United States Courts
Southern District of Texas
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Michael N. Milby, Clerk

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

MARK NEWBY,	§	CIVIL ACTION NO. 01-CV-3624
	§	(Consolidated)
Plaintiff,	§	
v.	§	
	§	
ENRON CORPORATION, et al.	§	

MOTION TO DISMISS OF DEFENDANTS ROBERT A. BELFER, NORMAN P. BLAKE, JR., RONNIE C. CHAN, JOHN H. DUNCAN, JOE H. FOY, WENDY L. GRAMM, ROBERT K. JAEDICKE, CHARLES A. LEMAISTRE, JOHN MENDELSOHN, JEROME J. MEYER, PAULO FERRAZ PEREIRA, FRANK SAVAGE, JOHN WAKEHAM, CHARLS E. WALKER, AND HERBERT S. WINOKUR

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TO THE HONORABLE MELINDA HARMON:

Among the more than eighty defendants Plaintiffs have sued are fifteen that Plaintiffs all but ignore in their Complaint: Enron's present and former outside directors. To be sure, Plaintiffs name the Outside Directors in their list of parties and list the committees on which those directors served. But when it comes to their obligation to allege facts supporting a claim that even one of these Outside Directors actually made a misstatement -- or that any of them knew that statements made by others were inaccurate or incomplete -- Plaintiffs are noticeably silent.

Their silence speaks volumes. Unlike the typical securities case, an abundance of information has already been made available about Enron and why it collapsed.[3] Yet even with this wealth of information, Plaintiffs still allege no particular facts showing wrongdoing by the individual outside directors -- perhaps because they recognize that there are none to plead. Having nothing to offer about these individuals, Plaintiffs resort to "group pleading", a tactic rejected four times by this Court. Instead, Plaintiffs make generic statements about a multitude of undifferentiated "Enron

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1 The Outside Directors also adopt the arguments in the Motions to Dismiss filed by other defendants in this action to the extent that those arguments are not inconsistent with the arguments set forth herein.

2 These Defendants are all present or former outside directors of Enron Corporation. For ease of reference, they will occasionally be referred to collectively as the Outside Director Defendants or the Outside Directors.

3 The array of available facts and evidence comes from several Congressional hearings in which key witnesses have testified under oath, extensive coverage by the media and the financial press, release of a wealth of significant documents, and even a lengthy investigative report commissioned by the directors (the "Powers report").

Defendants." The law of the Fifth Circuit is clear; Claims cannot proceed against the individual Outside Directors unless the Plaintiffs pleads, for example, what Wendy Gramm said, what John Duncan knew, when Robert Belfer knew it, and where Charles LeMaistre should have disclosed it. Importantly, Plaintiffs have pled no specific facts against any individual director. Their claims must, therefore, be dismissed.

Plaintiffs' complaint does little more than claim that these individuals were directors of Enron and did the things directors do -- they served on committees, reviewed financial information, approved transactions, and signed certain disclosure documents. The securities laws obviously do not condemn service as a director, so pleading that these individuals acted as directors of Enron does not state a claim for relief.

Though Plaintiffs devote enormous attention to "insider trading" and in fact base their entire fraud case on an argument that it indicates intentional wrongdoing and deception, the alleged trading by the Outside Directors is to the contrary: Most didn't sell any stock at all. Most increased their Enron holdings. Among those who sold, most sold only a small piece of their holdings. Most did so at such "inauspicious" times and prices that one could hardly presume the sales were suspicious in any way. The meager allegations of insider trading by the outside directors do not support Plaintiffs' claims.

The fact that this case involves the widely-publicized collapse of Enron does not alter the applicable law. It also does not relieve Plaintiffs of their obligation to plead their claims (if they have any) in compliance with the requirements of PSLRA, and Rule 9(b) and this Court's four prior decisions interpreting them. When the Court considers whether Plaintiffs have alleged sufficient, specific facts as to each Defendant, it will be clear that the meager facts pleaded about the Outside Directors do not support any claims.

For these reasons, and those stated in greater detail below, Plaintiffs claims against the outside directors should be dismissed with prejudice.

I. PLAINTIFFS HAVE FAILED TO ADEQUATELY ALLEGE MISREPRESENTATIONS OR OMISSIONS

All of the Plaintiffs' claims necessarily depend on the pleading of misrepresentations or omissions to disclose material facts. Other defendants are today filing a joint brief[4] challenging the existence of any misrepresentations or omissions by Enron.

As is demonstrated below, the individual Outside Directors are not alleged to have made any direct statement, individually, that is alleged to be a misrepresentation. Rather, they are sued only as alleged control persons or as signers of Enron disclosure documents. Accordingly, a determination by the Court that Enron's disclosures were adequate would, by definition, require dismissal of all of Plaintiffs' claims against the Outside Directors.

II. PLAINTIFFS HAVE FAILED TO PLEAD FRAUD AGAINST THE OUTSIDE DIRECTORS WITH PARTICULARITY

Parties seeking to assert a claim for securities fraud must plead the alleged fraud with particularity. Fed. R. Civ. P. 9(b); 15 U.S.C. § 78u - 4(b). On at least four occasions prior to the filing of the Consolidated Complaint, this Court has held that the heightened pleading requirements for securities fraud claims are not satisfied by group pleading. *In re: Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 913 n.50 (S.D. Tex. 2001) (listing cases). In studied disregard of those holdings, Plaintiffs rest their claims against the Outside Directors upon the proposition that "[i]t is appropriate to treat the Enron Defendants as a group for pleading purposes and to presume that the [alleged misrepresentations] are the collective actions of the Enron Defendants identified above." Newby Consolidated Complaint ("NCC") ¶ 89.

