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

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.	§	

PLAINTIFFS' RESPONSE TO THE DEUTSCHE BANK ENTITIES' NOTICE OF SUPPLEMENTAL AUTHORITY IN SUPPORT OF THEIR MOTION TO DISMISS THE FIRST AMENDED CONSOLIDATED COMPLAINT

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On December 9, 2003, Deutsche Bank submitted Defendants The Deutsche Bank Entities' Notice of Supplemental Authority in Support of their Motion to Dismiss the First Amended Consolidated Complaint (the "Supplemental Brief"). Therein, Deutsche Bank brings to the Court's attention the Final Report of Neal Batson, Court-Appointed Examiner (the "Final Report"). The Supplemental Brief is unfailingly replete with overstatement and logical fallacies. Nothing in the Final Report could possibly be interpreted to absolve Deutsche Bank of liability or undermine that which the Examiner has already established – a strong inference that Deutsche Bank knowingly or recklessly committed securities fraud.

The Supplemental Brief simply reaches conclusions unsupported by anything in the Final Report. For instance, Deutsche Bank claims the "Final Report presents more evidence undermining plaintiffs' conclusory assertions that the DB Entities engaged in fraudulent acts ...." Supplemental Brief at 2. Deutsche Bank, however, cites no affirmative finding of the Examiner. Rather, Deutsche Bank's entire argument stems from the illogical inference that the ***absence*** of evidence specific to Deutsche Bank in the Final Report absolves Deutsche Bank. But, Deutsche Bank's argument fails because the Examiner concluded his analysis of Deutsche Bank in his Third Report; the Final Report (the fourth report by the Examiner) only focuses upon other actors. For example, in reaching its conclusion, Deutsche Bank stresses the following:

> The Examiner found ***no*** evidence that the DB Entities misled or defrauded Arthur Andersen ... nor did the Examiner cite any evidence that the DB Entities (i) were aware of Andersen's application and interpretation of certain key accounting rules as Enron's auditors (Final Report at 105, App. B at 131-155, 161); (ii) had any knowledge about whether Andersen accurately presented the SSTs to the Enron Audit Committee (Final Report, App. B at 135-155); or (iii) knew anything about or was [sic] involved in any way in the tax cushion decisions that could have cured any accounting infirmities (*see generally* Final Report, App. B).

Supplemental Brief at 2 (emphasis in original). The ***absence*** of any such findings in the Final Report, however, is of little relevance to plaintiffs' claims. Notably, Deutsche Bank relies upon Appendix B to the Final Report, which is titled "Role of Andersen" and focuses entirely upon Arthur

Andersen. Indeed, Appendix B does not purport to reach any conclusions concerning Deutsche Bank. Therefore, it would be illogical to draw a negative inference about Deutsche Bank's scienter from the ***absence*** of information relating thereto in the Final Report. However, this is exactly what Deutsche Bank asks this Court to do.

In the above excerpt from the Supplemental Brief, Deutsche Bank also purports to find refuge in the Final Report at 105. That cited authority, however, merely discusses communications or the lack thereof between Enron's officers and Enron's board of directors. The Examiner concluded:

> The Enron Board was not informed that a critical function of Enron's tax department was to book earnings and that it was customary for the tax department to generate the "stretch" at the end of the year to meet Enron's earnings targets.

Final Report at 105 (all pages cited by plaintiffs attached hereto). The Examiner's conclusion has nothing to do with Deutsche Bank and does not contradict plaintiffs' allegations or the Examiner's earlier findings as to Deutsche Bank. This is true under any possible reading of the cited text, let alone drawing inferences in favor of plaintiffs as the Court must on a motion for dismissal. Indeed, the Examiner's conclusions in the Final Report substantiate plaintiffs' claim that the STDs were used to perpetrate a fraud upon plaintiffs. Accordingly, Deutsche Bank's ill-supported argument does not vitiate the strong inference of scienter pled by plaintiffs and does not support Deutsche Bank's motion for dismissal.

