

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

United States Courts
Southern District of Texas
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In re ENRON CORPORATION
SECURITIES LITIGATION

§
§ Civil Action No. H-01-3624
§ (Consolidated)
§

DEFENDANT LOU PAI'S
MEMORANDUM IN SUPPORT OF MOTION TO DISMISS

Roger E. Zuckerman*
Deborah J. Jeffrey*
Steven M. Salky*
Kristen M. Flynn
ZUCKERMAN SPAEDER LLP
1201 Connecticut Avenue, N.W.
Washington, D.C. 20036-2638
(202) 778-1800 Telephone
(202) 822-8106 Fax

Murray Fogler
McDADE FOGLER MAINES LLP
Attorney In Charge
Two Houston Center
909 Fannin, Suite 1200
Houston, Texas 77010-1006
(713) 654-4300 Telephone
(713) 654-4343 Fax

Attorneys for Defendant Lou L. Pai

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**DEFENDANT LOU PAI'S
MEMORANDUM IN SUPPORT OF MOTION TO DISMISS**

TO THE HONORABLE MELINDA F. HARMON, UNITED STATES DISTRICT JUDGE:

INTRODUCTION

As the individual who exercised the largest number of options during the proposed class period, Lou Pai became a target of opportunity for a “fraud by hindsight” securities claim as soon as Enron Corporation, parent company of his former employer, announced a restatement of its financial reports. The Private Securities Litigation Reform Act (PSLRA or the Reform Act). 15 U.S.C. § 78u-4 *et seq.*, was enacted specifically to protect people like Lou Pai from lawsuits like this one, which try to rope in as many peripheral players as possible based on the theory that they “must have known” that bad news was in the offing. The Reform Act prevents indiscriminate suits against company insiders following a corporate setback by subjecting all such claims to extraordinary standards of particularity in identifying each defendant’s deceptive acts and by requiring a strong factual basis for concluding that each defendant acted with the intent to defraud the public.

Measured against these rigorous standards, Plaintiffs’ securities fraud claims against Lou Pai cannot survive two fatal deficiencies: (1) the Complaint attributes to him no misleading conduct; and (2) the Complaint fails to ascribe to him any fraudulent intent. For all its length,

the Complaint nowhere alleges that Mr. Pai personally made a misleading public statement or did anything deceitful. Nor have Plaintiffs identified a single fact to show that Mr. Pai was aware that any public statement made by Enron or its directors or officers was inaccurate at the time it was made or that nonpublic information played any role in his personal securities transactions.

The Complaint alleges little about who Lou Pai is and even less about what he supposedly did to make him liable to Plaintiffs. Indeed, in a 503-page account replete with extravagant and colorful claims of a wide variety of purported misdeeds, his name appears a grand total of 16 times. Seven of those references recite his corporate titles and positions at Enron-related companies.¹ Five of the references concern his securities transactions during the proposed class period, all of which were publicly disclosed.² The last four references appear in excerpts from three analyst reports quoted by the Plaintiffs.³

Plaintiffs do not allege, because they cannot, that Mr. Pai signed any of the securities filings alleged to contain misleading statements, nor do they cite a single actionable oral or written statement made by him personally. Not once do Plaintiffs aver that he played any role in preparing the public statements that Plaintiffs claim were false or in any specific transaction that they consider improper. Nothing in their Complaint would serve to establish a strong inference that Mr. Pai was even aware of the undisclosed facts on which Plaintiffs rest their claims. In

¹ Plaintiffs' Consolidated Complaint for Violation of the Securities Laws ¶¶ 1(a), 88, 993(a) and 83(hh) (cited hereinafter as "NCC ¶ __"). Citations to the Appendix accompanying this Motion appear in the form "Pai App. Tab __." Citations to the Joint Brief filed by certain Enron Defendants relating to Enron disclosures appear in the form "Disclosure Brief ¶ __." Citations to the Appendices accompanying the Disclosure Brief appear in the form "Jt. App. Tab __" or "Jt. SEC App. Tab __."

² NCC ¶¶ 83(j), 84, 401, 402, 413 and 415

short, nothing in the Complaint ties Mr. Pai to the elaborate scheme that Plaintiffs go to such lengths to portray.

Undeterred, Plaintiffs couch their securities fraud allegations against 38 officers and directors of Enron and its subsidiaries *as a group*, hoping to spare themselves the effort of pleading their claims with the particularity required by Federal Rule of Civil Procedure 9(b) and the PSLRA. This Court, and other courts throughout the United States, have repeatedly rejected this form of group pleading as unacceptable under heightened pleading requirements imposed by Congress in 1995, when it enacted the Reform Act. Dismissing claims founded on almost identical averments, this Court has held that a securities fraud plaintiff must specify (1) the culpable conduct of each individual defendant, that is, the misleading statements that he is responsible for making; and (2) the particular facts that support a strong inference of scienter, that the defendant either knew that each of those statements was untrue when made or made them with reckless disregard for their truth. Plaintiffs cannot evade these intentionally demanding requirements through the artifice of collective pleading.

Plaintiffs' group allegations are deficient for the additional reason that they do not amount to a primary violation of the securities laws by Mr. Pai. At most, Plaintiffs' group allegations support a claim that Mr. Pai aided and abetted a violation of the securities laws or conspired with the other officer and director defendants to commit such a violation, both secondary forms of liability that the United States Supreme Court precluded in *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994).

Plaintiffs will undoubtedly seek cover behind Mr. Pai's securities trading, contending that it somehow compensates for all of the other defects in their pleading. These transactions,

³ NCC ¶¶ 167, 191 and 258.

however, are also subject to the heightened pleading requirements of Rule 9(b) and the PSLRA, meaning that Plaintiffs must allege specific facts to establish a strong inference that Mr. Pai executed these transactions on the basis of material nonpublic information. Here, Plaintiffs face an insurmountable task. Not only have they neglected to identify the material nonpublic information in Mr. Pai's possession at the time of the transactions, public records establish that the transactions in question were based on personal circumstances unrelated to inside information: Mr. Pai's divorce and division of marital assets in 2000 and his decision to leave Enron in 2001. As a result, the trades do not support either an inference of scienter for purposes of Plaintiffs' general securities fraud claim or liability for insider trading.

Although Plaintiffs allege no specific conduct by which Mr. Pai directed the affairs of Enron, the Complaint attempts to saddle him with vicarious liability as a controlling person. No such liability attaches to Mr. Pai, first because Plaintiffs have not pled a primary violation of the securities laws by Enron, for the reasons stated in the Enron Defendants' Joint Brief; and second because Mr. Pai's status as an officer or director of Enron subsidiaries, plus his service on a committee of the corporate parent, do not, without more, establish that he could actually influence the specific transactions challenged by Plaintiffs. To accept Plaintiffs' allegations as sufficient would be to water down controlling person liability to the point that it would be indistinguishable from liability for aiding and abetting securities violations, which the Supreme Court has ruled is not permissible under the securities laws.

Although we treat each of these issues in some detail in this Memorandum, we begin by directing the Court's attention to a recent case in which strikingly similar claims were dismissed against defendants similarly situated to Lou Pai. That case, *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084-85 (9th Cir. 2002), involved an insider defendant who had sold a high

percentage of his holdings but was not alleged to have personally made actionable statements. In *Vantive*, the plaintiffs brought securities fraud claims against Vantive's officers and directors, alleging that they had inflated the company's stock price by (1) making false and misleading statements; (2) manipulating the company's financial results through premature recognition of millions of dollars of revenue and; (3) falsely forecasting future revenues. The stock had tripled in price during the class period then plunged to a new low when the company missed an earnings forecast. *Id.* at 1084.

Even though the company's chairman had sold 74 percent of his stock during the class period, the court dismissed the claims against him because the plaintiffs had failed to connect him individually to the alleged fraud. In its opinion affirming that dismissal, the Ninth Circuit observed that the complaint in *Vantive* (which was prepared by the lead counsel in this case) suffered from the same two fatal deficiencies that plague the Complaint now before the Court.

First, the plaintiffs had failed to establish that the chairman had himself engaged in any fraudulent conduct. He was not alleged to have "uttered a word" during the class period or to have participated in preparing any of the challenged statements. *Id.* at 1094.

Second, the plaintiffs had not shown that the chairman had any fraudulent intent. The plaintiffs had relied on a series of generalized allegations concerning the officers and directors as a group, including their "'hands-on' management style, their 'interaction with other corporate officers and employees, their attendance at management and board meetings, and reports generated on a weekly and monthly basis in the Finance Department.'" *Id.* at 1087. However, the court found such allegations plainly insufficient to show that any of the defendants had actual knowledge of any of the supposedly "true but concealed" circumstances underlying the alleged misrepresentations. *Id.* Nor did the chairman's stock sales support an inference of fraud. As an

initial matter, the plaintiffs had failed to tie any of the stock sales to any particular misleading statements, making it “difficult to see how particular stock sales would strengthen allegations that particular statements were uttered with deliberate recklessness at the times they were made.”⁴ *Id.* at 1093. Moreover, the vast majority of the chairman’s sales occurred well before the stock price peaked and thus “below a price at which [he] could be seen to have maximized the value of alleged inside knowledge.” *Id.* at 1094. And finally, in the absence of any allegation that the chairman actually had made any of the false statements, his stock sales were not suspicious. *Id.*

As we demonstrate below, all of the considerations that led the court in *Vantive* to dismiss the claims against the chairman are present here; hence, the Plaintiffs’ claims against Lou Pai should fare no better.

This Court reached a similar result in the *BMC Software* litigation, dismissing claims against two insider defendants who had sold between 70 and 99 percent of their stock during the class period. *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860 (S.D. Tex. 2001). None of the statements alleged by the plaintiffs to have been misleading was attributed directly to either of these executives. Rather, the plaintiffs contended that the officers as a group, speakers and nonspeakers alike, were collectively responsible for the statements and collectively charged with knowledge of their falsity. *Id.* at 912-13, 915-16. This Court rejected the plaintiffs’ group pleading shortcut as barred by the PSLRA. Moreover, the Court continued, there was no need to consider the trading of those defendants who were not alleged to have personally made any of

⁴ This problem was only exacerbated by the fact that the plaintiffs had selected an “unusually long” class period of some fifteen months, allowing them to “sweep as many stock sales into their totals as possible, thereby making the stock sales appear more suspicious than they would be with a shorter class period.” *Id.* at 1092.

the offending statements. Whatever their state of mind, they could not be held liable under Section 10(b) for the misstatements of others, so their trading was irrelevant.

For these reasons, and as set forth in more detail below and in the brief captioned “Certain Defendants’ Joint Brief Relating to Enron Disclosures” (the Disclosure Brief), the claims against Lou Pai should be dismissed.

ARGUMENT

Lou Pai is named as a defendant in two of the four counts of Plaintiffs’ Complaint. In their First Claim for Relief, Plaintiffs allege that Mr. Pai violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, the general anti-fraud provisions of the federal securities laws, and is also liable as a “controlling person” under Section 20(a). NCC ¶¶ 992-97. Plaintiffs’ Second Claim for Relief, in which Mr. Pai is also named, alleges insider trading in violation of Section 20A of the 1934 Act. NCC ¶¶ 998-1004.

These claims against Lou Pai should be dismissed because the Complaint fails to meet both pleading and substantive requirements for claims under the federal securities laws. As we explain below, the Complaint fails to state a claim against Mr. Pai in that

- The only conduct of which Plaintiffs accuse Mr. Pai is not a violation of the securities laws and is not pled with particularity;
- Since Mr. Pai made no actionable statements, he is not a primary violator of the federal securities laws and cannot be sued under them; and
- The conclusory allegations of executive position and access to information do not establish the strong inference of scienter required by the Private Securities Litigation Reform Act for claims of securities fraud and insider trading.

I. PLAINTIFFS' ALLEGATIONS REGARDING MR. PAI DO NOT PLEAD WITH PARTICULARITY CONDUCT ACTIONABLE UNDER THE SECURITIES LAWS.

Plaintiffs allege generally that “each” Defendant is liable for making misleading statements or omissions and failing to disclose adverse facts when trading in Enron securities. See NCC ¶¶ 2, 89, 400. However, Plaintiffs’ token effort to plead conduct by Lou Pai that would fall within the ambit of the federal securities laws comes up short of the mark. The Complaint reveals Mr. Pai to be a bit player in the drama it portrays. Of its 1030 paragraphs, exactly *three* refer to statements by him, or more precisely, to references to him in stock analysts’ reports, and *one* recites that he was a director of EES and was involved in “setting up some of the bad deals.” NCC ¶¶ 83(j) (“bad deals”); 167, 191, 258 (analyst reports). Neither the analyst reports nor the bad deals allegation is actionable, and neither is pled with the degree of particularity required by Rule 9(b) and the PSLRA. Nor can Plaintiffs evade these requirements and disguise the insubstantial nature of their claims against Mr. Pai by artificially attributing to him the actions of others through the device of group pleading.

To state a claim under Section 10(b) and Rule 10b-5, a plaintiff must allege that the defendant, with scienter, made a material misstatement or omission on which the plaintiff relied that proximately caused the plaintiff’s injury. See, e.g., *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07 (5th Cir. 2001). The PSLRA demands great specificity in pleading these claims, requiring the complaint to specify “each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts upon which that belief is formed.” 15 U.S.C. § 78u-4(b)(2). The Fifth Circuit has repeatedly stated that this statutory language requirement, coupled with Rule 9(b), requires a plaintiff to

specify “the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.” *Nathenson*, 267 F.3d at 412 (quoting *Williams v. WMX Techs., Inc.*, 112 F.3d at 175, 177 (5th Cir. 1997)). The Fifth Circuit has described this as a requirement to plead “who, what, when, and where” *Williams*, 112 F.3d at 178.

Spurning these responsibilities, Plaintiffs have chosen a pleading structure guaranteed to obscure the particulars. Many courts have condemned the practice of reciting a number of statements alleged to be misleading, followed by an undifferentiated list of allegedly concealed facts, without showing any relationships between the two.⁵ As if this were not enough, the Complaint further confuses the issues by failing to make distinctions among the individual defendants, instead attributing actions to “Enron” or “Defendants” indiscriminately. For these reasons, as well as those set forth in the Disclosure Brief, in which Mr. Pai hereby joins, the claims against Mr. Pai must be dismissed.