When one considers only those allegations of the Complaint specifically directed at the Outside Directors by name, and disregards, as one must, the impermissible presumption of collective guilt, the Complaint wholly fails to state a claim against the individual Outside Directors. Rather, the allegations directed specifically at these defendants amount to little more than the assertion that they served as Outside Directors of Enron during the alleged "Class Period" and that some of them

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[4] *See* Certain Defendants' Joint Brief Relating to Enron's Disclosures ("Joint Brief").

sold Enron shares during that period. The Complaint makes no effort to tie any of the Outside Directors to any of the alleged misrepresentations, except to recite that they were signatories to some of Enron's public filings. There is not a single allegation that any Outside Director knew that any particular representation in those public filings was false or misleading when made. By disclaiming any intent to accuse mere signatories of fraud,[5] Plaintiffs have effectively admitted that this allegation does not suffice to state a claim for fraud. The fraud claims against the Outside Directors should therefore be dismissed for failure to state a claim.[6]

A. The Particularity Requirement

Scant space need be devoted to supporting the proposition that a securities fraud claim must be pleaded with particularity. Long prior to the passage of the PSLRA, the Fifth Circuit had consistently applied Rule 9(b) of the Federal Rules of Civil Procedure to securities fraud claims. *See, e.g., Williams v. WMX Technologies, Inc.*, 112 F.3d 175 (5th Cir. 1997); *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015 (5th Cir. 1996); *Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061 (5th Cir. 1994); *Sushany v. Allwaste, Inc.*, 992 F.2d 517 (5th Cir. 1993). Following the passage of the PSLRA, the Fifth Circuit has held that the statute "at a minimum," incorporated Rule 9(b)'s standard for pleading fraud. *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 412 (5th Cir. 2001). In *Nathenson* the court observed that the language of section 4(b)(2) of the statute, 15 U.S.C. § 78u-4(b)(2), "appears to comport with this Court's relatively strict interpretation of Rule 9(b), which requires a plaintiff to specify the statements contended to be fraudulent, the identity of the speaker, state when and where the statements were made, and explain why the statements were fraudulent."

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[5] *See* NCC n.1.

[6] "We treat a dismissal for failure to plead fraud with particularity under Rule 9(b) as a dismissal for failure to state a claim upon which relief can be granted." *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1017 (5th Cir. Tex. 1996).

Before the PSLRA, the Fifth Circuit permitted scienter to be "averred generally." A plaintiff was required to "set forth specific facts that support an inference of fraud." *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994). Since the passage of the PSLRA, the Fifth Circuit recognized that its previous rule was "supplanted by the PSLRA's 'strong' inference requirement." *Nathenson*, 267 F.3d at 407. Thus, "a plaintiff alleging a section 10(b) / Rule 10b-5 claim must now plead <u>specific</u> facts giving rise to a "strong inference" of scienter."[7] *Id.* Upon failure of the plaintiff to do so, the court "shall" dismiss the Complaint.

B. Plaintiffs' Group Pleading Allegations Must Be Disregarded

Relying upon the group pleading doctrine adopted by some courts, Plaintiffs lump all of the Outside Directors into a group of "Enron's top executives and directors," designated in the Complaint as "Enron Defendants." NCC ¶ 1. Plaintiffs then boldly assert at ¶ 89 that it is "appropriate to treat the Enron Defendants as a group for pleading purposes and to presume that the [alleged misrepresentations] are the collective actions" of all, relying precisely upon what this Court has referred to as the "traditional group pleading presumption." Compare *In re: BMC*, 183 F.Supp. 913 n.50 with NCC ¶¶ 88-89. The assertion flies directly in the face of this Court's repeated holdings that "the group pleading doctrine is at odds with the PSLRA and has not survived the amendments." *Id.* (citing three prior decisions of this Court)[8].

This Court's rejection of group pleading is entirely consistent with both the language and purpose of the PSLRA. In *Coates v. Heartland Wireless Communications, Inc.*, 26 F.Supp. 2d 910, 915 (N.D. Tex. 1998), Judge Fitzwater explained:

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[7] While the failings of the Complaint addressed in this section include the failure to plead facts giving rise to a strong inference of scienter, because Plaintiffs appear to have placed all their outside director eggs in a single insider trading basket, the allegations of insider trading and their failure to support any inference of scienter, let alone a strong one, is separately addressed in part III.B., *infra.*

[8] These Plaintiffs' election to rely heavily upon the group pleading doctrine to support their claims against the Outside Directors seems particularly telling. Lead counsel for Plaintiffs in this case, the Milberg Weiss firm, participated in all three of this Court's prior cases rejecting the group pleading doctrine. If Plaintiffs could muster sufficient allegations against the Outside Directors without resorting to the group pleading doctrine, they would surely have done so.

> [A] plaintiff must state with particularity the facts that give rise to a strong inference that the defendant acted with the required state of mind. 15 U.S.C. § 78u-4(b)(2). This [provision] requires that a plaintiff allege facts regarding scienter as to each defendant. So interpreted, § 78u-4(b)(2) is consistent with the PSLRA's policy of protecting defendants from unwarranted fraud claims . . . . It is nonsensical to require that a plaintiff specifically allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made a statement or omission. Any remnant of the group pleading presumption that remained in this circuit before enactment of the PSLRA did not survive it.

C. Plaintiffs' Specific Allegations Against the Individual Outside Directors Fail to State Claims for Fraud

Because this Court has rejected the group pleading doctrine, the Complaint must be evaluated on the basis of the allegations leveled specifically at each individual defendant, both with respect to the alleged misrepresentations attributed to each individual defendant and the allegations of scienter. *See Zishka v. Am. Pad & Paper Co.,* Fed. Sec. L. Rep. 91, 208; 2000 WL 1310529 at 1 (N.D. Tex. 2000) ("To comply with the PSLRA, Plaintiffs must plead with particularity their allegations against <u>each individual Defendant</u>" and must "delineate specifically what <u>each Defendant knew</u>");[9] *Coates*, 26 F. Supp. 2d at 915-917; *In re: BMC*, 183 F. Supp. 2d at 917 ("Where statements are not protected by safe harbor, the Court fully agrees with Defendants that Plaintiffs have failed to allege specific facts relating to each statement to demonstrate that it was misleading and to <u>each Defendant-speaker</u> sufficient to give rise to a strong inference that the speaker knew his statement was false when it was made.").