Deutsche Bank also asserts that, in the Final Report, the Examiner "admits" the accounting for Projects Steele and Cochise as pre-tax income was supported by "accounting authority and some public discussion of the issue (including an opinion from the SEC which acknowledged that accounting for the transaction [sic] as pre-tax income would be technically required)." Supplemental Brief at 2-3 (citing Final Report, App. B at 114-15). Like Deutsche Bank's previous argument, this

too is without any support in the text of the Final Report. Rather, the Examiner reaffirmed his earlier conclusions concerning Deutsche Bank and the STDs, stating:

- "[T]the Examiner concluded that Enron's accounting treatment of the Steele and Cochise Transactions violated GAAP, with the most aggressive and misleading aspects of the transactions being the creation of pre-tax income ...." Final Report, App. B at 110.

- Defendants' accounting "theory finds no credible support in the accounting literature." *Id.* at 111.

- "Consistent with Andersen's lack of cited authority, the Examiner has not located any persuasive authority for Andersen's position. In fact, accounting standards have long followed the practice of reflecting the effects of income taxes on net income within the income tax expense component of the income statement." *Id.* at 113 (footnotes omitted).

Thus, the Examiner "admits" to no mistake on his part and the Final Report in no way undermines the Examiner's prior findings – which clearly support the strong inference that Deutsche Bank acted with scienter to falsify Enron's reported financial results.

Deutsche Bank also claims that "the Final Report cites no evidence to ... conclude that ***any*** of [the] law firms [that worked on the STDs] committed fraud." Supplemental Authority at 3 (emphasis in original). Even if that were true, Deutsche Bank fails to explain how the Examiner's conclusions as to the lawyers have any bearing on Deutsche Bank's culpability. Both the lawyers and the banks were well informed as to the fraudulent nature of these transactions. Deutsche Bank's suggestion it is not liable because of its unsupported claims relating to the conduct of the law firms is no defense to the well-pleaded allegations of fraudulent conduct.

Lastly, Deutsche Bank asserts that the STDs only "had a minimal effect on [Enron's] financial statements" and that, because the STDs were approved by Andersen, that "Andersen's involvement was a supervening event which precludes plaintiffs from showing that the DB Entities were a proximate cause of their injuries." Supplemental Authority at 3-4. These arguments are simply erroneous. The net income effect of the STDs was – by any measure – huge. *See* ¶797.10 (showing $446 million income impact). Moreover, the $144 million in pre-tax income from Projects Cochise and Steele that Deutsche Bank specifically addresses (Supplemental Brief at 3, citing Third Report, App. G at 28) is orders of magnitude larger than the Nigerian Barge manipulations created by Merrill Lynch – which this Court found actionable. The law clearly supports this Court's conclusion. *See, e.g., Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163 (2d Cir. 2000) ("With respect to financial statements, the SEC has commented that various 'qualitative factors may cause misstatements of quantitatively small amounts to be material.'") (citation omitted). Finally, Deutsche Bank's proximate cause argument – that Andersen's audit was a supervening event destroying the causal connection between Deutsche Bank's actions and the STD's inflation of Enron's results – is without any basis in law or fact. Indeed, if Deutsche Bank was correct, than any defendant who cooked the books could avoid liability by blaming the company's auditor. That

simply is not the law. Deutsche Bank's proximate cause argument – like the rest of its assertions – should be summarily rejected and its motion for dismissal denied.

DATED: December 11, 2003

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing PLAINTIFFS' RESPONSE TO THE DEUTSCHE BANK ENTITIES' NOTICE OF SUPPLEMENTAL AUTHORITY IN SUPPORT OF THEIR MOTION TO DISMISS THE FIRST AMENDED CONSOLIDATED COMPLAINT document has been served by sending a copy via electronic mail to serve@ESL3624.com on this December 11, 2003.

I further certify that a copy of the foregoing PLAINTIFFS' RESPONSE TO THE DEUTSCHE BANK ENTITIES' NOTICE OF SUPPLEMENTAL AUTHORITY IN SUPPORT OF THEIR MOTION TO DISMISS THE FIRST AMENDED CONSOLIDATED COMPLAINT document has been served via overnight mail on the following parties, who do not accept service by electronic mail on this December 11, 2003.