- A. Analyst reports suggesting only general optimism on the part of Mr. Pai are not actionable, and the allegations concerning those reports are not pled with particularity.

The analyst reports cited by Plaintiffs do not purport to quote Mr. Pai,⁶ and at most attribute to him a generally optimistic outlook regarding EES. See NCC ¶ 167 (quoting from a 09/02/99 CS First Boston report indicating that “Enron Energy Services CEO, Lou Pai, noted

⁵ See, e.g., *In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 932 n.9 (9th Cir. 1996); *Schiller v. Physicians Resource Group, Inc.*, 2002 U.S. Dist. LEXIS 3240, at *16-17 & n.3 (N.D. Tex. Feb. 26, 2002); *In re MCI WorldCom, Inc. Sec. Litig.*, 2002 U.S. Dist. LEXIS 5819, at *5 (S.D. Miss. Mar. 29, 2002); *In re Splash Tech. Holdings, Inc.*, 160 F. Supp. 1059, 1073-75 (N.D. Cal. 2001); *In re Dura Pharm., Inc. Sec. Litig.*, 2000 U.S. Dist. LEXIS 15258, at *20-21 (S.D. Cal. 2000); *Copperstone v. TCSI Corp.*, 1999 U.S. Dist. LEXIS 20978, (N.D. Cal. 1999).

that EES...has proven through contracts signed to date that EDSing absolutely works”); 191 (quoting from a 11/30/99 CS First Boston report remarking that “[a]fter recently visiting with EES President Lou Pai and speaking with COO Jeff Skilling,...we continue to expect the retail business to turn earnings positive in the fourth quarter of 1999 as Enron continues to sign total outsourcing contracts” and that “[o]ur conversation with Mr. Skilling as well as a very recent visit with...Lou Pai suggested that momentum in the retail business continues to accelerate”). Indeed, one of the reports cited by Plaintiffs mentions him principally to observe in passing that “Vice-Chairman Lou Pai’s presentation at our annual investment conference was very well attended,” proceeding thereafter to summarize the analyst’s understanding that the *presentations*, and not just that of Mr. Pai, suggested that Enron’s new business lines were expected to pay off. NCC at ¶ 258 (quoting from a 09/19/00 Bank America report).

Mr. Pai cannot be liable for these statements because he did not make them. They are filtered through the prism of analysts, for whose remarks Mr. Pai is not responsible. As this Court stated in rejecting similar claims, “[g]enerally a company has no liability for misleading claims made about it by an independent third party and no obligation to correct statements made by outsiders.” *BMC*, 183 F. Supp. 2d at 872 n.21 (collecting cases); *see also Raab v. General Physics Corp.*, 4 F.3d 286, 288 (4th Cir. 1993)(securities laws do not require a company to “police statements made by third parties for inaccuracies, even if the third party attributes the statement to a defendant”). Liability for analyst statements attaches only if the defendant involved himself in the preparation of the analyst’s report or exercised control over its content. *See BMC*, 183 F. Supp. 2d at 872 n.21.; *Raab*, 4 F.3d at 288; *In re Browning-Ferris Indus. Inc.*

⁶ *Cf. Williams*, 112 F.3d 179 (complaint not particularized for purposes of Rule 9(b) because of absence of quotes by corporate officers from news articles about company cited by plaintiffs as misleading).

Sec. Litig., 876 F. Supp. 870, 903 (S.D. Tex. 1995); *see also Suna v. Bailey Corp.*, 107 F.3d 64, 73-74 (1st Cir. 1997). Further, because liability for analyst statements requires the defendant to have entangled him or herself in the making of the statement by the analyst, the circumstances surrounding the interaction between the insider and the analyst must be pled with particularity, as must the entanglement itself. *See Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1249 (N.D. Cal. 1998)(*cited with approval in BMC*, 183 F. Supp. 2d at 893). Having failed to allege such facts with respect to Mr. Pai, Plaintiffs cannot base their claims against him on these analyst statements. *BMC*, 183 F. Supp. 2d at 872 n.21. (“[T]here must be alleged facts showing some involvement in and control over the content of the analysts’ reports by the defendants to hold [the defendants] liable for misleading statements made in those reports.”).⁷

Even if these analyst statements could be attributed to Mr. Pai, they are not actionable for the additional reason that they are the kind of corporate cheerleading routinely dismissed as immaterial “puffery”. *See, e.g., Nathenson*, 267 F.3d at 419 (“[I]t is well-established that generalized positive statements about a company’s progress are not a basis for liability.”). Similarly, in *BMC*, this Court stated:

Vague, loose optimistic allegations that amount to little more than corporate cheerleading are “puffery,” projections of future performance not worded as guarantees, and are not actionable under federal securities law because no reasonable investor would consider such vague statements material and because investors and analysts are too sophisticated to rely on vague expressions of optimism rather than specific facts.

183 F. Supp. 2d at 888 (*citing Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1446 (5th Cir. 1993)). Statements similar to those cited by Plaintiffs are thus considered immaterial and

⁷ Had Mr. Pai controlled the analyst statements, he would scarcely have allowed himself to be misidentified by the Bank America analyst as “Vice Chairman of EES” (*see* NCC ¶ 258), a title that he never held.

therefore nonactionable. *See, e.g., Greebel v. FTP Software, Inc.*, 194 F.3d 185, 189, 207 (1st Cir. 1999) “[w]e are pleased with our performance for the second quarter” and “[s]ales continue to be strong”); *Lasker v. New York State Elec. & Gas Corp.*, 85 F.3d 55, 57-59 (2d Cir. 1996)(company is “convinced our business strategies will lead to continued prosperity” and that its “1994 sales goal is the most aggressive ever”); *Hillson Partners Ltd. P’ship v. Adage, Inc.*, 42 F.3d 204, 211-14, 216-17 (4th Cir. 1994) (“significant sales gain should be seen as year progresses;” “1992 will produce excellent results;” company is “on target toward achieving most profitable year in its history;” and company “should have an excellent fourth quarter”); *Lain v. Evans*, No. 3:99-CV-2594-H, 2000 U.S. Dist. LEXIS 9257, at *9 (N.D. Tex. June 30, 2000) (“we look forward to higher revenues and loan volume for the remainder of fiscal 1998” and “have aggressive growth plans...to become a major player”). And at the same time, the market was flooded with cautionary statements and disclosures concerning EES, risk management and mark-to-market accounting, discussed in detail in the Disclosure Brief. Under the “bespeaks caution” doctrine, general expressions of optimism are understood to be subject to these publicly available cautionary disclosures and therefore of little if any materiality. *Rubenstein v. Collins*, 20 F. 3d 160, 168 (5th Cir. 1994); *Melder v. Morris*, 27 F.3d at 1097, 1100 (5th Cir. 1994); *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122 (7th Cir. 1997).

Plaintiffs cannot state a claim against Mr. Pai based on these statements for the additional reason that the comments they attribute to Mr. Pai have not been pled with particularity. The reports do not state precisely what Mr. Pai said to the analysts, merely their interpretations of his remarks. *Cf. BMC*, 183 F. Supp. 2d at 893 (analyst reports may not adequately reflect content of defendant’s statements); *In re Waste Mgmt., Inc. Sec. Litig.*, No. H-99-2183, slip op. at 132 (S. D. Tex. Aug. 16, 2001). The Complaint does not state when or where Mr. Pai made the

supposed statements or under what circumstances, apart from a reference in one of the reports to a recent annual investor conference, the date of which Plaintiffs do not bother to supply. NCC ¶ 258. The Complaint does not identify in what respect the analyst reports were misleading⁸ or how these statements in particular were material or affected the stock price. Moreover, Plaintiffs have not pled a claim against Mr. Pai based on the 11/30/99 CS First Boston analyst report because that report states that the analyst communicated with both Jeffrey Skilling and Mr. Pai, without attributing any of the reported information specifically to Mr. Pai.² *Schiller v. Physicians Resource Group, Inc.*, 2002 U.S. Dist LEXIS 3240, at *21-22 (N. D. Tex. Feb. 26, 2002) (complaint that fails to state which of two, or which of three, named defendants made alleged misrepresentations lacks particularity under Rule 9(b) and PSLRA and must be dismissed). (The Complaint also pleads no facts to establish a strong inference that Mr. Pai knew that either his remarks or the analyst reports were inaccurate when made, a critical flaw that we address at length in the discussion of scienter in Part III of this Memorandum.)

Any one of these flaws would be a serious defect in a complaint for securities fraud. Together, they are overwhelming.

⁸ See *Lirette v. Shiva Corp.*, 27 F. Supp. 2d 268, 275-76 (D. Mass. 1998)(dismissing claims against company CEO, President, CFO and director for statements such as “[w]e are pleased with the results of this quarter” and “[w]e are encouraged by the momentum” of sales of specific products; although plaintiffs alleged content, time, place and speaker of each statement, they did not explain why these statements were fraudulent).

² NCC ¶ 191 (“After recently visiting with EES President Lou Pai and speaking with COO Jeff Skilling, ...” and “Our conversation with Mr. Skilling, as well as a very recent visit with ... Lou Pai...”).

B. Mr. Pai's undescribed "involvement" in unspecified "bad deals" does not state a claim under the securities laws and is not pled with particularity.

Neither can Plaintiffs state a claim of securities fraud against Mr. Pai based on his undescribed involvement in setting up "bad deals." Plaintiffs do not trouble to identify the deals in question, nor do they enlighten us with further descriptions of his involvement. The Complaint does not tell the reader in what respect these unidentified deals were "bad." Not only does this fail to plead fraud with particularity, it fails to plead fraud at all.

The securities laws do not extend to corporate mismanagement, such as making bad business deals, but only to fraudulent, deceptive or manipulative conduct in the sale of securities.¹⁰ Nor can a plaintiff bootstrap his way into a securities fraud claim by asserting that the defendant had a duty to disclose his management failures. *See Waste Mgmt.*, slip op. at 168-69 (collecting cases). Not every business deal can be successful, particularly on the leading edge in a new industry in the process of deregulation, as was the retail energy niche occupied by EES. Indeed, Enron repeatedly warned the public that its retail energy business, like its wholesale business, was exposed to a wide variety of risks, with potentially serious consequences. *See* discussion of risk disclosures in Disclosure Brief sections addressing EES, mark-to-market accounting, and Wholesale Energy Operations and Services. Here, there is no allegation that these unidentified bad deals were anything but routine transactions that happened to turn out

¹⁰ *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Pin v. Texaco, Inc.*, 793 F.2d 1448, 1451 (5th Cir. 1986) (claims for corporate mismanagement or fiduciary breach do not state a claim under Section 10(b) or Rule 10b-5); *Waste Mgmt.*, slip op. at 168; *see also Schiller*, 2002 LEXIS at *42 (citing *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 361 (1st Cir. 1994)).

badly.¹¹ Accusing an executive of making bad business deals, without more, does not state a claim under the securities laws.

And this fatal substantive defect is matched by an equally fatal defect in pleading. The allegation that Mr. Pai was involved in setting up bad deals is so devoid of factual content on its face that it cannot seriously be urged to comply with ordinary standards of notice pleading, to say nothing of the particularity requirements applicable to securities fraud. Not having identified the deals in question, or Mr. Pai's role in them, Plaintiffs likewise fail to allege when each of them occurred, why and how they turned out badly, who else was involved in them and whether and to what extent they had material effects on Enron. They also skip over such niceties as specifying any related misleading statements, explaining how they are misleading, identifying the speaker and the other express requirements of Section 78u-4(b) (1). The reader is simply left to guess at the "who, what, when, and where," in total disregard of the PSLRA and Rule 9(b). *Williams*, 112 F.3d at 178; *McNamara v. Bre-x Minerals Ltd.*, 57 F. Supp. 2d 396, 405-06 (E.D. Tex. 1999).¹²

If the phrase "bad deals" is meant as a reference to certain EES contracts criticized by Plaintiffs, the Complaint fails to say so. Mr. Pai is never mentioned in the allegations concerning those deals,¹³ as one would expect if the Plaintiffs had any information that he was personally

¹¹ There is also no allegation that these bad deals bore any relationship to the purchase or sale of securities or were the source of any reliance on the part of any investor. These "bad deal" allegations thus fail to state a claim against Mr. Pai under Section 10(b) and Rule 10b-5 for the additional reason that they did not take place "in connection with" the purchase or sale of a security or include the essential reliance element.

¹² Plaintiffs also fail to allege facts that would support the strong inference of scienter required by Section 78u-4(b) (2), a subject addressed later in this Memorandum.

¹³ NCC ¶¶ 37-38, 59(a)-(b), 121(j), 155(f)-(g), 214 (f)-(g), 300(g), 339(f)-(g), 340, 358, 496(b), 538, 540-45, 557, 640-41, 850, 853.

responsible for them. Moreover, the weasel words “some of”--“some of the bad deals” (NCC ¶ 83(j)) -- would rob even an allusion to the EES contracts collectively of specificity.

Alternatively, perhaps the Court and the parties are meant to guess that the bad deals in question refer to The New Power Company (New Power), spun off by Enron in an IPO in 2000 to market electric power to homeowners. NCC ¶¶ 42, 83(hh), 485-88, 597. Plaintiffs assert that New Power “was involved in the alleged wrongdoing,” and therefore purport to sue Mr. Pai in his capacity as an officer or director of New Power. NCC ¶ 83(hh). Here, again, the Complaint describes no conduct on the part of Mr. Pai that would constitute a violation of the securities laws. Plaintiffs’ only claim with respect to New Power arises from the way in which Enron recognized gains and losses on its New Power stock through the use of a vehicle referred to as Raptor III. NCC ¶¶ 485-88, 597. Mr. Pai, however, is not alleged to have had anything to do with how Enron accounted for its New Power investment.