When properly evaluated in light of the allegations actually leveled at each Outside Director, the Complaint falls woefully short. In a Complaint consisting of over 1000 numbered paragraphs covering 500 pages, one or more of the Outside Directors are mentioned in only 22 of those paragraphs: 1, 2, 84, 86, 87, 109, 110, 126, 134, 141, 164, 221, 292, 336, 401, 402, 410, 415, 855, 993, 1006, 1019. Those can be categorized as follows:

- Seven of those paragraphs, or nearly one-third of the total, do nothing more than identify the Outside Directors as defendants (¶ 1), detail their tenures on the board and committee memberships (¶¶ 86, 87), and identify which claims are being asserted against them (¶¶ 2, 993, 1006, 1009).

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[9] Unless otherwise indicated, emphasis is added throughout.

- Another eight of the 22 paragraphs simply identify one or more Outside Directors as signatories on certain Enron public filings. NCC ¶¶ 109, 110, 126, 134, 141, 164, 221, 292, and 336.

- Six of the remaining seven paragraphs deal with sales of Enron stock by some of the Outside Directors during the alleged Class Period. NCC ¶¶ 83, 84, 401, 402, 410, 415.[10]

- One paragraph, ¶ 855, mentions Dr. Jaedicke by quoting a Vinson & Elkins' letter of October 15, 2001. In the letter Vinson & Elkins recited that it had reported the results of its investigation to Dr. Jaedicke as Chairman of the Audit Committee and that, at Dr. Jaedicke's request, Vinson & Elkins had given a verbal summary of its review and conclusions to the full audit committee.

These very limited allegations are patently insufficient to meet the heightened pleading standards for securities fraud actions. In fact, the sole allegation of "fraud" in these paragraphs is the conclusory allegation that Enron's registration statements included "financial results that were materially false and misleading in violation of GAAP <u>as described herein</u>." *See e.g.* NCC ¶ 110. Plaintiffs do not specify where, in their 500 page opus, the detail of these false statements may be found. Nor do they specify which, if any, of the individual directors actually knew these statements were false, when they knew it, and what particular statements "described elsewhere" in the complaint were allegedly false and misleading. The absence of any effort to plead these required elements is fatal to Plaintiffs' claims. *See, e.g., Williams*, 112 F.3d at 177-79.

<u>At most</u>, these paragraphs allege a violation of GAAP in the presentation of Enron's financial statements. A violation of GAAP, without more, does not state a claim of securities fraud. *See Fine v. Ame. Solar King* Corp., 919 F.2d 290, 297 (5th Cir. 1990); *Vosgerichian v. Commodor Int'l.*, 832 F.Supp. 909, 915 n.8 (E.D. Pa. 1993) (complaint alleging violations of GAAP and GAAS was insufficient because "clearly, even deliberate violations of those guidelines, without more, do not amount to fraud").

The allegation that a director signed a public filing alleged to be false or misleading, without more, also does not state a claim for fraud. The elements of fraud include much more than a false

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[10] Exhibits to the Complaint set out certain details of alleged stock sales. NCC Exs. A-C.

statement: most notably, scienter. *E.g., Nathenson,* 267 F.3d at 406-407. In *Coates*, Judge Fitzwater expressly rejected the argument that a plaintiff could avoid dismissal by simply alleging that directors had signed false offering documents:

> In their briefing, plaintiffs argue that all of the individual defendants signed [two prospectuses] and thus made materially misleading statements..... Asserting such facts alone will not prevent dismissal. Plaintiffs must properly plead wrongdoing and scienter <u>as to each individual defendant</u> and cannot merely rely on the individual's positions or committee memberships within the Heartland organization.

26 F.Supp. 2d 910, 916.

Nowhere in the Complaint do Plaintiffs even attempt to identify any particular false statement or omission in Enron's public filings or assert that any one of the Outside Directors knew it was false or misleading when made, let alone offer any particular facts to support such a claim. Nowhere in the Complaint do Plaintiffs offer any specific factual assertions regarding what information was known to any Outside Director that would cause him or her to question or doubt any document he or she was being requested to sign.[11] Nowhere in the Complaint do Plaintiffs state facts to suggest that any particular Outside Director was negligent or derelict in performance of his or her duties, let alone allege facts to support the type of extreme recklessness that constitutes scienter. *See Nathenson,* 267 F.3d at 408. Finally, nowhere in the Complaint do Plaintiffs articulate how any

[11] Ironically, the only allegations that even attempt to allege that the Outside Directors had notice of potential problems with Enron's filings strongly <u>negate</u> any inference of scienter on their part. The Complaint alleges at paragraph 59 (in impermissible group pleading format) that "two employees complained to the Board" in August 2001, and goes on to quote from two letters detailing alleged misdeeds. Without offering any facts whatsoever regarding whether or when any individual Outside Director actually learned of the contents of these letters, the Complaint <u>first</u> asserts that Enron's directors "took no action to investigate or disclose these issues." The Complaint <u>next</u> alleges Vinson & Elkins was brought in to "cover up" the wrongdoing, and did so by writing a whitewash report. NCC ¶ 60. Most significantly, however, the Complaint relates that shortly <u>after</u> Vinson & Elkins delivered its report, "<u>the board of directors launched their own inquiry</u>, which quickly found massive impropriety." NCC ¶ 800, (quoting the *Los Angeles Times*).

There is no allegation that any outside director had any involvement in selecting Vinson & Elkins (¶ 851 specifically alleges that Mr. Lay, engaged Vinson & Elkins), let alone any allegation that any of them knew or understood that Vinson & Elkins or anybody else was to "coverup" or whitewash anything. No rational inference of fraud can be drawn from a claim that the Outside Directors cleverly obtained a "whitewash" report from one of the most prominent law firms in the country, only to immediately follow it up with their own, independent investigation that became the so-called "Powers Report." *See* NCC ¶800.

particular Outside Director participated in an alleged scheme to defraud. *See BMC*, 183 F. Supp. 2d at 915-16.

