were assigned to gather and review and then to shred select documents. No one knows what electronic data has been deleted. Amalgamated Bank requests that the Court order the company auditors, Enron's CEO, CFO and CAO to make available all relevant electronic evidence, including documents and e-mails from individual computers and Andersen computer servers, for recordation by an independent forensic computer data-recovery and preservation specialist, who will provide electronic back-ups to the Court for storage in the Court's registry. The justification is elementary and will remove any doubt as to what was destroyed and what is recoverable: "It is no secret that deleted files and other 'residual' data may be recovered from hard drives and floppy disks. How do you make sure you capture this data? ... [Y]ou must make what is known as an 'image copy' of the target drive ... [which] duplicates the disk surface sector by sector, thereby creating a mirror image ...."[15]

Amalgamated Bank incorporates the analysis in its Second Supplemental Brief for Expedited Discovery as the basis for requesting that the Court take control of Enron's documents related to the class-action suit, as well as those related to Andersen's Enron engagement. This is the surest way to protect the integrity of the documents and PSLRA process, and to replace the misplaced reliance

[15]Joan E. Feldman & Boyer I. Kohn, *Collecting Computer-Based Evidence*, N.Y.L.J. Jan. 26, 1998 (Ex. 6). *See also In re Pac. Gateway Exchange, Inc. Sec. Litig.*, No. C 00-1211 PJH (JL), 2001 U.S. Dist. LEXIS 18433, at *6 (N.D. Cal. Oct. 17, 2001) (granting partial lifting of PSLRA discovery stay to allow plaintiffs to a mirror image "and preserve electronic data").

on the purported cooperation of Enron's Ceo, CFO and CAO and Andersen and promised preservation with the knowledge that relevant evidence will no longer be destroyed.

DATED: January 21, 2002

Respectfully submitted,

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Exhibit A

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm, The New Power Co by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem – we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Summary of alleged issues:

Raptor

Entity was capitalized with LJM equity. That equity is at risk; however, the investment was completely offset by a cash fee paid to LJM. If the Raptor entities go bankrupt LJM is not affected, there is no commitment to contribute more equity.

The majority of the capitalization of the Raptor entities is some form of Enron N/P, restricted stock and stock rights.

Enron entered into several equity derivative transactions with the Raptor entities locking in our values for various equity investments we hold.

As disclosed, in 2000, we recognized $500 million of revenue from the equity derivatives offset by market value changes in the underlying securities.

This year, with the value of our stock declining, the underlying capitalization of the Raptor entities is declining and Credit is pushing for reserves against our MTM positions.

To avoid such a write-down or reserve in Q1 2001, we 'enhanced' the capital structure of the Raptor vehicles, committing more ENE shares.

My understanding of the Q3 problem is that we must 'enhance' the vehicles by $250 million.

I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day. (Please review the late 90's problems of Waste Management – where AA paid $130+ mm in litigation re: questionable accounting practices).

The overriding basic principle of accounting is that if you explain the 'accounting treatment' to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting.

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. In other words, the $500 million in revenue in 2000 would have been much lower. How much lower?

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us. The stocks, most notably Hanover, The New Power Co., and Avici are underwater to great or lesser degrees.

I firmly believe that executive management of the company must have a clear and precise knowledge of these transactions and they must have the transactions reviewed by objective experts in the fields of securities law and accounting. I believe Ken Lay deserves the right to judge for himself what he believes the probabilities of discovery to be and the estimated damages to the company from those discoveries and decide one of two courses of action:

1. The probability of discovery is low enough and the estimated damage too great; therefore we find a way to quietly and quickly reverse, unwind, write down these positions/transactions.
2. The probability of discovery is too great, the estimated damage to the company too great; therefore, we must quantify, develop damage containment plans and disclose.

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

Summary of Raptor oddities:

1. The accounting treatment looks questionable.

   a. Enron booked a $500 mm gain from equity derivatives from a related party.
   b. That related party is thinly capitalized, with no party at risk except Enron.
   c. It appears Enron has supported an income statement gain by a contribution of its own shares.

   One basic question: The related party entity has lost $500 mm in its equity derivative transactions with Enron. Who bears that loss? I can't find an equity or debt holder that bears that loss. Find out who will lose this money. Who will pay for this loss at the related party entity?

   If it's Enron, from our shares, then I think we do not have a fact pattern that would look good to the SEC or investors.

2. The equity derivative transactions do not appear to be at arms length.

   a. Enron hedged New Power, Hanover, and Avici with the related party at what now appears to be the peak of the market. New Power and Avici have fallen away significantly since. The related party was unable to lay off this risk. This fact pattern is once again very negative for Enron.
   b. I don't think any other unrelated company would have entered into these transactions at these prices. What else is going on here? What was the compensation to the related party to induce it to enter into such transactions?