If the “bad deals” phrase is intended as a reference to Enron’s Raptor III transaction, the lack of particularity concerning Mr. Pai is even more telling. This transaction, as well as most of the other related party transactions dubbed “partnership/SPE deals” in the Complaint (NCC ¶ 88), has been the subject of extensive investigation by a Special Committee of Enron’s Board of Directors. The Special Committee’s task included determining the roles played by Enron executives in the questioned transactions, and the Committee composed a lengthy report (the Powers Report) detailing the results of its review of relevant documents and interviews with knowledgeable current and former Enron executives and employees. The Powers Report does not once mention Lou Pai, by name or by position. Though Plaintiffs rely on the Powers Report

as the source for many of their allegations,¹⁴ its omission of any reference to Lou Pai forces Plaintiffs to resort to the conclusory allegations repeatedly barred by this Court.

C. Identifying Mr. Pai as one of many executives of Enron does not constitute fraud pled with particularity.

Recognizing that they cannot plead that Mr. Pai personally misled investors, Plaintiffs rely almost exclusively on the forbidden practice of “group pleading,” loudly insisting that the circumstances of this case make it “appropriate to treat the Enron Defendants as a group for pleading purposes....” NCC ¶ 89. Whereas this Court has concluded that “Plaintiffs must allege *what actions each Defendant took* in furtherance of the scheme,”¹⁵ Plaintiffs in this case deploy group pleading as a device to obscure the fact that they cannot cite any action by Mr. Pai. They say, in essence, that they have satisfied the heightened particularity requirements of Rule 9(b) and the PSLRA on the theory of “fraud by association” -- by pleading nothing more than the fact that Mr. Pai was one of Enron’s many high-level executives whom they have chosen to sue.

The PSLRA requires that plaintiffs specify, among other items, the person responsible for each misrepresentation. *See* 15 U.S.C. § 78u-4(b)(1). Where, as here, plaintiffs base their claim on more than 250 purported misrepresentations by 38 “Enron Defendants,” occurring over a three-year period, plaintiffs are “obligated to distinguish among those they sue and enlighten each defendant as to his or her part in the alleged fraud.” *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 915 (N.D. Tex. 1998) (*Coates I*) (quoting *In re*

¹⁴ The Special Committee investigation and the Powers report are cited directly at NCC ¶¶ 825, 830, 833, 847 and 849 and mentioned in news articles cited at NCC ¶ 800. Apart from these explicit references, other sections of the Powers Report appear to be copied verbatim in the Complaint, although Plaintiffs neglect to identify it as their source, as required by the PSLRA. *See* 15 U.S.C. § 78u-4(b)(1).

¹⁵ *BMC*, 183 F. Supp. 2d at 886 (emphasis added).

Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 752 (S.D. Cal. 1997)). And, because the PSLRA provides for proportional liability among defendants for certain violations, it may be critical to sort out from the outset which defendant is alleged to be responsible for which misrepresentation. 15 U.S.C. § 78u-4(e)(2). Further, inasmuch as the Reform Act requires a plaintiff to allege facts regarding scienter as to each defendant, it would be “nonsensical,” in the words of one judge, to allow the plaintiff to rely on group pleading to show that the defendant made the statement in question. *Coates I*, 26 F. Supp. 2d at 916 (Fitzwater, J.) (PSLRA “codifies a ban against group pleading”).

Here, there is not a single allegation that Mr. Pai personally participated in drafting, editing or disseminating any actionable misleading statements. There is no allegation that he attended a particular meeting or had a conversation in which the preparation of the offending statements was discussed. In fact, Plaintiffs are forced to concede that they merely “*presume* that the false, misleading and incomplete information conveyed in the Company’s public filings, press releases and other publications, as alleged herein, are the collective actions of the Enron Defendants,” and that they have no basis to apply this presumption to Mr. Pai apart from his executive position. NCC ¶ 89. In other words, by concealing Mr. Pai within a large group of executives, some of whom signed public filings, had responsibility for the publication of financial statements and are credited with specific public statements, Plaintiffs hope to obscure the fact that Mr. Pai, himself, did no such things.

Courts do not allow their attention to be so easily misdirected by pleading sleight of hand. This Court has thoughtfully condemned the group pleading doctrine in a series of cases, finding it to be inconsistent with the particularity requirements of Rule 9(b) and the PSLRA. *See In re Landry’s Seafood Rest., Inc. Sec. Litig.*, No. H-99-1948, slip op. at 52-55 (S.D. Tex. Feb. 20,

2001); *Waste Mgmt.*, slip op. at 90-92, 187 n.71; *BMC*, 183 F. Supp. 2d at 902 n.45. Since the enactment of the PSLRA, the sister courts of this Circuit have repeatedly endorsed this conclusion,¹⁶ as have other courts throughout the United States.¹⁷ For example, in *Schiller v. Physicians Resource Group*, the plaintiffs attempted to plead misleading statements on a collective basis against four directors and officers. All four, they alleged, reviewed and approved misleading reports by analysts and made misstatements during analyst calls and roadshows. Two signed the Form 10-Qs filed with the SEC. The plaintiffs failed to ascribe any misstatements specifically to two of the individuals, and, in 31 references to the third individual, none contained any statements attributable to him apart from the group. The court was unimpressed by the plaintiffs' efforts to rope into their class action individuals whose offending conduct they could not specify:

The PSLRA and Rule 9(b) require Plaintiffs to identify the particular individual who made the misstatements or omissions. Plaintiffs cannot avoid the bar on group pleading by simply identifying the constituents of a group of defendants in rote and conclusory fashion. Plaintiffs cannot satisfy Rule 9(b) by attributing statements or omissions to the corporation without identification of the officer or director responsible for making the statement.

Schiller, 2002 U.S. Dist. LEXIS 3240 at *20-21 (citing *Coates v. Heartland Wireless Communications, Inc.*, 55 F. Supp. 2d 628, 633 n.3 (N.D. Tex. 1999) (*Coates II*)).

On three recent occasions, this Court has determined that group pleading did not survive the PSLRA and will not substitute for allegations specifying the offending conduct of each

¹⁶ See, e.g., *Coates I*, 26 F. Supp. 2d at 916; *Calliott v. HFS, Inc.*, No. Civ. A. 3:97-CV-0924i, 2000 WL 351753, at *5 n.3 (N.D. Tex. Mar. 31, 2000); *Branca v. Paymentech, Inc.*, No. Civ. A. 3:97-CV-2507-L, 2000 WL 145083 (N.D. Tex. Feb. 8, 2000).

¹⁷ See, e.g., *Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1350 (S.D. Cal. 1998); *Marra v. Tel-Save Holdings, Inc.*, 1999 WL 317103, at *5 (E.D. Pa May 18, 1999).

defendant. Despite these decisions, Plaintiffs seek to hold Mr. Pai vicariously liable for statements that he did not make and words that he did not speak, although group pleading is no more permissible here than it was in those cases. Here, as in *BMC*, the Court has before it securities fraud claims against a corporate officer who is not alleged to have made any actionable misstatements. In dismissing the claims in *BMC*, the Court said, in words equally applicable to Mr. Pai: “Nor have Plaintiffs specifically alleged how the individual nonspeaking Defendants have participated in the alleged scheme to defraud or how they could have controlled misstatements by other named Defendants . . . who were their superiors” *BMC*, 183 F. Supp.2d at 902 n.45, 915. When these impermissible allegations are eliminated, no basis remains for a claim against Mr. Pai for violating Section 10(b), and Plaintiffs’ claims should be dismissed.

When it comes to particularizing their allegations, Plaintiffs in this case have a distinct advantage over the typical plaintiff in a securities fraud case. Here, they have the benefit of information made available by virtue of the release of the Powers Report and supporting materials, the testimony offered before Congress, documents released by House and Senate Committees and the plethora of investigative reporters dogging the Enron story. Under these circumstances, it is certainly not unduly harsh to hold these Plaintiffs to the same standards that must be met by all others who would prosecute similar claims.

II. PLAINTIFFS’ ALLEGATIONS REGARDING MR. PAI FAIL TO STATE A CLAIM UNDER SECTION 10(b) AND RULE 10b-5 IN CONFORMITY WITH *CENTRAL BANK*.

As a further consequence of the pleading deficiencies identified above, Plaintiffs’ First Claim for Relief fails to state a claim against Mr. Pai because the conduct attributed to him is too insubstantial to make him a primary violator of Section 10(b) or Rule 10b-5. In *Central Bank v.*

First Interstate Bank, 511 U.S. 164, 177 (1994), the United States Supreme Court limited liability in private suits under Section 10(b) to “primary violators” -- that is, to persons whose conduct actually violates the text of the statute. Recognizing that the statute “prohibits only the *making* of a material misstatement (or omission) or the *commission* of a manipulative act,” *Id.* (emphasis added), the Court went on to hold that aiding and abetting such a violation is not enough:

Because the text of [Section] 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under [Section] 10(b).

Id. at 191.

The case law in the wake of *Central Bank* makes clear that the Supreme Court’s reasoning in that case applies equally to conspiracy claims under Section 10(b) and that such claims are no longer viable. E.g., *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 841 (2d Cir. 1998) (“[E]very court to have addressed the viability of a conspiracy cause of action under [Section] 10(b) and Rule 10b-5 . . . has agreed that *Central Bank* precludes such a cause of action.”) (collecting cases); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (same). Indeed, even the dissenters in *Central Bank* recognized that the majority’s holding would eliminate conspiracy liability under Section 10(b), *see* 511 U.S. at 201 n.12 (Stevens, J., dissenting) (commenting that “[t]he Court’s rationale would sweep away the decisions recognizing that a Defendant may be found liable in a private action for *conspiring* to violate Section 10(b) and Rule 10b-5”) (emphasis in original), and the majority did not contest that observation. Likewise, following *Central Bank*, private securities plaintiffs may no longer rely on a theory of vicarious liability. *See Waste Management*, slip op. at 134-35 n.50 (discussing respondeat superior and secondary liability of corporation for statements of

employees acting informally); *Warden v. Crown Am. Realty Trust*, 1999 U.S. Dist. LEXIS 10262, at *14 (W.D. Pa. 1999) (finding “little reason” to distinguish between an agency theory and an aiding and abetting theory and dismissing plaintiffs’ agency claims under Section 10(b) pursuant to *Central Bank*); *Converse, Inc. v. Norwood Venture Corp.*, 1997 WL 742534, at *2-3 (S.D.N.Y. Dec.1, 1997); *cf. Central Bank*, 511 U.S. at 201 n.12 (Stevens, J., dissenting) (commenting that respondeat superior liability “appear[s] unlikely to survive the Court’s decision”).

Rather, after *Central Bank*, only those persons who “employ[] a manipulative device or make[] a material misstatement (or omission) on which a purchaser or seller of securities relies” may be liable as primary violators under Rule 10b-5. *Id.* Thus, having pled their claims based on a fraud on the market theory (NCC ¶¶ 983-84), under which Plaintiffs’ reliance upon Enron’s alleged misstatements during the class period may be proven by demonstrating “investors’ reliance upon the integrity of the market price for a security and that a defendant’s actions distorted the market price,”¹⁸ to show a primary violation under Section 10(b), Plaintiffs must allege some actionable conduct by Mr. Pai that directly affected Enron’s stock price. In particular, Plaintiffs must show that Mr. Pai actually made a material misstatement or omission:

If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

¹⁸ *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996) (emphasis added); *see also Nathenson*, 267 F.3d at 415 (5th Cir. 2001) (fraud on the market theory cannot serve as a basis for recovery unless “the complained of misrepresentation or omission have actually affected the market price of the stock”).

Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) (quoting *In re MTC Elec. Techs. Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995)); see also *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175-76, (2d Cir. 1998); *In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d 214, 232-33 (D.N.J. 2002); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994).¹⁹

This Plaintiffs cannot do. Even the few “statements” that Plaintiffs try to connect to Mr. Pai cannot properly be attributed to him and are not actionable in any event.²⁰ Plaintiffs do not allege that Mr. Pai signed any of Enron’s SEC filings or prepared any of the press releases they

¹⁹ The Ninth Circuit has extended primary liability under Section 10(b) to defendants who are alleged to have played a “significant role” in preparing a false or misleading statement uttered by another. *E.g.*, *In re Software Toolworks*, 50 F.3d 615, 628 n.3 (9th Cir. 1995). As the Eleventh Circuit recognized in *Ziemba v. Cascade Int'l, Inc.*, however, permitting primary liability to attach to persons who were never identified to investors as having played a role in the misrepresentations would permit plaintiffs “to avoid the ‘reliance’ requirement for stating a claim under Rule 10b-5,” a construction that the Supreme Court expressly rejected in *Central Bank* 256 F.3d at 1206; see also *Central Bank*, 511 U.S. at 180 (“Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.”) Likewise, this construction, which has not been adopted by the Fifth Circuit, is inconsistent with the Supreme Court’s suggestion in *Central Bank* that Section 10(b) “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.” *Id.* at 177.

Even under this standard, however, Plaintiffs have not alleged a primary violation by Mr. Pai. Plaintiffs do not allege with particularity that Mr. Pai actually reviewed any of the securities filings or other documents alleged to contain material misstatements, nor do they claim that Mr. Pai was present at any meetings at which such documents were discussed. Indeed, Plaintiffs fail to identify anything that Mr. Pai did in connection with the preparation of the statements they challenge.

²⁰ Nor do Plaintiffs allege any actionable conduct by Mr. Pai that directly affected Enron’s stock price. Plaintiffs nowhere allege that Mr. Pai engaged in any market-manipulating conduct. Indeed, apart from his securities transactions, a matter we discuss in Section IV, *infra*. Plaintiffs’ allegations concerning Mr. Pai’s conduct are limited to the assertion that “he was involved in setting up some of the bad deals.” NCC ¶ 83(j). Such allegations, even if true, do not reflect conduct that is actionable, see Section I.B., *supra*, much less sufficient to support primary liability under *Central Bank*.

challenge. Instead, Plaintiffs rely on allegations of what Mr. Pai should be presumed to have known or done, and duties he should be presumed to have had, by virtue of his position in the company and his membership on Enron's Management Committee. See NCC ¶¶ 89 (asking the Court to "presume" that Enron's alleged misstatements "are the collective actions of the Enron Defendants" and alleging that those Defendants are "primarily liable" for the misstatements based on their "high-level positions with the company"); 90 (alleging that "[e]ach Enron Defendant was provided with copies of the documents alleged herein to be misleading prior to or shortly after their issuance"); 400 (asserting that the Enron Defendants "knowingly and substantially participated or acquiesced in the issuance or dissemination [of the alleged misstatements]").