Plaintiffs tacitly admit that their allegations regarding the Outside Directors' service as directors and committee members and signing of public filings do not themselves support a fraud claim. They do so by effectively dividing the Outside Directors into two groups -- those who sold Enron shares during the Class Period and those who did not. Those who sold shares during the Class Period are accused of fraud; those who did not sell shares during the Class Period are not.[12] Plaintiffs thus effectively concede that the only allegations even they believe can support an inference of scienter on the part of the Outside Directors are those regarding insider trading. As shown in part III(B) below, those allegations support no inference of scienter, let alone a strong inference of scienter.

Plaintiffs have not alleged that any individual director made a specific statement about Enron that he or she knew to be false when he or she made it.[13] In the absence of such allegations, Plaintiffs' complaint fails to state a claim for relief under Rule 9(b), the PSLRA and settled case law from this court and the Fifth Circuit. The Complaint should be dismissed.

III. PLAINTIFFS HAVE FAILED TO RAISE A STRONG INFERENCE THAT THE OUTSIDE DIRECTORS ACTED WITH THE REQUISITE SCIENTER

The PSLRA imposes a heightened pleading standard for allegations of scienter:

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[12] At the very beginning of the Complaint, in a footnote on page 3, Plaintiffs state that they are not alleging fraud against the nine Outside Directors (out of 17 total) who had no sales of Enron stock during the purported class period. The only distinction between the Outside Directors accused of fraud and those not accused of fraud is the presence or absence of stock sales during the purported class period.

[13] Although Plaintiffs' Complaints is replete with references to analysts' reports, they allege no facts to suggest that the Outside Directors are responsible for those reports, were somehow "intertwined" with the analysts who prepared them, or controlled the content of those reports. Not a single Outside Director is even quoted in the dozens of reports cited by Plaintiffs. The absence of these facts is fatal to Plaintiffs' half-hearted effort to hold the directors liable for analysts' statements. *See Raab v. General Physics Corp.* 4 F.3d 286, 289 (4th Cir. 1993); *accord In re BMC Software*, 183 F.Supp.2d at 872 n.21 ("The Court agrees with the majority view that there must be alleged facts showing some involvement in and control over the content of the analysts' reports by the defendants to hold them liable for misleading statements made in those reports.").

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, **the 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.

15 U.S.C. § 78u-4(b)(2); *see also Nathenson*, 267 F.3d at 407 ("In order to survive a motion to dismiss, a plaintiff alleging a Section 10(b)/Rule 10(b)(5) claim must now plead **specific facts** giving rise to a '**strong inference**' of scienter."). If a plaintiff fails to meet this requirement as to any individual defendant, the district court shall dismiss the complaint against that defendant. 15 U.S.C. § 78u-4(b)(3).

To pursue a securities fraud claim against an individual defendant, a plaintiff must establish that individual acted with an "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The Complaint, then, must allege facts that raise a strong inference that the individual *knew* "that [he or she was] publishing materially false information, or [that he or she was] *severely reckless* in publishing [that] information." *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1020 (5th Cir. 1996). Severe recklessness 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*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc).[14]

A plaintiff cannot survive a motion to dismiss by conclusorily alleging fraudulent intent. *In re Waste Management Sec. Litig.* H-99-2183, Slip Op. at 20 n.7 (S.D. Tex. Aug. 16, 2001). Plaintiffs must plead that *each* of the individual Outside Directors acted with conscious misbehavior

[14] In adopting this definition of severe recklessness from the Seventh Circuit, the Fifth Circuit made clear that severe recklessness is a much higher mental state than ordinary recklessness, noting that "[t]he Seventh Circuit characterized that sort of recklessness as 'equivalent to willful fraud.'" *Broad v. Rockwell*, 642 F.2d 929, 962 (5th Cir. 1981), citing *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

or recklessness, a "stringent standard which requires strong circumstantial evidence." *In re Baker Hughes Sec. Litig*, 136 F. Supp. 2d 630, 647 (S.D. Tex. 2001). In rejecting allegations strikingly similar to those alleged by Plaintiffs here, this Court has been very clear:

> Plaintiffs must allege what actions each Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it and how Plaintiffs know what he learned.

In re BMC Software, 183 F. Supp. 2d at 885. (emphasis added).

Plaintiffs' allegations of scienter against the Outside Directors do not come close to satisfying these requirements.

A. Aside From Their Individual Stock Sales, Plaintiffs Fail to Allege Any Allegations of Scienter Against Each of the Outside Directors

As an initial matter, Plaintiffs have not even attempted to plead that *each* of the Outside Directors accused of fraud had the requisite scienter. Even before the Reform Act, the Fifth Circuit had held that merely alleging that the defendants knew, or must have known, facts or had access to information by virtue of their board positions was insufficient to plead scienter. *See Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994). Now, "[t]o comply with the PSLRA, Plaintiffs must plead with particularity their allegations against *each individual Defendant.*" and must "delineate specifically what each Defendant knew." *Zishka*, 2000 WL 1310529 at *1 (N.D. Tex. 2000).

Plaintiffs' Complaint is devoid of any such allegations as to the Outside Directors. With respect to the few individual directors accused of fraud, nowhere in the Complaint do Plaintiffs identify what he or she did wrong, what he or she knew, when he or she knew it, or that he or she acted with an intent to deceive anyone. Indeed, in the entire Complaint, Plaintiffs only mention the individual Outside Directors that they accuse of fraud to list them as parties (NCC ¶¶ 1, 76(v)-(ee)), identify their stock sales (NCC ¶¶ 83, 84, 401, 402, 410, 415), identify when each of them served on the Board and what committees they were on (NCC ¶¶ 86-87), and identify what SEC filings they each signed (NCC ¶¶ 109, 110, 126, 134, 141, 164, 221, 292, 336). These allegations are, on their face, insufficient to allege scienter against any of the individual Outside Director defendants. *See*

In re Sunterra Corp. Sec. Litig., 2002 WL 480620 (M.D. Fla. Mar. 12, 2002) (Dismissing claims against Outside Directors, agreeing that "allegations of committee membership, stock sales, and signatures on the Company's Form 10-K are insufficient to satisfy the PSLRA requirements.")[15]