3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly. This alone is cause for concern.

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling and laid out 5 steps he thought should be taken if he was to remain as Treasurer. 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets and never addressed the 5 steps with him.
   b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.
   c. I have heard one manager level employee from the principle investments group say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." The principle investments group hedged a large number of their investments with Raptor. These people know and see a lot. Many similar comments are made when you ask about these deals. Employees quote our CFO as saying that he has a handshake deal with Skilling that LJM will never lose money.

4. Can the General Counsel of Enron audit the deal trail and the money trail between Enron and LJM/Raptor and its principals? Can he look at LJM? At Raptor? If the CFO says no, isn't that a problem?

Condor and Raptor work:

1. Postpone decision on filling office of the chair, if the current decision includes CFO and/or CAO.

2. Involve Jim Derrick and Rex Rogers to hire a law firm to investigate the Condor and Raptor transactions to give Enron attorney client privilege on the work product. (Can't use V&E due to conflict – they provided some true sale opinions on some of the deals).

3. Law firm to hire one of the big 6, but not Arthur Andersen or PricewaterhouseCoopers due to their conflicts of interest: AA&Co (Enron); PWC (LJM).

4. Investigate the transactions, our accounting treatment and our future commitments to these vehicles in the form of stock, N/P, etc..
   For instance: In Q3 we have a $250 mm problem with Raptor 3 (NPW) if we don't 'enhance' the capital structure of Raptor 3 to commit more ENE shares. By the way: in Q1 we enhanced the Raptor 3 deal, committing more ENE shares to avoid a write down.

5. Develop clean up plan:

   a. Best case: Clean up quietly if possible.

   b. Worst case: Quantify, develop PR and IR campaigns, customer assurance plans (don't want to go the way of Salomon's trading shop), legal actions, severance actions, disclosure.

6. Personnel to quiz confidentially to determine if I'm all wet:
   a. Jeff McMahon
   b. Mark Koenig
   c. Rick Buy
   d. Greg Whalley

To put the accounting treatment in perspective I offer the following:

1. We've contributed contingent Enron equity to the Raptor entities. Since it's contingent, we have the consideration given and received at zero. We do, as Causey points out, include the shares in our fully diluted computations of shares outstanding if the current economics of the deal imply that Enron will have to issue the shares in the future. This impacts 2002 – 2004 EPS projections only.

2. We lost value in several equity investments in 2000. $500 million of lost value. These were fair value investments, we wrote them down. However, we also booked gains from our price risk management transactions with Raptor, recording a corresponding PRM account receivable from the Raptor entities. That's a $500 million related party transaction – it's 20% of 2000 IBIT, 51% of NI pre tax, 33% of NI after tax.

3. Credit reviews the underlying capitalization of Raptor, reviews the contingent shares and determines whether the Raptor entities will have enough capital to pay Enron its $500 million when the equity derivatives expire.

4. The Raptor entities are technically bankrupt; the value of the contingent Enron shares equals or is just below the PRM account payable that Raptor owes Enron. Raptor's inception to date income statement is a $500 million loss.

5. Where are the equity and debt investors that lost out? LJM is whole on a cash on cash basis. Where did the $500 million in value come from? It came from Enron shares. Why haven't we booked the transaction as $500 million in a promise of shares to the Raptor entity and $500 million of value in our "Economic Interests" in these entities? Then we would have a write down of our value in the Raptor entities. We have not booked the latter, because we do not have to yet. Technically, we can wait and face the music in 2002 – 2004.

6. The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring over that footnote disclosure right now? I can just hear the discussions – "It looks like they booked a $500 million gain from this related party company and I think, from all the undecipherable ½ page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." ..... "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA&Co wouldn't let them get away with that?" ..... "Go back to the drawing board, it's got to be something else. But find it!" ..... "Hey, just in case you might be right, try and find some insiders or 'redeployed' former employees to validate your theory."

Exhibit B

Raymond, Maureen

From: Legal - James Derrick Jr.
Sent: Monday, January 14, 2002 4:02 PM
To: DL-GA-all_enron_worldwide2
Subject: Retention of Documents

This is to remind all employees that, as earlier instructed, in view of the pending and threatened legal proceedings involving the company, no company records, either in electronic or paper form, should be destroyed. In the event of an office closing, please contact Bob Williams at (713) 345-2402 to arrange for storage of any records.

Please call Bob with any questions.