Plaintiffs' attempt to impose indiscriminate liability on all members of Enron's Management Committees for false statements made by Enron during the class period not only fails to provide the particularity required by Federal Rule of Procedure 9(b) and the PSLRA, see Section I, but, at best, these allegations amount to a claim that Mr. Pai aided and abetted violations of Section 10(b) or conspired with the other Enron Defendants to commit such a violation. *E.g.*, *Shapiro*, 123 F.3d at 720 ("Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*."). Neither of these theories of liability remains available to Plaintiffs after the Supreme Court's decision in *Central Bank*; hence, Plaintiffs have failed to state a claim against Mr. Pai under Section 10(b).

Moreover, Plaintiffs' suggestion that all of the Enron Defendants are primarily liable for Enron's alleged misstatements because those misstatements should be regarded as "the collective actions of the Enron Defendants" is the same argument that this Court rejected in *BMC Software*.

In *BMC*, as in this case, the plaintiffs sought to impose primary liability under Section 10(b) on a number of high-ranking corporate executives for corporate misstatements, notwithstanding that only two of the defendants, the President/CEO and the CFO of the company, were alleged to have actually made the misstatements. 183 F. Supp. 2d at 871. The plaintiffs maintained that they had nevertheless stated a claim for primary violations of Section 10(b) against these nonspeaking defendants based on their allegation that the challenged statements should be presumed to be “the collective work of the company’s officers and directors,” which, according to plaintiffs, amounted to “participat[ion] in a scheme to defraud.” *Id.* at 904-05, 912-13. The Court rejected these arguments, observing that plaintiffs had not alleged “how the individual nonspeaking Defendants ha[d] participated in the alleged scheme to defraud or how they could have controlled misstatements by other named Defendants . . . , who were their superiors at *BMC*.” *Id.* at 915.

A similar effort to premise primary liability for violations of Section 10(b) on a defendant’s high-level corporate position was likewise rejected in *In re Cybershop.com Sec. Litig.* In *Cybershop*, the plaintiff brought claims under Section 10(b) against certain corporate officers and directors based on a number of alleged misstatements by the company in its securities filings, press releases and other public announcements. 189 F. Supp. 2d at 217-23. The SEC filings had been signed by the company’s President and CEO, who was also responsible for issuing statements on the company’s behalf. *Id.* at 216. None of the alleged misstatements were attributed to either of the two remaining individual defendants, a company director, who was also the CEO of a wholly-owned subsidiary, and the company’s COO and CFO. *Id.* at 216, 232-33. Nor were these defendants alleged to have signed any of the supposedly false documents. *Id.* at 232-33. Finding no basis for a primary violation by either

defendant, the court dismissed the claims against them, observing that “[t]hese two parties can not be linked to the alleged misconduct merely because they held corporate positions at relevant times in this litigation.” *Id.* at 233.

Here, Plaintiffs’ inability to plead Mr. Pai’s conduct with particularity and failure to state a claim for a primary violation of Section 10(b) are symptoms of the same problem: There is no connection between Mr. Pai and the misdeeds alleged in this suit. The cure is simple. The claims against him should be dismissed.

III. PLAINTIFFS’ GENERAL ALLEGATIONS DO NOT SUPPORT THE REQUIRED STRONG INFERENCE OF SCIENTER.

Plaintiffs have also shirked their obligation to provide detailed information to establish that Lou Pai acted towards them with a culpable state of mind. The PSLRA and Rule 9(b) together demand of Plaintiffs great specificity in their allegations with respect to Mr. Pai’s scienter. Their Complaint must “with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2). To prosecute claims under Section 10(b) and Rule 10b-5, the facts alleged in the Complaint would have to show that Lou Pai acted with “intent to deceive, manipulate or defraud,” that is, that he knew that particular public statements for which he was responsible were untrue when made. *Nathenson*, 267 F.3d at 408 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976));²¹ see also *Lovelace v.*

²¹ Plaintiffs can also satisfy the scienter requirement by pleading facts that would establish the defendant’s severe recklessness, a slightly lesser species of intentional misconduct,” which is “limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.” *Nathenson*, 267 F.3d at 408 (quoting *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)).

Software Spectrum, Inc., 78 F.3d 1015, 1018 (5th Cir. 1996); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1066 (5th Cir. 1994); *In re Paracelsus Corp. Sec. Litig.*, 61 F. Supp. 2d 591, 595 (S.D. Tex. 1998). Claims for insider trading would require factual allegations creating a strong inference that Mr. Pai was aware of particular material nonpublic information at the time of his securities transactions and traded on the basis of it. *See, e.g., BMC*, 183 F. Supp. 2d at 916 (“To state a private claim for insider trading, a plaintiff must show that the defendant (1) used material nonpublic information, (2) knew or recklessly disregarded that the information was material and nonpublic, and (3) traded contemporaneously with the [plaintiff].”) General averments of knowledge will not suffice, nor will suggestions that the defendant “must have known.” *Id.* at 865-66 n.15; *Lovelace*, 78 F.3d at 1020 (alleging that Defendants “must have known” does not meet heightened pleading standard). A complaint that lacks the factual foundation for a strong inference that a defendant acted with fraudulent intent must be dismissed.²² Here, Plaintiffs assert their claims against Mr. Pai without any factual allegations that reflect adversely on his state of mind, and those claims must therefore be dismissed.

Moreover, the facts establishing a strong inference of scienter must be pled for each defendant, individually. *See, e.g., Schiller*, 2002 U.S. Dist. LEXIS 3240, at *35 n.10 (absent individualized allegations of scienter pertaining to each defendant, “[t]he court might find

If Plaintiffs predicate their claim on a contention that forward looking statements were misleading, they must demonstrate that the defendant made the statement in question “with actual knowledge...that the statement was false or misleading.” 15 U.S.C. §78u-5(c) (1) (B) (i); *Vantive*, 283 F.3d at 1084.

²² *See, e.g., Tuchman* 14 F.3d at 1069 (dismissing for failure to state a claim a complaint that “contains no assertion of any fact that makes it reasonable to believe that the defendants knew that...their statements were materially false or misleading when made”); *GlenFed*, 42 F.3d at 1548-49 (same); *Paracelsus*, 61 F. Supp. 2d at 600 (S.D. Tex. 1998) (dismissing securities fraud action for failure “to state with particularity facts giving rise to a strong inference that [defendant] acted with scienter”).

plaintiffs' scienter allegations deficient on this basis alone") (citation omitted); *BMC*, 183 F. Supp. 2d at 886 (PSLRA precludes group pleading of scienter); *Coates I*, 26 F. Supp. 2d at 916 (plaintiff must allege particular facts regarding scienter with respect to each defendant individually). To meet their burden, Plaintiffs must thus advance specific facts that would demonstrate that Lou Pai knew that the statements attributable to him were false *at the time those statements were made*. *Williams*, 112 F.3d at 178 (plaintiffs must specify "when" defendant learned that its statement was false); *Lovelace*, 78 F.3d at 1020 (plaintiffs must identify who had knowledge and when); *Tuchman*, 14 F.3d at 1069; *Branca v. Paymentech*, 2000 WL 145083, at *10 (N.D. Tex. Feb. 8, 2000) (dismissing complaint because plaintiff pleaded no facts showing that, at time allegedly false statements were made, defendants had actual knowledge of contradictory facts); *see also Greenstone v. Cambex Corp.*, 975 F.2d 22, 25-26 (1st Cir. 1992).

Plaintiffs had the benefit of considerable step-by-step guidance as to how to plead scienter properly. As this Court explained in *BMC*, to demonstrate a defendant's state of mind, plaintiffs must – at a minimum -- “specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned.” 183 F. Supp. 2d at 886; *see Williams*, 112 F.3d at 178 (plaintiffs must allege the “who, what, when, and where” of the statements they challenge). And as the Ninth Circuit explained, “[t]o meet this pleading requirement, the complaint must contain allegations of specific ‘contemporaneous statements or conditions’ that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made.” *Ronconi v. Larkin*, 253 F.3d 423, 432 (9th Cir. 2001)(citations omitted). If the facts pled do not create a strong inference that the defendant knew that the challenged statements were false when made, the PSLRA mandates that the complaint be dismissed. 15 U.S.C. § 78u-4(b)(3). In other

words, for every statement for which they seek to hold Mr. Pai liable,²³ Plaintiffs must point to specific documents that Mr. Pai read, specific conversations or meetings in which he took part or other sources from which he learned facts incompatible with that statement. They must also state when these events took place and how they know. This basic information is nowhere to be found, and the claims against Mr. Pai must consequently be dismissed.

To put an end to the practice of pleading fraud by hindsight,²⁴ courts have set a high threshold for determining that an inference of scienter is “strong”, the facts must be so compelling that fraud is the most likely of the available explanations. In the words of the Sixth Circuit, “[t]he ‘strong inference’ requirement means that plaintiffs are entitled to *only the most plausible* of competing inferences.” *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001)(en banc)(emphasis added). The First Circuit agrees, noting that a “mere reasonable inference is insufficient to survive a motion to dismiss.” *Greebel*, 194 F.3d at 196. Within this Circuit, district courts have stated that the well-pled facts, if true, must “constitute persuasive, effective, and cogent evidence” that the defendant intended to deceive, manipulate or defraud. *Schiller*, 2002 LEXIS 3240, at *22 (quoting *Coates v. Heartland Wireless Communications, Inc.*, 100 F. Supp. 2d 417, 422 (N.D. Tex. 2000)(*Coates III*)).

And what do Plaintiffs ask this Court to accept as the facts that, if proven, would constitute such persuasive, effective and cogent evidence that they make fraudulent intent the most plausible of the possible explanations for Mr. Pai’s actions? Three innocuous allegations,

²³ 15 U.S.C. §78u-4(b) (2) (emphasis added); see also *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 361, 367-68 (1st Cir. 1994) (“[T]he complaint shall, with respect to *each act or omission* alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”).

²⁴ *Vantive*, 283 F.3d at 1084-85 (purpose of PSLRA was to prevent suits based on fraud by hindsight).

each held insufficient in prior cases and all of which are insufficient in the present context.

Plaintiffs would have this Court draw a strong inference of scienter solely on the basis of:

- Pai's positions as Chairman of Enron subsidiaries Enron Energy Services and later Enron Xcelerator (NCC ¶ 83(j)), director of The New Power Corporation, a residential energy retailer founded by EES that ultimately went public (NCC ¶ 83(hh)), and a member of Enron Corporation's Management Committee (NCC ¶ 88), and consequent access to corporate information;
- Pai's alleged involvement in an unspecified way in "setting up" certain unspecified "deals" that they characterize as "bad" for unspecified reasons, NCC ¶ 83(j) and (ff); and
- Pai's sale of 3,912,205 shares of Enron stock, most of it derived from the exercise of deep in the money options that Plaintiffs' own expert finds to be neither suspicious nor unusual, NCC ¶ 83(j) and Hakala Decl. ¶¶ 9(d), 13 n.21, 25 n.27.

Reason and experience, together with the prior decisions of this Court and courts throughout the country,²⁵ establish that none of these facts, taken singly or in combination, satisfies the threshold showing of a strong inference of scienter. Even if true, none of these facts suggests culpable intent on the part of Mr. Pai or even awareness of inaccuracies in Enron's financial statements. Plaintiffs' fruitless reliance on these discredited scienter averments can only be taken as an admission that there are no particularized facts to suggest that Lou Pai acted deceptively. Indeed, what is most striking about Plaintiffs' claims against Lou Pai is what they cannot allege. They do not allege that Lou Pai personally made a single cognizable statement that he knew to be false. They do not describe a single event, occasion or source from which Mr. Pai had contemporaneous knowledge that any of Enron's statements were inaccurate. They do not plead facts to establish that Mr. Pai was aware of any particular material nonpublic information at the time that he sold his stock or that such information played any role in his

²⁵ See *Nathenson*, 267 F.3d at 412 ("The probative force of facts alleged ultimately depends on reason and experience, and in this respect guidance can properly be afforded by prior judicial decisions.").

decision to trade. Without such particularized facts, the claims against Mr. Pai must be dismissed. *Cf. BMC*, 183 F. Supp. 2d at 886 (to survive motion to dismiss, plaintiff must plead what defendant knew, how and when he learned it and how plaintiff learned that information).

A. High corporate position does not establish knowledge of undisclosed information.

Although they tout their Complaint as a “creative work,”²⁶ Plaintiffs recycle the same shopworn scienter arguments consistently rejected by this and other courts as insufficient under Rule 9(b) and the PSLRA as a matter of law: the contention that a strong inference of scienter arises from a defendant’s executive position, involvement in day-to-day corporate affairs and access to information.

Thus, among the “Enron Defendants’ Scienter Allegations,” the Complaint pleads that Lou Pai, as one of 13 to 22 members of Enron’s Management Committee (depending on the year), was a top executive of Enron, had daily contact with other Management Committee members “dealing with the important issues facing Enron’s business” and was provided with copies of the public filings that Plaintiffs now claim to contain misleading statements. NCC ¶ 397. Moreover, “[b]ecause of the Enron Defendants’ positions with the Company, they each had access to the adverse non-public information about its businesses, partnerships and investments, finances, products, markets and present and future business prospects via access to internal corporate documents (including the Company’s operating plans, budgets, and forecasts and reports of actual operations compared thereto), conversations and connections with other corporate officers and employees, attendance at management and/or Board of Directors meetings and committees thereof and via reports and other information provided to them in connection therewith.” NCC ¶ 399. Further, the alleged fraud was pervasive and so complicated that it

²⁶ See copyright notice asserting the originality of the Complaint.

required the personal attention of “several” top executives of Enron [whom the Complaint does not name], making it, according to Plaintiffs, “logical, if not obvious” that all of Enron’s officers either knew of or acted in reckless disregard of the falsification of Enron’s financial reports. NCC ¶ 395. In other words, Plaintiffs ask this Court to accept their assurance that Mr. Pai “must have known” that all of the challenged statements were false and therefore excuse Plaintiffs from their statutory obligation to allege specific facts to show—as to each statement—when, how and from whom Mr. Pai received the precise information that showed it to be false.