B. Plaintiffs' Allegations of Stock Sales by Certain Outside Directors Are Insufficient to Establish a Strong Inference of Scienter

The only particular fact Plaintiffs allege against Outside Directors in hopes of adequately pleading scienter is that certain of them sold some amount of Enron stock during the past three years. Plaintiffs' allegations of scienter as to the Outside Directors are thus explicitly based solely upon inferences to be drawn from the Director's trading in Enron stock. They allege fraudulent misconduct *only* as to the Outside Directors who sold stock during the Class Period. *See* NCC ¶ 396 ("Every Enron Defendant sued for fraudulent misconduct sold substantial amounts . . . of his or her Enron stock"). Directors not alleged to have sold stock are not accused of fraud. NCC n.1 (listing persons not accused of fraud); NCC ¶ 83(dd) (listing directors not sued for fraud); NCC ¶ 83(v – ee) (listing directors alleged to have sold stock). Plaintiffs' Complaint thus acknowledges that without a potential inference to be drawn from stock trading, the factual allegations concerning all of the Outside Directors are insufficient to state a fraud claim.

Of the seventeen[16] Outside Directors who are defendants, nine – more than half – have no alleged stock sales at all and are not even accused of having fraudulent "scienter." The eight who did sell some stock are not alleged or explained to have any different knowledge or role than the nine who did not. The only difference in the two groups is that Plaintiffs claim fraud by anyone who

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[15] *See also In re Cendant Corp. Sec. Litig.*, 76 F. Supp.2d 539, 547 (D.N.J. 1999) ("Allegations that a director or officer signed public disclosures and/or was involved in the company's daily operations, standing alone, will not satisfy the pleading requirements of the PSLRA or Rule 9(b).").

[16] Paragraphs 83(v) through 83(ee) list the seventeen persons identified as directors but not identified as having any other office or employment with Enron. As noted earlier, the fifteen movants under this motion are among the seventeen Outside Directors named in the Complaint. Messrs. Willison and Urquart are Outside Directors not represented by the undersigned counsel and thus are not movants under this Motion.

made even one stock sale at any time during the three-year class period. Plaintiffs' only basis for alleging scienter on the part of those eight Outside Directors is, therefore, stock trading – and nothing more.

Accordingly, to survive the motion to dismiss, Plaintiffs must allege specific facts sufficient to establish – for *each* of the Outside Directors – that the individual's trading was sufficiently suspicious to give rise to the necessary strong inference of scienter.[17]

1. Pleading The Existence of Insider Sales Is Insufficient to Establish a Strong Inference of Scienter

Under the securities laws, a plaintiff who seeks to establish fraudulent intent based upon stock trading faces an uphill battle: "The mere sale of stock by insiders alone will not establish fraudulent intent." *In re Waste Management, Inc. Sec. Litig.,* C.A. No. H-99-2183 (S.D. Tex., Aug. 16, 2001) at 129 (citing *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999) ("We have held that we will not infer fraudulent intent from the mere fact that some officers sold stock.") (internal quotations omitted)); *see Wenger v. Lumisys*, 2 F. Supp. 2d 1231, 1250 (N.D.Cal. 1998) ("Stock sales alone cannot create a strong inference of scienter.").

Courts have recognized that sales of stock by corporate insiders are perfectly normal. "A large number of today's corporate executives are compensated in terms of stock and stock options. It follows then that these individuals will trade those securities in the normal course of events." *Burlington*, 114 F.3d at 1424; *see also Waste Management* at 130. Plaintiff's own pleading acknowledges the same thing. "Insiders will naturally tend to sell their company's shares over time

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[17] Plaintiffs offer allegations of stock sales as purported evidence of "motive and opportunity." The Fifth Circuit in *Nathenson* expressed serious doubt as to whether allegations of motive and opportunity, standing alone, can ever be sufficient to raise a strong inference of scienter. *Nathenson v. Zonagen*, 267 F.3d 400, 412 (5th Cir. 2001); *Accord*, *In re Baker Hughes Sec. Litig.*, 136 F. Supp. 2d 630, 641 ("[F]acts alleging motive and opportunity to commit fraud will not raise a strong inference of scienter unless they simultaneously establish that the defendant acted recklessly or consciously misbehaved."). As demonstrated below, the stock sales of the individual Outside Directors are not extraordinary and do not establish that any Outside Director acted with recklessness or conscious scienter.

for wealth diversification purposes and liquidity purposes." NCC Ex. B at 14-15. Thus, "in many cases," the "individual trading patterns [of corporate insiders] are often not sufficiently distinguishable from normal patterns of insider trading to draw an inference or strong inference" of scienter. NCC Ex. B at 18.

Accordingly, a court analyzing whether sales by a company's "insiders" are suspicious must do so against the backdrop that insiders will necessarily be selling at *some* time, so the mere fact that a seller sells means nothing with regard to an inference of improper scienter. As discussed below, stock sales give rise to a strong inference of scienter only if their amount, their timing, and their variation from normal practice make them particularly suspicious.

2. Insider Sales Can Support a Strong Inference of Scienter Only If They are Suspicious in Amount and in Timing, Inconsistent with Prior Patterns, and Not Explainable by Other Facts in the Pleadings

"Plaintiffs must allege that the trades were at times and in quantities that [a]re suspicious enough to support the necessary strong inference of scienter." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997). As this Court has stated, trading by insiders will be considered in assessing scienter only if the plaintiff can delineate: (a) **unusual** trading, (b) at **suspicious times**, (c) in **suspicious amounts**, (d) **inconsistent with prior established patterns** (if any). *See In re BMC Software,* 83 F.Supp.2d at 901 (citing *Rubenstein v. Collins,* 20 F.3d at 160, 169-70 (5th Cir. 1994); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1204 (1st Cir. 1996); *Greebel v FTP Software, Inc.*, 194 F.3d 185, 197 & 206 (1st Cir. 1999), and *In re Silicon Graphics Sec. Litig.*, 183 F.3d at 970, 986 (9th Cir. 1999)). Failure to show any one of these criteria negates scienter. Otherwise-suspicious amounts, for example, will be insufficient to show scienter if they are not also at "suspicious times" and inconsistent with prior selling practices. *See, e.g., In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1092 (9th Cir. 2002) (no inference from trades "suspicious in amount, but not in timing" and even if trades are "suspicious in amount and timing," plaintiff must also show they were "dramatically out of line with prior trading practices").