Carolyn S. Schwartz
United States Trustee, Region 2
33 Whitehall Street, 21st Floor
New York, NY 10004

Mo Maloney

Mo Maloney

14455

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
ENRON CORP., *et al.*,	:	Case No. 01-16034 (AJG)
Debtors.	:	Jointly Administered

FINAL REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER

November 4, 2003

but the information provided appears not to have been presented in a manner that was conducive to a full understanding of the SPEs. Furthermore, the use of misleading terms and confusing jargon by Enron officers when they described SPE transactions exacerbated their complexity. On many occasions, it appears that several groups of persons, including the Enron Board and Rating Agencies, understood the meaning of these terms and phrases in a materially different way than the meaning ascribed to them by the Enron officers. Examples include:

SPE Transactions in General

- *Total Debt Obligations.* In an August 13, 2001 presentation to the Enron Board, Fastow presented an analysis of $36.4 billion in "Outstanding Financings and Debt" of Enron, including the nature and extent of off-balance sheet financings. Since at least 1997, this information had not been presented in this fashion to the Enron Board or to any of its committees.[206]

- *Tax Strategy.* The Enron Board was not informed that a critical function of Enron's tax department was to book earnings and that it was customary for the tax department to generate the "stretch" at the end of the year to meet Enron's earnings targets.[207]

- *Monetized Assets.* Enron officers used the term "monetize" in numerous presentations to the Enron Board. Enron also used this term in its public filings.[208] For example, Enron's officers referred to its

[206] Ironically, Fastow's report actually overstated Enron's outstanding financings and debt by double counting $1.9 billion of Enron's Yosemite Prepays. The Finance Committee received information, never clearly explained or presented, showing that from August 2000 through August 2001, Enron's interest bearing obligations increased from $22.3 billion to $36.3 billion – a $14 billion increase in one year. *Compare* Materials from Enron Finance Committee Meeting, Aug. 7, 2000, at AB0247 01363 (slide from the CFO Report) [AB0247 01347-AB0247 01520] *with* Materials from Enron Finance Committee Meeting, Aug. 13, 2001 (the "8/13/01 Finance Committee Materials"), at AB0247 02302 (slide from the CFO Report) [AB0247 02285-AB0247 02359].

[207] *See* Second Interim Report, Appendix J (Tax Transactions); *see also* Third Interim Report, Appendix C (Role of Enron's Officers), at 16-23.

[208] *See, e.g.*, Enron Form 10-Q filed with the SEC for the Quarter ended Sept. 30, 2001, at 22 ("Between September 1999 and December 2000, LJM1 or LJM2 purchased equity or debt interests in nine Enron-sponsored SPEs. LJM1 and LJM2 invested $175 million in the nine SPEs. These transactions enabled Enron to monetize assets and generated pre-tax earnings to Enron of $2 million in 1999."); EOG Resources, Inc. Schedule 13D/A filed by Enron with the SEC, Apr. 5, 1999, at 4 ("Enron is currently

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
ENRON CORP., et *al.*,	:	Case No. 01-16034 (AJG)
Debtors.	:	Jointly Administered

APPENDIX B

(Role of Andersen)

to

**FINAL REPORT OF NEAL BATSON,
COURT-APPOINTED EXAMINER**

Reference is made to the preceding Final Report of Neal Batson, Court-Appointed Examiner (the "Report"). This Appendix constitutes an integral part of the Report. All capitalized terms not otherwise defined herein shall have the meanings set forth in the Report.