Relying on Fifth Circuit precedent,²⁷ this Court has twice in the past eight months condemned as inadequate scienter allegations virtually identical to the ones in this case. In *BMC*, as in this case, plaintiffs contended that they were exempt from the requirement of providing details as to what the defendants knew, when and how they knew it, and the basis of those allegations, asserting instead a right to plead scienter based on the defendants’ executive positions, their participation in the day-to-day management of company business, their access to internal corporate information, their conversations with other officers and employees and their attendance at management and board meetings. *See* 183 F. Supp. 2d at 887. As in this case, the plaintiffs had sued executives who, like Mr. Pai, made none of the challenged statements. The Court made short work of this argument, suggesting that it was particularly egregious to attribute fraudulent intent to *nonspeakers* merely because of their executive status.

The amended complaint does not show how the non-speaking Defendants “had knowledge of the fraud” sufficient to give rise to a strong inference of scienter, or allege what information they knew, or when and how they learned it. It generally attributes to them knowledge of the alleged fraud to their high positions in BMC and their day-to-day involvement in the business or from

²⁷ *See, e.g., Nathenson*, 267 F.3d at 424 (“normally an officer’s position with a company does not suffice to create an inference of scienter”).

unidentified internal corporate documents and conversations. Defendants correctly state that this Court has previously rejected just such vague pleading as insufficient to give rise to a strong inference of scienter under the PSLRA.

Id. at 915-916. When the plaintiffs in *Kurtzman v. Compaq Computer Corp.*, Civ. A. No. H-99-779 (S.D. Tex. Mar. 30, 2002), embellished these allegations with the added assertion that the undisclosed information concerned the performance of business units essential to the company's performance, the whole package was no more acceptable. The Court declined "to substitute presumption and speculation for the facts required by the Reform Act" and dismissed the claims, describing such allegations as having minimal if any probative value. *Kurtzman*, slip op. at 34-35.

Executive status, committee membership, attendance at meetings, management style or receipt of regularly generated reports of unspecified content cannot create a strong inference of scienter because they do not link individual executives to any particular fact that Plaintiffs claim was true but undisclosed.²⁸ As with Mr. Pai in this case, the complaints in *BMC* and *Kurtzman*

²⁸ Courts routinely dismiss securities fraud claims alleging scienter based on corporate position unless the plaintiff can detail precise circumstances under which the defendant became aware of specific facts inconsistent with the public statements in question. *See, e.g., In re Azurix Corp. Sec. Litig.*, 2002 WL 562819, at *21 (S.D. Tex. Mar. 21, 2002) (granting, in part, defendants' motion to dismiss because allegations of access to corporate information and control over public statements is insufficient to plead scienter without allegations of particularized facts); *Branca*, 2000 U.S. Dist. LEXIS 1704, at *10-11 (conclusory allegations of scienter based upon executive positions, involvement in day-to-day management, access to internal corporate documents, conversations with corporate officers and employees, and their attendance at management and board meetings insufficient to plead scienter); *Lirette*, 27 F. Supp. 2d at 283 ("inferences that the defendants by virtue of their positions within the company, 'must have known about the problems when they undertook the allegedly fraudulent actions'...are precisely the types of inferences which this court, on numerous occasions, has determined to be inadequate to withstand the special pleading requirements in securities fraud cases."); *In re NAHC, Inc. Sec. Litig.*, 2001 WL 1241007, at *18 (E.D. Pa., Oct. 17, 2001) ("Blanket statements that the defendant must have been aware of impending losses or that a statement was false or misleading by virtue of his position within a company are inadequate to withstand Rule 9(b) or PSLRA

did not allege that a particular defendant read a particular report containing specific information, nor did they assert that the defendant attended a particular meeting at which specific information was made known to him. *Kurtzman*, slip op. at 46; *BMC*, 183 F. Supp. 2d at 886-87.²⁹ If averments of this type sufficed, any executive of a corporation with a management structure or internal reporting system would be an easy mark for fraud by hindsight claims by opportunistic plaintiffs whenever that company restated its financial reports, failed to meet forecasted earnings or wrote off assets as impaired.³⁰ As the Ninth Circuit explained earlier this year when it affirmed the dismissal of a similar securities fraud claim brought by the lead counsel in this case:

The plaintiffs attempt to establish [that the individual defendant officers and directors had knowledge of the supposedly true but concealed facts] by advertent to the defendants' "hands-on" management style, their interaction with other corporate officers and employees, their attendance at management and board meetings, and reports generated in the Finance Department (under [one of the defendants]). ...

These allegations are insufficient in light of our decision in *Silicon Graphics*, 183 F.3d at 985, [where] [w]e stated that, if a plaintiff is to rely on the existence of reports as a means of establishing knowledge, she must "include adequate corroborating details," such as the "sources of her information with respect to the reports, who drafted them, ...which officers received them,"

scrutiny. ...Where plaintiffs contend that the defendants had access to contrary facts, they must specifically identify the reports or statements containing this information. ...").

²⁹ See also *Kurtzman*, slip op. at 57, adopting these arguments, and 20-22, collecting cases; accord *Coates I*, 26 F. Supp. 2d at 916 (plaintiffs cannot rely on defendants' committee memberships to establish scienter).

³⁰ For much the same reason, the Fifth Circuit has determined that scienter cannot be predicated on the allegation that a corporate executive inflated the stock price of his company in order to obtain incentive compensation. *Tuchman*, 14 F.3d at 1068-69); see also *Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001) (desire to increase or maintain lucrative compensation does not give rise to inference of fraud because it is not limited to executives with fraudulent intent). In *Melder v. Morris*, the Fifth Circuit observed that permitting scienter to be found on the basis of incentive compensation would effectively eliminate the state of mind requirement for corporate directors and officers. 27 F.3d 1097, 1102-03 (5th Cir. 1994). Thus, allegations that Lou Pai received bonus payments of "millions of dollars" based on Enron's false financial reports and inflated stock price (NCC ¶ 83(j)) do not serve to establish scienter.

and “an adequate description of their contents.” *Id.* The reason for requiring such detail was that “every sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts,” and that allowing a plaintiff “to go forward with a case based on general allegations of ‘negative internal reports’ would expose all those companies to securities litigation whenever their stock prices dropped.” *Id.* at 988.

Vantive, 283 F.3d at 1087-88. The Court went on to note that, as in this case, the plaintiffs had failed to cite to any specific report, to mention any dates or contents of reports or to identify their sources of information regarding the knowledge of individual defendants. Their allegations regarding attendance at meetings in general and hands-on management style were held likewise deficient because they failed to establish specifically what each defendant knew, how he knew it and when he learned it. *Id.* at 1088. Plaintiffs likewise cannot establish a strong inference that Lou Pai knew that public statements regarding Enron were false when made or was severely reckless in allowing them to be made merely by pleading his executive position, authority and consequent access to information. Dismissal is therefore required pursuant to 15 U.S.C. §78u-4(b)(3).

- B. Mr. Pai’s alleged undefined involvement in unspecified bad deals does not establish contemporaneous knowledge that public statements concerning Enron were false.

Just as Plaintiffs’ unexplained allusion to Mr. Pai’s unspecified involvement in unidentified bad business deals (NCC ¶ 83(j)) fails to describe with particularity the offending fraudulent conduct, it likewise fails to give rise to a strong inference of scienter. In fact, there is no allegation that the deals in question, whatever they may be, were fraudulent. On its face, this averment cannot support a claim against Mr. Pai. *See Melder*, 27 F.3d at 1104 (dismissing securities fraud complaint under Rule 9(b) where facts pled did not support inference of conscious behavior) (*cited with approval in Lovelace*, 78 F.3d at 1019)).

The fact that a transaction has a bad outcome does not imply that an executive who was involved in setting it up expected or intended that it would turn out badly. *See, e.g., GlenFed*, 42 F.3d at 1548. (“[O]ften there is no reason to assume that what is true at the moment [of the plaintiff’s loss] was also true at the moment of the alleged misrepresentation, and that therefore simply because the alleged misrepresentation conflicts with the current state of facts, the charged statement must have been false.”); *In re Azurix Corp. Sec. Litig.*, 2002 WL 562819, *21,*23 (S.D. Tex. Mar. 21, 2002) (disclosure of adverse business results does not give rise to strong inference that prior statements of financial condition were false when made). The strong inference requirement of the PSLRA was intended to bar fraud claims based on such *post hoc* reasoning. *See Vantive*, 283 F. 3d at 1084-85; *BMC*, 183 F. Supp. 2d at 915 (rejecting hindsight analysis to prove fraud). The Complaint makes no further mention of the business of Enron Xcelerator, and, although it touches on a handful of EES transactions that it claims to have been improper, none of those allegations so much as mentions Lou Pai.³¹ These averments cannot support an inference that Mr. Pai harbored any fraudulent intent with respect to those transactions or that he was aware of information inconsistent with the public statements about them. Plaintiffs simply fail to allege any facts that could link Mr. Pai to either the transactions or the mark-to-market accounting practices at EES of which they complain. They do not, as required, provide “details as to what [Mr. Pai] knew, when and how [he] knew it, and the basis for Plaintiffs’ allegations” against him in particular. *BMC*, 183 F. Supp. 2d at 887; *Williams*, 112 F.3d at 178. Nor is there any factual basis upon which it can be inferred that Mr. Pai knew that any public statements were false when made or that he acted with severely reckless disregard for

³¹ NCC ¶¶ 37-38, 59(a)-(b), 121(g), 121(j), 155(f)-(g), 214(f)-(g), 339(f)-(g), 340, 358, 496(b), 538, 540-45, 557, 640-41, 850, 853.

their truth. *Id.*; see also *Paracelsus*, 61 F. Supp. 2d at 599. As we have explained, absent particularized factual allegations as to how he obtained the information, such knowledge cannot be imputed to him merely because he served as a director of EES:

A director, officer, or even the president of a corporation often has superior knowledge and information, but neither the knowledge nor the information invariably attaches to those positions, and plaintiffs have not pointed to specific reports, circulated among defendants, which contained the adverse information defendants are charged with knowing.

Coates I, 26 F. Supp. 2d at 916 (quoting *In re Advanta Corp. Sec. Litig.*, 1988 WL 3787595, at *7 (E.D. Pa. July 9, 1998)).

Nor can Plaintiffs bolster their scienter allegations by putting the same conclusory assertions in the mouths of others who are equally indefinite and likewise fail to connect Mr. Pai to the challenged transactions. *Cf. BMC*, 183 F. Supp. 2d at 871 n.21. For example, the Complaint excerpts an email from a former EES employee relating her jaundiced opinions on many aspects of EES operations, including such issues as lack of strategic planning, inadequate compensation, layoffs and the removal of the office coffee machine. NCC ¶ 853. Had Plaintiffs appended the entire text of the email, it would have been apparent that the writer's only mention of Lou Pai was to note that he left EES shortly after she arrived there, which makes her unable to shed light on Mr. Pai's state of mind.³² Pai App. Tab 9. She makes no claim to have had conversations with Mr. Pai, makes no allegations regarding what role, if any, he played in the transactions that she asserts were losing money, and generally provides no facts cognizable as

³² The speculative and conclusory nature of her remarks is also reflected in the fact that, although she makes assertions about EES's contracting practices for the past two years, she admits later in the same email that she had been employed at Enron for only the previous nine months. NCC ¶ 853. Since her email is dated August 29, 2001, this places her hiring at EES at the end of 2000. Inasmuch as she admittedly came to EES with "NO commodity or energy experience" (Pai App. Tab 9), she was likely not in a position to second guess decisions made by Mr. Pai or others working under his direction during the very brief period in which they were both at EES.

regards his state of mind.³³ Equally uninformative regarding Mr. Pai's state of mind are the reported remarks of former EES employee Glenn Dickson that it was not unusual on large deals to provide customer discounts. NCC ¶ 542. And even if Mr. Dickson and the email writer had disagreed with decisions made by Mr. Pai, disagreements, even on significant matters, do not raise a strong inference of fraud. *See Waste Management*, slip op. at 116-17.

This vague allusion to Mr. Pai's claimed involvement in setting up bad deals states at most a conclusory allegation of corporate mismanagement. It does not allege that he had forewarning that the deals were likely to be problematic or that he personally undertook them for an improper purpose. *Cf. BMC*, 183 F. Supp. 2d at 889. No inference of scienter arises from involvement in bad deals. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Schiller*, 2002 U.S. Dist. LEXIS 3240 at *42; *see also Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 361 (1st Cir. 1994)("[T]he securities laws simply do not guarantee sound business practices.") (further citations omitted).

Measured against the minimum requirement that Plaintiffs identify a particular statement and plead what specific facts about it Lou Pai knew, when he knew them, the source from which

³³ Likewise, the transfer of risk management functions from EES to WEOS, which the writer criticizes as improper and a violation of GAAP, occurred in the first quarter of 2001, after Mr. Pai left EES. Pai App. Tab 9. Failure to follow GAAP, however, is not a violation of the securities laws. *See* discussion, *passim*, in the Disclosure Brief. Moreover, as detailed in the Enron Defendants' Joint Memorandum, this resegmentation was fully disclosed in Enron's securities filings, making it even more difficult for Plaintiffs to create a strong inference that any errors or omissions were conscious or severely reckless. *See* the discussion of this issue in the section of the Disclosure Brief directed to Enron Energy Services; Jt. SEC App. Tab 17; Jt. App. Tab 12, at 3; *Lovelace*, 78 F.3d at 1019-20 (disclosure, even if incomplete, precludes finding that defendants intended to mislead concerning challenged statement). Plaintiffs have alleged no facts to suggest that Mr. Pai had any knowledge of the decision that differed from the disclosures in Enron's public filings.

he learned them and the basis for Plaintiffs' allegation, this single averment relating to Mr. Pai's business activity is manifestly inadequate.

IV. PLAINTIFF'S ALLEGATIONS REGARDING LOU PAI'S TRADING DURING THE CLASS PERIOD DO NOT GIVE RISE TO THE REQUISITE STRONG INFERENCE OF SCIENTER.