The Plaintiff's burden is not simply to allege selling patterns that are consistent (or not inconsistent) with the possibility that the insider intended a fraud. Because Plaintiffs' scienter allegations depend solely on insider trading, the test is whether, based simply on looking at those selling patterns, one can rationally draw a "strong inference" that the individual was in fact acting improperly. Plaintiffs' allegations regarding the Outside Directors' trades do not satisfy these requirements.

a. Suspicious Amounts. In determining whether the sale was in an unusual or suspicious amount, the court must examine the proportion of shares actually sold by the insider to the volume of shares he could have sold. *See, e.g., Silicon Graphics*, 183 F.3d at 986. Numerous courts have therefore held that an allegedly suspicious sale of securities does not give rise to a strong inference of scienter if it is only a fraction of the seller's holdings, or if the seller in fact retained a significant portion of his stock. *Nathenson*, 267 F.3d at 420-21 (outside director's sale of **only "a fraction of his holdings"** does not suffice to establish scienter); *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 540-41 (3d Cir. 1999); *Silicon Graphics*, 183 F.3d at 987-88; *Wenger v. Lumisys, Inc.,* 2 F. Supp. 2d 1231, 1251 (N.D. Cal. 1998) (noting officers "retained the vast majority of their holdings"). As this Court has noted, "[r]etention of the vast majority of their stock negates any inference of scienter." *Waste Management*, Slip Op. at 131 (citing *In re Vantive Corp. Sec. Litig.,* 110 F. Supp 1209, 1219 (N.D.Cal.2000) ("*Vantive I*") (finding no scienter because sales of 38% of stock "necessarily means they retained 62%"), *aff'd* , 283 F.3d 1079 (9th Cir. 2002) ("*Vantive*")).

b. Suspicious Timing. To satisfy the "suspicious timing" element, plaintiffs must show that the trades were "at times calculated to maximize personal benefit" to the seller. *In re: Apple Computer Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989). A paradigmatic example would be a sale of a significant proportion of one's holdings "immediately before a negative earnings announcement." *Wenger*, 2 F. Supp. 2d at 1251.[18] Conversely, trades made well before the stock price peaks, after

[18] See also, e.g., *Lilly v. State Teachers Retirement System*, 608 F.2d 55, 56 (2d Cir.1979), *cert.*
(continued...)

it drops, or at other times which do not appear to have maximized the seller's proceeds, do not support a strong inference of scienter. *See id.*; *Nathenson*, 267 F.3d at 420-21; *Greebel*, 194 F.3d at 206 (finding "timing does not appear very suspicious" where stock was **not "sold at the high** points of the stock price."). In *Nathenson*, for example, the Fifth Circuit held that sales made at times when the stock was well below its "class period high" were "so inauspiciously timed" they "d[id] not meet this test." 267 F.3d at 421 (quoting *Apple Computer* at 1118). *See also Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001) ("When insiders **miss the boat** [by selling at times when prices are well off the allegedly-inflated peak price], their sales do not support an inference" of scienter). Even sales of very high percentages of the seller's holdings will not support the inference if they are not made at suspicious times. *E.g., Ronconi* at 435 (seven defendants who each sold at least 69% of their respective holdings); *Wenger* at 1238, 1251 n.6 (sales of 25%, 26%, 32%, 38%, 36%, 40%, 65%, 91%, and 100%); *Vantive* at 1093-96 (sales of 74%, 26%, 32%, 48% and 55%).

c. Inconsistency with Established Prior Practice. Even significant sales at fortuitous times will not be sufficient unless they are shown to be "**dramatically out of line** with prior trading practices." *Silicon Graphics* at 986. *See Greebel v. FTP Software*, 194 F.3d 185, 198 (1st Cir. 1999) ("must be unusual, well beyond the normal patterns of trading by those defendants"). Thus, the existence of trades prior to the class period – or even "unsuspicious" trades earlier in the class period – can prevent any inference of scienter from subsequent, similar trading. *E.g., In re BMC* 183 F. Supp. 2d at 901; *Vantive*, 283 F.3d at 1096 (no inference from insider's sale that "was not out of keeping with his unsuspicious trading history earlier in the class period.").

d. Inference Not Negated by other facts in the Pleadings. Finally, the case law also makes clear that, where pleadings reveal facts that explain or justify even otherwise-arguably-

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(...continued)
denied, 446 U.S. 939, 100 S.Ct. 2159, 64 L.Ed.2d 792 (1980) (sale of large block of shares nine days prior to public announcement that "problem loans" had increased from $7 million to $16 million); *Jefferies & Co. v. Arkus-Duntov*, 357 F. Supp. 1206 (S.D.N.Y.1973) (sale of shares two days before the SEC suspended trading in the stock).

suspicious sales or make the scienter inference less plausible, those facts may negate any strong inference of scienter. *E.g., Greebel v. FTP Software*, 194 F.3d 185, 206 (1st Cir. 1999) ("**closer look provides ready explanations**" of trades that otherwise "could be suspicious," since the **seller had retired** in that time frame); *In re BMC Software,* No. H-99-715 (S.D. Tex. Jun. 28, 2000) (Hittner, J.) (Herein "*BMC* 2000"), at 30 (sale representing exercise of an **option about to expire** is not suspicious); *Vantive*, 110 F. Supp.2d at 1219; *Allison*, 999 F. Supp. at 1352-53 (fact that the others allegedly involved in wrongdoing were **purchasing stock** makes it "particularly difficult" to establish scienter based upon stock sales).