"deferred credit"[381] (reflecting the bargain purchase element of each transaction).[382] In the Cochise Transaction, Enron took the additional step of offsetting a portion of the deferred credit against the book basis of the Cochise Planes, thus reducing the aircraft book basis to zero and the amount of the deferred credit by an equal amount.[383] Enron then amortized the remaining deferred credit in each transaction into pre-tax income over a five year period.[384] As noted above, the Examiner concluded that Enron's accounting treatment of the Steele and Cochise Transactions violated GAAP, with the most aggressive and misleading aspects of the transactions being the creation of pre-tax income (as opposed to after-tax income through a reduction in tax expense in the tax

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[381] If a transaction is treated as a business combination under ABP 16 and the sum of the net assets exceeds the purchase price, "negative" goodwill (the presumed discount or bargain on net assets acquired) is created. See Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS* 109. Under GAAP, the negative goodwill is treated as a proportionate reduction in non-current assets other than long-term investments in marketable securities. *Id.* If the book value of these assets is less than the negative goodwill, the remainder is required to be recorded as a "deferred credit" in the liability section of the balance sheet. *Id.* Enron treated the deferred credit as having no tax basis. See Letter from Thomas Finley, Managing Director, Bankers Trust, to R. Davis Maxey, Enron, Nov. 7, 1997, attaching Letter from Bill Boyle, Vice President, Bankers Trust, to William McKee, King & Spalding, June 2, 1997 [AB000187757-AB000187776]; Enron Consolidated Financial Statement Reporting, Limited Financial Accounting Summary of Certain Projects, as requested by the Examiner, Oct. 2002 (the "Enron Consolidated Accounting Summary"), at 8 [AB000427661-AB000427684]. As a result, Enron recorded an additional deferred tax asset for the book and tax basis disparity of the deferred credit, which then increased the amount of the deferred credit recorded on a "gross-up" basis on Enron's books. Enron Consolidated Accounting Summary, at 7-8. Enron apparently used this gross-up procedure until the release of EITF 98-11, which specifically states: "The deferred credit is not a temporary difference under [FAS] 109," which means that a deferred tax asset may not be recognized for the difference in book basis and tax basis of the deferred credit, but only for the difference for the initial asset purchased. Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations, 2 EITF Abstracts (FASB) 98-11, ¶ 3b (Jan. 24, 2002) ("EITF 98-11"); see *also* Enron Consolidated Accounting Summary, at 5-20.

[382] See Second Interim Report, Appendix J (Tax Transactions), *Em-on's REMIC Carryover Basis Transactions;* Second Interim Report, Annexes 1 and 2 to Appendix J (Tax Transactions).

[383] See Second Interim Report, Appendix J (Tax Transactions), *Enron 's REMIC Carryover Basis Transactions;* Second Interim Report, Annex 2 to Appendix J (Tax Transactions).

[384] See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions;* Second Interim Report, Annexes 1 and 2 to Appendix J (Tax Transactions).

provision section of Enron's income statement) and the artificially shortened amortization period.[385]

In approving the accounting treatment, Andersen acknowledged that the REMIC Residual Interests and Facilitating Assets did not provide an operating business and that these transactions did not technically constitute business combinations.[386] Andersen, however, determined that APB 16 provided the best guidance, presumably because the assets were purchased from the same consolidated group, i.e., the BT/Deutsche consolidated group.[387] This "same seller" theory finds no credible support in the accounting literature. Under ABP 16, a business combination occurs when "a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity."[388] Other accounting literature defines a "business" as a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors.[389] As previously determined by the Examiner, the purchase of the unrelated assets in the Steele and Cochise Transactions did not

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[385] See Second Interim Report, Appendix J (Tax Transactions), ***Enron's REMIC Carryover Basis Transactions;*** Second Interim Report, Annexes 1 and 2 to Appendix J (Tax Transactions); see ***also*** Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 27-42, 77-79.

[386] Steele Accounting Memo, at 4; Facsimile from Roger Willard, Andersen, to Bob Palmquist, Andersen, Sept. 30, 1997, attaching Project Steele Summary of Considerations, Sept. 30, 1997 ("Steele Summary of Considerations"), at AA-EX000 16357 [AA-EX000 16356-AA-EX000 16358]; Cochise Accounting Memo, at4.

[387] See Steele Accounting Memo, at 4; Cochise Accounting Memo, at 4; Second Cochise SAS 50 Letter, at 8; Third Cochise SAS 50 Letter, at 8.

[388] APB 16, ¶ 1.