Because their scienter allegations are so woefully inadequate, Plaintiffs are left asking this Court to infer scienter from Lou Pai's trading in Enron stock during the proposed class period. They will doubtless urge that his stock sales and option exercises are out of line with his prior trading and then argue that this changed behavior means that Mr. Pai must have known that something was amiss at Enron. They will suggest to the Court that this alone supports an inference of scienter for securities fraud and insider trading. They will be wrong.

The fact that Mr. Pai exercised options and sold stock during the class period, even in large amounts, does not support a strong inference of scienter. *See, e.g., BMC*, 183 F. Supp. 2d at 900-01. "[E]ven large sales with large profits, without more, are not enough." *In re First Union Corp. Sec. Litig.*, 128 F. Supp. 2d 871, 897 (W.D.N.C. 2001).

Whether asserted as a basis for scienter or as an independent claim, Plaintiffs' insider trading allegations fail in the face of two fatal defects. First, the circumstances surrounding those transactions more plausibly suggest that they were driven by events unrelated to adverse information concerning Enron, specifically, Mr. Pai's divorce and division of marital property and his departure from Enron. Second, as in *Vantive* and *BMC*, Plaintiffs fail to allege that Mr. Pai personally made misleading statements or had specific knowledge of the misleading statements or omissions by others at the time that he traded. The facts pled will not support a strong inference that Mr. Pai used material adverse nonpublic information in his trading because

Plaintiffs have failed to specify the “who, what, when, and where” of it and because the personal reasons that he offers are more than plausible.

Given that corporate executives are frequently compensated in terms of stock and stock options,³⁴ “it follows . . . that . . . [such] individuals will trade those securities in the normal course of events.” *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997).³⁵ The proceeds from such option exercises may be an intended part of an executive’s overall compensation package, from which no improper motive may be inferred. *Id.*; *see also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir. 1999); *In re Party City Sec. Litig.*, 147 F. Supp. 2d 282, 313 (D.N.J. 2001). Rather, the inference to be drawn from an insider’s trading depends upon the circumstances surrounding the trades. *Greebel*, 194 F.3d at 197-98; *BMC*, 183 F. Supp. 2d at 900-01; *Gaylinn v. 3Com Corp.*, No. C-99-2185 *11 (N.D. Cal. June 9, 2000).

Courts recognize that insiders may sell their stock for any number of legitimate reasons unrelated to the possession of adverse information about the company. As one court recently put it:

[N]ot every sale of stock by a corporate insider shows that the share price is about to decline. A corporate insider may sell stock to fund major family expenses, diversify his portfolio, or arrange his estate plan. He may sell stock in a pattern that has nothing to do with any inside information, such as selling stock twice a year when the college tuition for his children is due.

³⁴ This was certainly the case at Enron. According to a June 9, 1999 JP Morgan analyst report on which plaintiffs themselves rely (NCC ¶ 153), executive compensation at Enron was heavily weighted toward stock and stock options, with “a target of 75% of total compensation . . . ‘at risk’” (Jt. App. Tab 21 at 16, 18).

³⁵ A long class period, such as the more than three years proposed in this case, may thus exaggerate the appearance of insider trading. *Vantive*, 283 F3d at 1092 (suggesting that plaintiffs had deliberately chosen a class period of 63 weeks, about one-third of that in this case, in order to achieve this effect).

Ronconi, 253 F.3d at 435. Where the circumstances surrounding an insider's trades suggest such alternative explanations, the trading cannot support the requisite strong inference of scienter. *E.g.*, *Helwig*, 251 F.3d at 553 (holding that "the 'strong inference' requirement means that plaintiffs are entitled only to the *most plausible* of competing inferences") (emphasis added); *Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 910 (N.D. Ill. 2001) (the strong inference requirement "means that the *most reasonable* interpretation of the[] facts [must be] mischievous") (emphasis added); *First Union*, 128 F. Supp. 2d at 886 (recognizing that to survive a motion to dismiss "[i]t is not sufficient for a plaintiff to plead facts that could plausibly be consistent with innocent conduct").

As we demonstrate below, far from suggesting that Mr. Pai's trading during the class period was driven by any improper intent, the circumstances surrounding those trades more plausibly suggest that they were driven by events unrelated to information concerning Enron. Viewed in context, it is clear that Mr. Pai's trading in 1999 was due to the fact that some of his options were about to expire, that his trading in 2000 related to his ongoing divorce, and that his trading in 2001 was in connection with his departure from Enron. This trading "pattern" does not support the requisite strong inference of scienter.

- A. The circumstances surrounding Mr. Pai's trading in Enron stock demonstrate that those transactions were driven by events unrelated to information concerning Enron.

Mr. Pai's trading during the class period occurred in three discrete segments: on two occasions in early 1999, during the period from mid-January to mid-May 2000, and during an approximately three-week period in late May and early June 2001.

1. The 1999 option exercises.

Mr. Pai's trading during the first of these three periods was unremarkable by any standard. On January 8, 1999 and April 19, 1999, Mr. Pai exercised a total of 50,490 vested options and sold the shares acquired as a result. NCC Ex. C; Pai App. Tab 1 (Form 4s).³⁶ In both instances, the options exercised were about to expire, and, in both instances, Mr. Pai filed a Form 144 in advance of the transaction so indicating. See Pai App. Tab 2 (1/8/99 Form 144, stating that "[t]hese transactions represent the cashless exercise of options . . . which expire in less than 30 days" and 4/19/99 Form 144, stating that "[t]hese transactions represent the cashless exercise of options . . . which expire in a few days"). In fact, Mr. Pai reported not only these but his other transactions to the SEC on a timely basis.

2. The 2000 option exercises.

During the second of these trading periods, between January 21 and May 17, 2000, Mr. Pai exercised a total of 2,950,000 vested stock options,³⁷ again selling the shares acquired as a result.³⁸ See Pai App. Tab 1 (Form 4s); NCC Ex. C. It is a matter of public record that these transactions occurred at a time when Mr. Pai and his now-former wife were in the process of

³⁶ The share amounts listed in Exhibit C to the Plaintiffs' Complaint have been adjusted to account for Enron's two for one stock split on August 31, 1999. The share amounts listed in Mr. Pai's January 1999 and May 1999 Form 4's have not been so adjusted.

³⁷ As in the previous year, some of the options that Mr. Pai exercised in January 2000 were about to expire. Of the options that Mr. Pai exercised on January 21, 2000, 42,470 were set to expire four days later on January 25th, and an additional 6400 were set to expire in May of that year. Pai App. Tab 1 (Jan. 2000 Form 4).

³⁸ Mr. Pai also delivered or withheld shares incident to the vesting of a grant of restricted stock in order to pay the tax liability on the shares received. Pai App. Tab 1 (Feb. 2000 Form 4).

dividing their marital property in contemplation of their divorce.³⁹ Mr. Pai formally filed his divorce petition in the middle of this period, on March 3, 2000, expressing in it the expectation that the parties would formalize an agreement as to on the division of property.⁴⁰ These transactions plainly concerned a valuable asset of the Pais' marital estate, in which, under the Texas community property statute, *see* Tex. Fam. Code § 3.002 (1998), Mr. Pai's former wife had a one-half interest. The parties' divorce was finalized on August 21, 2000, a few months after completion of these divorce-related transactions (Pai App. Tab 6), and Mr. Pai remarried almost immediately (Pai App. Tab 7). While Mr. Pai was trading during this period, Enron's stock price was, for the most part, fluctuating between the mid-\$60s and the low- to mid-\$70s. It was not until Mr. Pai's last few trades in mid-May 2000 that the stock price rose to the high-\$70s, and it was not until after Mr. Pai stopped trading that the stock price climbed toward its peak of more than \$90 per share in August 2000. As of May 17, 2000, Mr. Pai continued to hold more than 700,000 options and close to a half million Enron shares. Pai App. Tab 1 (May 2000 Form 4). Yet despite the fact that the stock price rose significantly in the late summer and early fall of 2000, after completing his option exercises in May, Mr. Pai did not exercise any of these

³⁹ In *Nathenson*, the Fifth Circuit directed the Courts to evaluate whether specific facts support a strong inference of scienter in light of reason and experience, as well as normative considerations, including the purpose of the PSLRA to winnow out meritless claims. 267 F.3d at 407, 412. We therefore ask the Court to take judicial notice of certain public records, described herein, which will aid the Court in assessing whether fraudulent intent is the most plausible inference that can be drawn from the publicly available facts regarding Mr. Pai's trading.

⁴⁰ The initial divorce petition was filed by Mr. Pai's former wife in June 1999. Pai App. Tab 4. Mr. Pai subsequently filed a new petition on March 3, 2000. Pai App. Tab 5. Both divorce petitions expressed the belief that the parties would "enter into an agreement for the division of their estate." Pai App. Tab 4, at ¶ 8; Pai App. Tab 5, at ¶ 9; *see also* Pai App. Tab 1 (April 2000 Form 4).

options or sell any shares. Nor did he do so as the stock price fluctuated and then began to fall later in 2000 and into 2001.

Viewed in this context, Mr. Pai's trading during the first half of 2000 does not support a strong inference of scienter. To the contrary, that Mr. Pai exercised a substantial portion of his vested options while his divorce was in progress, and thus at a time when decisions affecting the parties' community property would have been scrutinized not only by the parties themselves but also by any attorneys, accountants or mediators involved in the divorce process, strongly suggests that the exercises and corresponding stock sales related to the divorce. Indeed, that Mr. Pai's trading was driven by his divorce and the related financial issues is readily apparent from the fact that, in addition to exercising options in which his former wife had an interest, Mr. Pai transferred a substantial number of shares to her during this period. Pai App. Tab 1 (Apr. 2000 Form 4).

Had Mr. Pai's trading been driven by adverse information concerning Enron's business, as Plaintiffs allege, and not by his divorce, he would have continued to sell his substantial Enron holdings as the price increased, rather than passively watching while the price rose and then fell substantially. *E.g.*, *Vantive*, 283 F.3d at 1095 (fact that stock price "steadily increased for the next several months" following CFO's sales "greatly weakened" any inference of scienter); *Ronconi*, 253 F.3d at 435 (no inference of scienter where multiple insiders sold more than 69 percent of their stock at \$52-\$56 while the stock later rose to \$73 as "[w]hen insiders miss the boat this dramatically, their sales do not support an inference that they are preying on ribbon clerks who do not know what the insiders know"). The circumstances surrounding Mr. Pai's trading during the first half of 2000 more plausibly support the inference that the trading related to his ongoing divorce and division of marital assets; hence, that trading does not give rise to a

strong inference of scienter. The fact that Mr. Pai continued to hold a total of 1.2 million shares and options combined for one year as Enron climbed from the \$70s to \$90 then fell steadily to the \$50s undermines any inference of scienter suggested by Plaintiffs.

3. The 2001 option exercises and stock sales.

Mr. Pai's final period of trading did not occur until late May and early June 2001.⁴¹ Between May 23 and June 6, 2001, Mr. Pai exercised his remaining stock options, a total of 572,818 at that point, and sold the shares thus acquired at prices in the mid-to-low \$50s. Pai App. Tab 1. Likewise, between May 23 and June 12, 2001, Mr. Pai sold an additional 338,897 Enron shares.⁴² Id. Although Plaintiffs conveniently omit any mention of Mr. Pai's departure from Enron, as Plaintiffs' own expert acknowledges, this last series of transactions occurred shortly before Mr. Pai left his employment with Enron, and therefore at a time when it was not only reasonable but expected that he would dispose of his remaining Enron holdings. Hakala Decl. ¶ 41 n.33; *see also* Pai App. Tab 8, at 72 (New Power Form 10-K for 2001 (reflecting Mr. Pai's departure from his last position at Enron by July 2001)).

"It is not unusual for individuals leaving a company . . . to sell shares," and trading in these circumstances does not support an inference of scienter. *Greebel*, 194 F.3d at 206; *Kwalbrun v. Glenayre Tech., Inc.*, No. 99-7125, 1999 WL 1212491, *2 (2d Cir. 1999); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *First Union*, 128 F. Supp. 2d at 898;

⁴¹ Plaintiff's expert characterizes Mr. Pai's 2001 trading as beginning in February. Hakala Decl. ¶ 40. Apart from the delivery or withholding of securities to pay tax liability incurred in connection with the vesting of a grant of restricted stock on February 28, however, Mr. Pai had no transactions during this period until late May, as described above. *See* NCC Ex. C; Pai App. Tab 1.

⁴² This was the first time that Mr. Pai sold any of his Enron stock, other than shares acquired as a result of option exercises or shares delivered or withheld in connection with the vesting of

Gaylinn, 2000 WL 33598337, at *12; *In re Read-Rite Corp. Sec. Litig.*, 115 F. Supp. 2d 1181, 1184 (N.D. Cal. 2000); *In re Carter-Wallace, Inc. Sec. Litig.*, No. 94-5704, 1999 WL 1029713, *5 (S.D.N.Y. Nov. 10, 1999). This is particularly true with respect to stock options, which often must be exercised within a limited period of time after the executive's departure. *Greebel*, 194 F.3d at 206; *Gaylinn*, 2000 WL 33598337, at *12.

Indeed, Plaintiffs' own expert does not seriously challenge this explanation for Mr. Pai's 2001 sales, conceding that "[s]ome of these transactions may have been in anticipation of [Mr. Pai's] departure." Hakala Decl. ¶ 41 n.33. Rather, his criticism of these transactions is limited to the cryptic speculation that "given an exercise window after departure, one would ordinarily not chose [sic] to exercise options prior to departure in the absence of a belief that the underlying shares of stock were fairly priced." *Id.* This criticism is unfounded. Plaintiffs' expert says nothing about the length of whatever post-departure "exercise window" may have existed and is thus in no position to comment on whether Mr. Pai would have had any kind of realistic opportunity to exercise his remaining options after leaving Enron. Likewise, he fails to take into account the fact that post-departure restrictions might also be imposed on Mr. Pai, who would thus have had reason to exercise his remaining options at the earliest opportunity. Moreover, if executives routinely sell their stock in connection with their departures, then the salient event is the executive's decision to leave, about which Plaintiffs are silent. Stock sales in the month preceding an executive's departure are equally explicable with reference to the separation from employment as are sales in the month following the departure. *E.g.*, *Greebel*, 194 F.3d at 206 (finding that insider's sale of stock three months prior to his retirement could be readily

restricted stock in order to pay the tax liability on the receipt of such stock, during the class period.

explained by his departure). Indeed, unless Mr. Pai had waited more than five months to divest, his transactions would still fall within the proposed class period.