3. The Plaintiffs' Allegations About the Outside Directors' Stock Sales are Insufficient to Establish Scienter for Each of the Outside Directors

Insider trading-based scienter allegations must ultimately be judged and analyzed on a person-by-person basis. *E.g., Allison v. Brooktree*, 999 F. Supp. 1342, 1352 (S.D. Cal. 1998) ("Since scienter must be pled as to each defendant, the court analyzes the stock sales of each defendant."). Even so, a number of observations common to and/or about a similarly-situated or "equally knowledgeable" group can be relevant to the individualized analysis. *See Vantive*, 283 F.3d at 1092-96 (dismissing after examining in detail "the specific circumstances of each of the defendant's stock sales alleged in the complaint, and the circumstances of the defendants' stock sales overall").

a. The Fact That Most of the Outside Directors *Sold No Stock At All* Negates Any Inference of Scienter

Creating a strong inference of scienter from insider trading for Outside Directors is particularly difficult where, as here, most of the Outside Directors are not even alleged to have engaged in any trading.[19] As the Fifth Circuit recently reiterated in this context, "the fact that other defendants did not sell during the class period undermines plaintiffs' claims." *Nathenson*, 267 F.3d at 421 (quoting *Acito v. IMCERA Group Inc.*, 47 F.3d 47, 54 (2nd Cir. 1995)); *see Advanta*, 180 F.3d

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[19] Outside Directors Mendelsohn, Meyer, Ferraz Pereira, Savage, Urquart, Wakeham, Walker and Willison and Winokur have no alleged trades and are not accused of fraud.

at 541 (absence of any sales by three individual defendants "rais[es] doubt whether the sales were motivated by [fraudulent] intent") (citing *Acito*); *Leventhal v. Tow*, 48 F. Supp. 2d 104, 114 (D. Conn. 1999) ("the allegation of insider trading [to show scienter] is undermined by the fact that only three of the five named individual defendants sold their stock during the class period."). The same is true where others similarly situated had only small or non-suspicious trades. *See, e.g,, Ronconi* at 436.

Particularly where, as here, the Plaintiff offers no allegations meaningfully differentiating the role or knowledge of the directors who sold from those who did not sell, the fact that the majority of the Outside Directors were <u>not</u> sellers undermines any inference of scienter for all members of the group. *See Ronconi* at 436 (potential inference from isolated individuals' sales is mitigated where "other, **equally knowledgeable** insiders" were not engaged in suspicious trades) (emphasis added). Thus the overall *lack* of substantial or unusual selling by the Outside Director group negates any potential adverse inferences for the handful who happened to have sold in larger amounts or at fortuitous times.

b. Many Outside Directors Actually Increased Their Enron Holdings.

Plaintiffs' Complaint fails to acknowledge purchases or acquisitions of Enron shares by the Outside Directors, but even the limited information before the Court indicates that *at least* eight Outside Directors actually increased their holdings in 1998-2001,[20] including three[21] of the eight

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[20]See Ex. A hereto (summarizing proxy statement holdings disclosures for Outside Directors whose increase in holdings could be discerned from the 1998-2001 Proxy Statements) (Chan, Jaedicke, LeMaistre, Mendelsohn, Meyer, Pereira, Savage and Wakeham). On a motion to dismiss, it is proper for the Court to consider Enron's annual proxy statements (SEC App. Tabs 88 & 20-22 and the Forms 3, 4 and 5 of the Outside Director Defendants (attached as Exs. E-M. *See In re BMC Sec. Litig.*, 183 F. Supp. 2d at 864. In addition, the charts attached as Exs. A-E may be considered as summaries of information found in the proxy statements, and SEC forms. *Id.* ("Summary chart may be included because the underlying documents are also submitted for consideration by the Court and thus not hearsay").

[21]Chan, Jaedicke, and LeMaistre, as discussed in part III(B)(3)(g) below.

Outside Directors who are accused of some sales. Thus the *vast* majority (at least twelve) of the Outside Directors either (1) had no sales, (2) actually increased their holdings, or (3) both. This fact further negates any inference of scienter for <u>all</u> of the Outside Directors. Sales by some of a group of equally knowledgeable insiders "do not support the 'strong inference' required by the statute where the rest of the equally knowledgeable insiders act in a way inconsistent with the inference that the favorable characterizations of the company's affairs were known to be false when made." *Ronconi*, 253 F.3d at 436. The fact that many of the Outside Directors actually *increased* their holdings makes it very difficult, if not impossible, to make to a strong inference that the acts of the group were motivated by the knowledge or belief that the stock price was artificially inflated by misrepresentations. *Cf. Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1353 (S.D.Cal. 1998) (plaintiff had "particularly difficult task" trying to show scienter based on insider trading where key figure was "purchasing, and not selling, stock").[22]

c. The Outside Directors Sold Only Small, Non-Suspicious Portions of Their Holdings

The Courts have routinely held that sales of only a modest portion of one's stock holdings is inherently unsuspicious. The district court in *Vantive*, for example, noted that while the group had collectively sold about 38% of their stock, this "necessarily means that they retained 62 percent of it." 110 F. Supp.2d at 1219. This court has echoed that analysis. *Waste Management,* Slip Op. at 131.

Analysis of the alleged percentages of stock sales by the defendants in this action must first be placed in the context of the unusually long class period here: 37 months. Since stock and options are a form of compensation and selling is thus wholly normal under the law, *Burlington* at 1424, it

[22] Despite his purchase of over 25,000 shares during the class period and absolutely no sales, Finance Committee chairman Herbert Winokur's holdings did not increase. See Ex L; SEC App. Tabs 88 & 20-22. SEC records reveal the explanation: gifts of shares to charity. Ex L (Transaction code "G" for gift). Winokur's purchases -- and lack of sales -- are inconsistent with, and negate, any inference of scienter for the group. *Cf. Allison*, 999 F. Supp at 1353 (no scienter where powerful figure in group was "purchasing, not selling, stock.")

is obvious that one would expect more sales in a three-year class period than in a class period that lasted only a few months. The Ninth Circuit's 2002 opinion in *In re Vantive Corp. Securities Litigation*, 283 F.3d 1079 (9th Cir. 2002) noted that Mr. Lerach and Milberg Weiss had "selected an unusually long class period of sixty-three weeks [fifteen months]" and noted with some disapproval that "lengthening the class period ha[d] allowed the plaintiffs to sweep as many stock sales into their totals as possible." *Id.* at 1092. The Court's analysis of the potential "suspiciousness" of the amounts sold thus took into account the longer period. For one executive who sold a cumulative 26% of his stock in the fifteen-month period, the Court held, for example,

> The unusually long class period inflates [the individual's sales percentage]. It is not inherently alarming or unusual that an insider might sell a quarter [26%] of his holdings over the course of fifteen months.