[389] EITF 98-3, ¶ 6.

Consistent with Andersen's lack of cited authority, the Examiner has not located any persuasive authority for Andersen's position.[394] In fact, accounting standards have long followed the practice of reflecting the effects of income taxes on net income within the income tax expense component of the income statement.[395] Accounting interpretations, including EITF 98-1 1, adopted and effective after Enron engaged in the Cochise and Steele transactions, make it clear that those effects are reflected in net (after-

[394] During the course of the Examiner's investigation, Andersen indicated that its position was required by FASB Statement No. 109, Accounting for Income Taxes, and supported by analogy to: (i) Accounting for "Investment Credit," Accounting Principles Bd. Opinion No. 2 (Financial Accounting Standards Bd. 1962) ("APB 2"); (ii) Accounting for the Investment Credit, Accounting Principles Bd. Opinion No. 4 (Financial Accounting Standards Bd. 1964) ("APB 4") (amending APB 2); (iii) Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4, AICPA Accounting Interpretation No. AIN-APB 4, (Financial Accounting Standards Bd. Feb. 1972-Mar. 1972) ("AIN-APB 4"); and (iv) Business Combination, Accounting Principles Bd. Opinion No. 16 (Financial Accounting Standards Bd. 1970) ("APB 16"). Telephone Interview with Richard Petersen, Andersen, by Philip C. Cook, A&B, Oct. 14, 2003 ("Petersen 10/14/03 Interview"). APB 2, APB 4, and AIN-APB 4, which predated implementation of FAS 109, provide that the investment tax credit ("ITC") may be accounted for as a reduction to the cost of the asset. According to Andersen, this results in the depreciation of a lower basis that could affect pre-tax income, a result which supports the amortization of the deferred credit in both the Steele and Cochise Transactions into pre-tax income. *Id.* However, the only issue addressed by APB 2, APB 4, and AIN-APB 4 is the timing of the net income effect for financial accounting purposes. Under GAAP, the ITC can be accounted for under the flow-through method (i.e., a direct reduction to income tax expense in the year the asset is purchased) or under the deferral method (i.e., a reduction to the cost of the asset (either directly or through a contra account) with the ITC allocated over the life of the asset as a direct reduction of periodic income tax expense). Under either approach, the ITC is accounted for as income tax expense. AIN-APB 4, however, does provide one exception for financial institutions in that they may include the ITC as part of the proceeds from leased property and include the ITC in determining the yield from the loan that is reflected in income over the term of the lease. Because Em-on was not a financial institution, AIN-APB 4 (like APB 2 and APB 4) offers no support for Andersen's position in the Steele and Cochise Transactions. The Safe Harbor Leasing Exposure Draft, which was never finalized, is inapposite to the Steele and Cochise Transaction because it addresses transactions structured in the form of leases but are in substance solely the purchase or sale of tax benefits such as ITC.

[395] See, e.g., FAS 109; Accounting for Income Taxes, Statement of Financial Accounting Standards No. 96 (Financial Accounting Standards Bd. 1987) ("FAS 96") (superseded by FAS 109); Accounting for Income Taxes, Accounting Principles Bd. Opinion No. 11 (Financial Accounting Standards Bd. 1967) (superseded by FAS 96 and FAS 109); APB 2 (accounting for investment tax credits requires a reduction of income tax expense); APB 4 (same); AIN-APB 4 (same). During the course of the Examiner's investigation, Andersen indicated that paragraph 16 of FAS 109 precluded the amortization of the deferred credit through the income tax provision because it provided, in part: "Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit [i.e., change in deferred tax liabilities or assets] and income taxes currently payable or refundable." Petersen 10/14/03 Interview. The Examiner agrees that paragraph 16 of FAS 109 requires that these two items are reflected in the income tax provision; the Examiner does not agree with Andersen's interpretation that nothing else can be reflected in the income tax provision. For example, FAS 96 precluded interest and penalties from being reported as income tax expense, but this preclusion was removed from FAS 109. ***Compare*** FAS 96, ¶ 27 with FAS 109, ¶ 45.