- B. Mr. Pai's investment in New Power, a company that plaintiffs claim was part of the Enron fraud, undermines any inference that his Enron sales were driven by adverse information.

Lending further support to the notion that Mr. Pai's option exercises and stock sales described above were driven by events unrelated to any inside information is the substantial investment that Mr. Pai made during the class period in New Power, a company that, according to plaintiffs, was part of the Enron "Ponzi scheme." *E.g.*, NCC ¶ 42.

Plaintiffs allege, for example, that owning millions of shares of New Power stock, Enron took New Power public in order to create a trading market in its stock so that Enron "could recognize a profit on the gain in value on its shares by 'hedging' that gain via yet another non-arm's length transaction with the LJM2 entity." *Id.* Additionally, in suing Mr. Pai and certain of the other Enron defendants in their capacity as officers and directors of New Power, Plaintiffs describe New Power as "a company related to Enron . . . which was involved in the alleged wrongdoing." NCC ¶ 83(hh). Yet, following his option exercises in the first half of 2000, Mr. Pai invested more than \$12 million in New Power, putting \$5 million into the company's July 2000 private placement (Jt. SEC App. Tab 61, at 55 (New Power IPO, filed October 5, 2000)), and purchasing a million shares on the open market between November 2000 and February 2001 at a cost of over \$7 million (Pai App. Tab 3 (Form 4s)).

Mr. Pai's investment in New Power is directly at odds with Plaintiffs' allegations of scienter. For if, as Plaintiffs allege, it is "logical" that Mr. Pai, as a senior insider of Enron, knew of "the financial fraud and fraudulent course of business at Enron [that] permeated virtually all aspects of Enron's operations," including New Power (NCC ¶ 83(hh), 395), then he would have

had no reason to invest a dime in New Power, much less \$12 million. That Mr. Pai did make such an investment thus suggests that, in fact, he did not believe that Enron was using New Power to commit fraud and that his option exercises in 2000 were driven by something other than inside information.

C. Plaintiffs' expert declaration lends no support to their allegations of scienter based on Mr. Pai's trading during the class period.

To bolster their claim that the insider selling during the class period supports an inference of scienter, Plaintiffs have submitted a declaration from Scott Hakala, a valuation consultant, reflecting his analysis of the trading patterns of certain of the Enron defendants. NCC Ex. B. It is clear, however, that in relying on expert evidence at the pleading stage, Plaintiffs are asking the Court not only to accept Hakala's factual assertions as true, but to accept the validity of his methodology, conclusions and status as an expert as well. Plaintiffs' attempt to inject expert evidence, and the whole host of evidentiary issues it raises, at this stage of the proceedings is inconsistent with the mandatory stay provision of the PSLRA, *see* 15 U.S.C. § 78u-4(b)(3)(B), and the Court should therefore disregard the Hakala Declaration in its entirety. *See DeMarco v. Depotech Corp.*, 149 F. Supp. 2d 1212, 1221-22 (S.D. Cal. 2001) (granting defendant's motion to strike expert affidavit attached to plaintiff's complaint, finding that to consider such an affidavit on a motion to dismiss would "force[] [the] district court to confront a myriad of complex evidentiary issues not generally capable of resolution at the pleading stage").

Even if the Hakala Declaration were to be considered as part of the Complaint, Plaintiffs' allegations concerning Mr. Pai's trading pattern are still insufficient to create a strong inference of scienter.

First, Hakala's averments are entitled to no additional weight simply because Plaintiffs have sponsored him as an expert. *DeMarco*, 149 F. Supp. 2d at 1222 ("[A]verments in an expert

affidavit carry no additional probative weight merely because they appear within an affidavit rather than numbered paragraphs of the complaint.”). To the contrary, where the circumstances surrounding an insider’s trading do not support a strong inference of scienter, a statistician’s conclusion that the trades must have been driven by the insider’s possession and use of material adverse information does not create the lacking inference. *See Gaylinn*, 2000 WL 33598337, at *11 (finding plaintiffs’ allegations of scienter insufficient notwithstanding that plaintiffs attached to their complaint a declaration from a statistician attesting that “the chances are remote -- with odds of hundreds to one against -- that the abnormal returns to the Insider Sales occurred by chance alone, independent of the defendants’ possession and use of material, adverse non-public information”).

Second, under Hakala’s own model, the vast majority of Mr. Pai’s option exercises were entirely consistent with rational economic behavior. Although Hakala’s analysis is apparently based on the notion “executives will be generally hesitant to exercise an option well in advance of the expiration date of the option” (NCC ¶ 408), according to Hakala, such “premature” option exercises are economically rational when the stock price is three to four times greater than the exercise price (Hakala Decl. ¶ 12 & n.21; *see also* NCC ¶ 408). As Hakala himself implicitly concedes, under this standard, ***all of Mr. Pai’s option exercises were explainable as rational economic behavior without any inside information***, with the exception of the option exercises in late May and early June 2001. Hakala Decl. ¶ 9(d) (challenging *only* “[c]ertain exercises of stock options by Pai in May 2001” as “inconsistent with rational economic behavior”); 25 n.27 (observing that “a lot of option exercises in early 2000 were deep-in-the-money and, therefore, could be explained by wealth diversification and risk aversion”). And those 2001 option exercises, Hakala concedes, occurred around the time of Mr. Pai’s departure from Enron, when

Mr. Pai would have been expected to liquidate his remaining Enron holdings. “Some of these [May and June 2001] transactions may have been in anticipation of his departure.” Hakala Decl. ¶ 41 n.33.

Third, although Hakala concludes that Mr. Pai’s economic behavior “is inconsistent with the sale of shares for mere wealth diversification purposes and liquidity and strongly consistent with the sales of shares with foreknowledge that the shares were inflated in value in 2000 and 2001” (Hakala Decl. ¶ 42), there is no indication, either in his Declaration or in the Complaint, that Hakala considered, much less ruled out, any of the myriad reasons, other than wealth diversification, why an insider might be prompted to sell. As discussed above, the courts have widely recognized that company insiders sell their stock for any number of reasons unrelated to inside information. Apart from wealth diversification, courts have recognized that that insiders may sell, for example, to fund major family expenses⁴³ (such as a divorce and the financial obligations attendant thereto⁴⁴), pay college tuition,⁴⁵ meet tax liabilities,⁴⁶ purchase a new home⁴⁷ or service a pressing debt.⁴⁸ Likewise, courts have recognized that “it is not unusual for individuals leaving a company . . . to sell shares.” *Greebel*, 194 F.3d at 206. Although Hakala

⁴³ *Ronconi*, 253 F.3d at 435.

⁴⁴ *Landgraff v. Columbia/HCA Healthcare Corp.*, No. 8-98-0090, 2000 WL 33726564, *18 (M.D. Tenn. May 24, 2000) (concluding that executive’s option exercises and corresponding stock sales were “because he was going through a divorce and had certain housing needs” and not because he believed that the stock was an imprudent investment).

⁴⁵ *Ronconi*, 253 F.3d at 435.

⁴⁶ *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989).

⁴⁷ *Provenz v. Miller*, 102 F.3d 1478, 1491 (9th Cir. 1996); *Searls v. Glasser*, 64 F.3d 1061, 1068 (7th Cir. 1995).

⁴⁸ *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1428 (9th Cir. 1994).

briefly alludes to this last explanation (Hakala Decl. ¶ 41 n.33), he gives no indication that he considered any of these other legitimate explanations.⁴⁹ Having never considered whether any of these explanations played a role in Mr. Pai's trading, Hakala cannot rule them out.

Finally, notwithstanding that much of Hakala's analysis depends upon how risk-averse and diversified an executive is, and how much of the executive's compensation consists of stock and stock options, nothing in his Declaration suggests that Hakala possessed, much less considered, information about any of these factors as to any of the insiders whose trading he scrutinizes. Hakala recognizes, for example, that the "general pattern of increasing insider selling is especially significant in the 1990s as a result of increasing compensation from executive stock option awards, restricted stock grants and other forms of stock-based executive compensation." Hakala Decl. ¶ 12. But nowhere in his Declaration (or in the Complaint, for that matter) does he claim to know what proportion of Mr. Pai's compensation was derived from stock and stock options. Likewise, Hakala's conclusions about the circumstances in which premature option exercises are rational depend upon several factors, including the executive's level of risk-aversion and diversification. *E.g.*, Hakala Decl. ¶ 13 n.21. Yet he says nothing about whether or to what extent Mr. Pai was diversified. On the question of risk-aversion, moreover, Hakala simply infers that Mr. Pai "exhibited a relatively low level of risk aversion" based solely on the fact that although Mr. Pai exercised two groups about-to-expire options in early 1999, he refrained from exercising certain other options with a similar strike price, which were not yet about to expire, at the same time. In fact, this trading is equally consistent with an

⁴⁹ Hakala likewise does not consider whether Mr. Pai maintained his retirement investments in the various Enron programs after his departure, which would be inconsistent with scienter or use of material nonpublic information.

inference that Mr. Pai liquidated his holdings only when prompted to do so by events extrinsic to Enron. It is not a foundation for a strong inference of scienter.

D. Plaintiffs' pleading deficiencies preclude a strong inference of scienter.

1. Plaintiffs fail to allege that Mr. Pai personally made any fraudulent statements or had specific knowledge that statements by other alleged wrongdoers were false.

To support a strong inference of scienter based on allegations of insider trading, Plaintiffs must allege not only that Mr. Pai sold Enron stock during the class period, but that he personally made fraudulent statements or had specific knowledge that statements by others at the company were false. *In re Ashworth, Inc. Sec. Litig.*, No. 99CV0121-L(JAH), 2000 WL 33176041, at *11 (S.D. Cal. July 18, 2000); *In re Ciena Corp. Sec. Litig.*, 99 F. Supp. 2d 650, 663 (D. Md. May 15, 2000); *Head v. Netmanage, Inc.*, No. C 97-4385 CRB, 1998 WL 917794, at *5 (N.D. Cal. Dec. 30, 1998). Indeed, this Court recognized as much in *BMC*, holding that allegations of trading by insiders other than the two individuals alleged to have actually participated in the fraud were “irrelevant.” 183 F. Supp. 2d at 902. The Ninth Circuit reached the same conclusion in *Vantive*.

Absent such specific allegations of fraudulent conduct, or knowledge of others' fraudulent conduct, by a company insider, even allegations that the insider sold all of virtually all of his stock during the class period are inadequate. In *Head v. Netmanage, Inc.*, for example, where three company insiders had sold 100%, 76% and 94% of their shares respectively, the court held that “even if their sales were somehow suspicious or unusual, they are insufficient to create the requisite strong inference of scienter in light of the lack of any specific allegations as to their fraudulent conduct, including the lack of any allegation that they personally made any of the allegedly fraudulent statements.” 1998 WL 917794, at *5. *See also Vantive*, 283 F.3d at

1094 (finding that there was “no basis for finding circumstantial evidence of fraud” in stock sales of company chairman, who was “not alleged to have uttered a word, or have participated in preparing statements”), 1096 (inference of fraud weakened where insider “did not make any of the allegedly misleading statements”); *Silicon Graphics*, 183 F.3d at 987-88 (insider’s sale of “a vast quantity” of shares, constituting 65 percent of all insider sales during the class period, did not give rise to a strong inference of deliberate recklessness where insider “did not make any of the allegedly misleading statements”); *Ashworth*, 2000 WL 33176041, at *11 (holding that plaintiffs failed to allege facts that made insider’s sale of 100% of her stock suspicious “in light of the absence of any specific allegations directly attributing misrepresentations to [insider] or particularized facts indicating that [insider] had specific knowledge of the fraudulent manipulation of accounting practices”).

As set forth elsewhere in this brief, in close to 500 pages of allegations, Plaintiffs allude, at most, to three statements by Mr. Pai. (NCC ¶¶ 167, 191, 258.) For the reasons previously discussed, because all three of these statements appear in analyst reports, none of them can properly be attributed to Mr. Pai, and none of them would be actionable if they were attributable to him. Absent any specific allegations that Mr. Pai personally made any fraudulent statements, or that he had specific knowledge that statements made by others at Enron were fraudulent, his trading during the class period is insufficient to support either a strong inference of scienter or liability for insider trading. *Ashworth*, 2000 WL 33176041, at *11; *Ciena Corp.*, 99 F. Supp. 2d at 663; *Head*, 1998 WL 917794, at *5.

2. Plaintiffs fail to relate particular stock sales by Mr. Pai to specific materially false and misleading statements or to identify specific nonpublic information that Mr. Pai used to trade.

Plaintiffs' allegations concerning Mr. Pai's trading are likewise deficient because they fail to link Mr. Pai's option exercises and stock sales to particular fraudulent statements. As the Ninth Circuit has recognized, stock sales are helpful in demonstrating "that certain statements were misleading and made with knowledge or deliberate recklessness *when those sales are able to be related to the challenged statements.*" *Vantive*, 283 F.3d at 1093 (emphasis added). Absent some correlation between an insider's sales and the fraudulent statements alleged, however, "it becomes difficult to see how particular stock sales would strengthen allegations that particular statements were uttered with deliberate recklessness at the times they were made," and the trades do not support a strong inference of scienter. *Id.* Thus, because Plaintiffs make no effort whatsoever to relate any of Mr. Pai's Enron transactions to any particular fraudulent statements, no inference of scienter can be drawn.

V. PLAINTIFFS' CONTROL PERSON CLAIM AGAINST MR. PAI SHOULD BE DISMISSED.

Plaintiffs do not allege that Mr. Pai was either a director or an officer of Enron Corporation, the issuer of the securities they purchased. Indeed, the Complaint and Enron Corporation's public filings identify him only as a Chairman and officer of one of Enron's subsidiaries, and as a onetime officer in another Enron subsidiary. *See* NCC ¶ 83 (identifying Mr. Pai as the "Chairman and Chief Executive Officer of Enron Accelerator and, prior to that . . . director of EES"). Yet despite Mr. Pai's lack of any formal position within Enron, the Complaint paradoxically claims that Mr. Pai, in addition to being directly liable to Plaintiffs under Section 10(b) of the 1934 Act, is a "control person" of Enron who is derivatively liable for

the primary violations of the Act by the company pursuant to Section 20(a) of the 1934 Act. 15 U.S.C. §78t(a).⁵⁰

Plaintiffs' control person claims against Mr. Pai fail for two reasons.

First, control person liability requires proof of a primary violation by the "controlled" person – here, Enron. *Schiller*, 2002 U.S. Dist. LEXIS 3240; *Calliott v. HFS, Inc.*, 2000 U.S. Dist. LEXIS 4368 (N.D. Tex. Mar. 31, 2000). If a plaintiff's claim of a primary violation should be dismissed, so too should the related control person claim. *Schiller*, 2002 U.S. Dist. LEXIS 3240, at *54 ("Where a primary violation by the 'controlled person' has not been adequately pleaded, the court should also dismiss a section 20(a) claim."). Although Enron itself is not a defendant in this litigation, as discussed in detail in the Enron Defendants' Joint Memorandum, Plaintiffs have failed to adequately plead the company's violation of the 1934 Act. Consequently, Plaintiffs' control person claims against Mr. Pai should be dismissed as well.

Second, Plaintiffs' Section 20(a) claims against Mr. Pai fail on their own terms because the Complaint's allegations are insufficient to demonstrate that Mr. Pai was a control person of Enron.

In the Fifth Circuit, as in several other circuits, a plaintiff seeking to state a claim of control person status must allege facts demonstrating (1) that the alleged control person actually exercised control over the operations of the primary violator in general,⁵¹ and (2) that the alleged control person possessed the power to control the specific transaction or activity upon which the

⁵⁰ "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable"

⁵¹ *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990); see also *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985), cert. denied, 474 U.S. 1072 (1986).

primary violation is predicated.⁵² These elements must be pled with particularity as to each alleged control person. In *Re Splash Tech. Holdings, Inc.*, Sec. Litig., 2000 U.S. Dist. LEXIS 15370, at *50 (N.D. Ca. Sept. 29, 2000); *Meyer Feldman v. Motorola, Inc.*, 1993 U.S. Dist. LEXIS 14631, at *32 (N.D. Ill. Oct. 14, 1993); *In Re Elscint, Ltd.*, Sec. Litig., 1987 U.S. Dist. LEXIS 16746, at *13-14 (D. Mass. June 22, 1987).

The Complaint does not even attempt to allege with particularity specific conduct by Mr. Pai that could give rise to control person status. Rather, the Complaint founds its claim that Mr. Pai controlled Enron on a single fact: Mr. Pai's membership on the Enron Management Committee, which, according to the Complaint, consisted of "the top executives of Enron" (NCC ¶ 397) and "controlled and/or possessed the power and authority to control" the materials Plaintiffs claim to have been false and misleading. *Id.* In short, there is nothing in the Complaint about what Mr. Pai as an individual might have done to merit control person status -- only very general and conclusory allegations about what the Management Committee, to which Mr. Pai belonged, was and did.

The law is clear that allegations of an individual's status as an officer, director or owner of a corporation are not sufficient to state a claim of control person liability. *E.g.*, *Lane Hartman, Ltd.*, 1997 U.S. Dist. LEXIS 23067, at *15 ("[T]he issue of control person liability cannot hinge merely upon a party's position and title."); *Dartley v. Ergobilt, Inc.*, 2001 U.S. Dist. LEXIS 4154 (N.D. Tex. Mar. 30, 2001) (defendant's status as major shareholder and party

⁵² See *Abbott v. The Equity Group, Inc.*, 2 F.3d 613, 620 (5th Cir. 1993); *Lane Hartman, Ltd., v. Parker*, 1997 U.S. Dist. LEXIS 23067, at *14 (N.D. Tex. Aug. 5, 1997) (citing *Abbott*).

to voting agreement at issue in the case insufficient to render him a control person).⁵³ Consistent with the need for plaintiffs to allege control person status with particularity, courts have required specific allegations that officers, directors, and controlling shareholders of a company engaged in *individual* conduct that demonstrated their control under Section 20(a). *E.g., In re Netsolve, Inc. Sec. Litig.*, 185 F. Supp. 2d 684, 699 (W.D. Tex. 2001) (plaintiffs stated a claim for control person status where each alleged control person was “at the top of the corporate ladder” *and* was a contact person for the company on allegedly misleading press releases and conference calls).⁵⁴ If this exacting standard applies to a company’s officers and directors – the top tier of executive officials within a corporation – it should surely be applied to individuals such as Mr. Pai, who merely served as one of 13-22 members on one of several of the company’s important committees. Yet no allegations of individual conduct can be found with respect to Mr. Pai in the Complaint – just allegations of “control by status.”

Even if it were possible to infer control status from an individual’s position within the controlled company, the allegations in the Complaint fail to achieve that goal. Plaintiffs appear to rely on three principal allegations in an effort to suggest Mr. Pai’s control over Enron through

⁵³ *Accord In Re Fine Host Corp. Sec. Litig.*, 25 F. Supp. 2d 61, 72 (D. Conn. 1998) (“[A]n allegation of ‘control by status’ as an officer, director, or shareholder, without more is not enough to satisfy [the control person test].”); *In Re Rospatch Sec. Litig.*, 1991 U.S. Dist. LEXIS 9648, at *4 (W.D. Mich July 3, 1991) (“Mere status as a director of a corporation is insufficient to establish control person liability.”) (*quoting Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981)); *Hemming v. Alfin Fragrances, Inc.*, 690 F. Supp. 239, 245 (S.D.N.Y. 1988) (“[A] party’s status as an officer, director, or shareholder, without more, is not enough.”).

⁵⁴ *Accord Fine Host*, 25 F. Supp. 2d at 73 (plaintiffs alleged more than control by mere status where complaint noted each individual defendant’s responsibility for the company’s financial reporting); *Degulis v. LXR Biotech, Inc.*, 928 F. Supp. 1301, 1315 (S.D.N.Y. 1996) (plaintiffs went beyond alleging control by mere status where complaint noted, among other things, each individual defendant’s signatures on the offering documents at issue); *Meyer Feldman*, 1993 U.S. Dist. LEXIS 14631 (holding that defendant’s principal executive officers were control persons only if they also made misleading statements to analysts, and not by virtue of their status alone).

his membership on the Management Committee: (1) the allegation that the Management Committee consisted of “the top executives of Enron” (NCC ¶ 397); (2) the allegation that the Committee dealt with the company’s day-to-day business (NCC ¶ 88); and (3) the allegation that the Committee controlled or had authority to review and approve the materials alleged in the Complaint to be fraudulent (NCC ¶ 397).

The first of these allegations is, in fact, wrong on its face, at least with respect to Mr. Pai. As is clear from the face of the Complaint, Mr. Pai was not a “top executive” at Enron. *See* NCC ¶ 83(j) (referring to Mr. Pai only as “Chairman and Chief Executive Officer of Enron Accelerator and, prior to that . . . director of EES”). Thus, his membership on the Management Committee does not provide any additional facts about his role and position in Enron. Indeed, it is absurd to suggest that, simply by virtue of serving on the Management Committee, Mr. Pai actually or potentially exercised control over the actions of Enron officials to whom he, as an officer of one of the Company’s subsidiaries, was obliged to report. *See Kurtzman v. Compaq Computer Corp.*, H-99-779, slip op. at 61-62, 128-29 (S.D. Tex. Dec. 12, 2000) (no control person liability for subordinates when complaint fails to allege with particularity how they could control misstatements of superiors); *accord BMC*, 183 F. Supp. 2d at 915 (“Nor have Plaintiffs specifically alleged how the individual nonspeaking Defendants . . . could have controlled misstatements by the other named Defendants who were their superiors at *BMC*.”)

Plaintiffs’ second allegation – that the Management Committee ran the day-to-day operations of Enron – is meaningless in the absence of a discussion of what those day-to-day activities were. No such discussion is in the Complaint, which therefore sheds no light on Mr. Pai’s role in Enron by virtue of the Committee’s day-to-day management of the company.

Plaintiffs' third allegation – that the Committee controlled and/or possessed the power to control the allegedly fraudulent representations made by Enron -- is simply conclusory, and, as such, cannot give rise to an inference that Committee members meet the control person test. *See In Re Deutsche Telekom AG Sec. Litig.*, 2002 U.S. Dist. LEXIS 2627, at *20 (S.D.N.Y. Feb. 20, 2002) (dismissing control person claims where “actual control over the primary violator is required and plaintiffs fail to allege facts supporting an inference of actual control but rather, simply restate the legal standard for control person liability”).

Meyer Feldman v. Motorola, Inc., is particularly instructive for this case. There, the court considered the control person status of two sets of individual defendants – “principal executive officers” of Motorola who had made allegedly misleading statements to analysts and “principal executive officers” of Motorola who had not made such statements, but who were alleged to have “controlled the dissemination of information to securities analysts and the investing public” by virtue of their positions within the company. 1993 U.S. Dist. LEXIS 14631, at *31. The court determined that only the first set of individuals – to whom individual conduct showing control could be attributed -- qualified as control persons. With respect to the second set of individuals, the court noted that “sweeping” and “conclusory” allegations about the individuals’ control over the dissemination of the company’s financial information were insufficient to give rise to a control person claim, given the absence of “facts detailing the individual defendants’ place in the flow of corporate information.” *Id.* at *31-*32. “Without these details,” the court pointed out, “control person liability is premised solely on status within the Company.” *Id.* at *31. The allegations against Mr. Pai in this case amount to no more than conclusory statements about the Management Committee’s ability to control Enron and do not even attempt to identify specific facts that would demonstrate Mr. Pai’s individual control over the Company. The

Complaint claims nothing more against Mr. Pai than “control by association,” and it does so in a conclusory and generalized fashion. Such claims are clearly insufficient to support Plaintiffs’ Section 20(a) claim against him.

To hold otherwise would enable a plaintiff to circumvent both the strict pleading requirements imposed by the PSLRA and *Central Bank’s* prohibition of aiding and abetting liability through artful use of Section 20(a). As discussed elsewhere in this brief, Congress enacted the PSLRA to raise the pleading bar on claims of securities fraud, and courts have applied that law so as to afford individual defendants the opportunity to know the individual conduct giving rise to the claims against them.⁵⁵ A determination that Mr. Pai, absent any specific allegation regarding actionable individual conduct that gave rise to his control of Enron, is liable as a control person would allow plaintiffs to avoid this bar altogether, and to frustrate the basic purposes of the PSLRA. *See BMC*, 183 F. Supp. 2d at 916 (stating that claims insufficient to sustain Section 10(b) liability will not state a claim under Section 20(a)).

Similarly, holding a subordinate liable as a control person of the parent company, in the absence of specific conduct indicative of actual control, would stretch the concept of control person liability so far that the Supreme Court’s holding in *Central Bank* would be rendered nugatory. Control person liability would be, in large measure, indistinguishable from the now-prohibited category aiding and abetting liability.

⁵⁵ *See, e.g., Kennilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp. 2d 417, 430 (D.N.J. 1999) (“The plaintiffs here lump the defendants together and make general conclusory allegations of wrongdoing. By this, plaintiffs do not afford the defendants the necessary opportunity to know exactly of what each is accused.”); *Lirette*, 27 F. Supp. 2d at 283 (finding that “inferences that the defendants, by virtue of their positions within the company, ‘must have known’ about the company’s problems . . . are precisely the types of inferences which this court . . . has determined to be inadequate to withstand the special pleading requirements in securities fraud cases”) (citation omitted).

In short, Plaintiffs should not be able to use control person liability as an easy alternative to circumvent the substantive and procedural protections that have been determined necessary to protect individuals from ill-founded or opportunistic claims of fraud. *See Meyer Feldman*, 1993 U.S. Dist. LEXIS 14631, at *32 (dismissing control person claims based on status within the defendant company while “[b]earing in mind that fraud must be pleaded with particularity and that the liability to be imposed here is vicarious”). The control person claims against Mr. Pai should be dismissed.

CONCLUSION

For the foregoing reasons, as well as those stated in the Enron Defendants’ Joint Motion to Dismiss, Defendant Lou L. Pai respectfully requests that all claims against him be dismissed, with prejudice.

Respectfully submitted,

ZUCKERMAN SPAEDER LLP

BY:



Roger E. Zuckerman*
Deborah J. Jeffrey*
Steven M. Salky*
Kristen M. Flynn
1201 Connecticut Avenue, N.W.
Washington, D.C. 20036-2638
(202) 778-1800 Telephone
(202) 822-8106 Fax

McDADE FOGLER MAINES LLP

BY: 

Murray Fogler
Attorney In Charge
State Bar No. 07207300
SD ID No. 2003
Two Houston Center
909 Fannin, Suite 1200
Houston, Texas 77010-1006
(713) 654-4300 Telephone
(713) 654-4343 Fax

Attorneys for Defendant Lou L. Pai

*Motion for admission *pro hac vice* pending

LOU L. PAI APPENDIX

TAB	DATE	DESCRIPTION
1	1999–2001	Lou L. Pai's Form 4 filings with the SEC (Enron Corp.)
2	1999–2001	Lou L. Pai's Form 144 filings with the SEC (Enron Corp.)
3	2000–2001	Lou L. Pai's Form 4 filings with the SEC (New Power) (Lexis Abstracts)
4	06/15/99	Original Petition for Divorce filed by Lanna L. Pai, No. 99-31016 (Harris County)
5	03/03/00	Original Petition for Divorce filed by Lou L. Pai, No. 2000-11541 (Harris County)
6	08/21/00	Final Decree of Divorce, No. 2000-11541 (Harris County)
7	09/25/00	Marriage License for Lou L. Pai and Melanie M. Fewell
8	04/16/02	Excerpt from Form 10-K for New Power for the year ended 12/31/01 filed with the SEC
9	08/29/01	Email from Enron employee Margaret Ceconi to Kenneth Lay, Rebecca Carter and Cathy Olson

The Exhibit(s) May
Be Viewed in the
Office of the Clerk