Id. at 1094. The class period here is about 2 ½ times as long as the "unusually long" one in *Vantive.* With such an even-more-unusually long class period, cumulative sales of well over 50% would not be unusual or suspicious in amount.

In *Silicon Graphics*, the court found average sales of about 10% (with individuals ranging up 75%) to be insufficient to give rise to an inference of scienter, *even in a class period lasting only **fifteen weeks***. *Silicon Graphics* at 985-86 and 987. This Court's recent ruling in *Waste Management* found no strong inference of scienter even when individuals sold 27.2 and 39.6% of their stock in just a **five month** class period. *Waste Management*, Slip Op. at 16 and 131. In *Ronconi*, the court found that a sale of 17% of holdings during a seven-month period was so clearly "not suspicious in amount" that the Court did not even address whether the timing was suspicious. 253 F.3d at 435.

The Outside Directors' sales rates – taking into account the length of the class periods – were substantially below those that have been consistently ruled nonsuspicious as a matter of law. Dividing their sales into one-year periods (to make them more comparable to the case law) shows that the annual rate of sales by these Outside Directors is quite typical, and is actually lower than the selling rates found to be non-suspicious in the ample case law:

Annual Sales Percentage of Available Holdings

	1998	**1999**	**2000**	**2001**[23]
Robert Belfer[24]	0.0%	5.2%	8.1%	7.2%
All Other Outside Directors Accused of Fraud	2.2%	9.9%	7.6%	10.9%
All Outside Directors (except Belfer)	1.5%	6.9%	5.3%	7.6%

See Exh. B (compiling figures from NCC Ex. C and NCC ¶ 402). *Cf., e.g., Silicon Graphics* at 985-87 (10% average in fifteen week class period); *Vantive* at 1219 (38% average in fifteen month class period); *Waste Management*, Slip Op. at 16 and 131 (sales of between 27% and 39% in a five month period).[25] This analysis makes clear that the Outside Directors' annual sales percentage levels are at rates lower than those that have repeatedly been found to be insufficient as a matter of law to be deemed suspicious in amount or to support an inference of scienter.

d. The Outside Directors' Sales Were Not Suspiciously Timed

The Outside Directors' sales do not meet the standard of having been "at times calculated to maximize the personal benefit from the undisclosed inside information." *Silicon Graphics*, 183 F.3d

[23] 1998 and 2001 include only the portions of those years during the class period.

[24] Because Mr. Belfer's holdings are many times that of the remainder of the group, weighted averages including Mr. Belfer would not be meaningful, so Mr. Belfer's percentages are presented separately. Figures for the group are weighted averages, as calculated at Ex. B hereto. Percentages are based upon the accused sales figures in the complaint (set out by date in NCC Ex. C) and the "available holdings" figure as calculated and alleged by Plaintiffs at ¶ 402.

[25] If the time periods in *Vantive*, *Silicon Graphics* and *Waste Management* were made comparable to the three-year class period in this case, the typical sales in those cases – all found to be normal and non-suspicious – would have accumulated to at least 90 percent of holdings. In *Silicon Graphics*, for example, selling at a rate that totaled 10% of holdings in fifteen weeks would accumulate to 100% of holdings if continued through a class period three years long – yet they were held "not suspicious" as a matter of law.

at 986. Though Enron's stock was frequently at $70 or more for well over a year, only a small fraction of the Outside Directors' sales were at or above that price.

Sales at Specified Price Levels as Percentage of All Sales

	$20 - $30	$30 - $40	$40 -$50	$50 - $60	$60 - $70	$70 - $80	$80 - $90	TOTAL
Robert Belfer	5.3%	5.5%	24.7%	31.9%	26.9%	3.7%	2.1%	100%
All Other Outside Directors Accused of Fraud	8.6%	20 3%	10.7%	30.0%	9.3%	6.4%	14.8%	100%

Ex. C. (Compiling figures from NCC Ex. C and NCC ¶ 402). Where, as here, the bulk of the accused sales are made at times when the prices were far from their peak levels,[26] one cannot draw a strong inference of scienter. The Ninth Circuit recently analyzed insider sales made at around $55 a few months before a stock spiked to $73, and concluded that "[w]hen insiders miss the boat this dramatically, their sales do not support an inference" of scienter. *Ronconi*, 253 F.3d at 435. *See Nathenson*, 267 F.3d at 421 (sales well below "class period high" were "so inauspiciously timed" they "d[id] not meet th[e] test."); *Greebel*, 194 F.3d at 206 ("timing does not appear very suspicious" where stock was not "sold at the high points of the stock price."); *Vantive*, 283 F.3d at 1093-96 (sales made at $20 to $25 were not suspicious – even if in substantial quantities – where stock price peak was several months later at $40).[27]

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[26]Plaintiffs actually concede repeatedly in their pleading the sensible fact that it would be quite normal for selling to increase when the stock reached higher values. NCC Ex. B at 14 ("insiders will tend to sell after a period when the company's stock price has substantially increased."). Interestingly, the Outside Directors' sales do not even reflect this "sensible" approach; very few sold during 2000 when the stock price was soaring. Such "inauspicious" timing negates any strong inference of scienter.

[27]Plaintiffs' graphical methodology for expressing supposedly-suspicious timing is quite misleading. Plaintiff's bar charts reflect quarterly sales in dollar proceeds, not shares. Thus, the sales *appear to be* much more significant at the times when the stock was at its highs of $70 to $90, but in fact much of what is portrayed is simply the mathematical fact that *proceeds* are higher when share prices are higher. Plaintiff's summary chart at ¶403 is a prime example. Plaintiffs use the chart to argue that that overall insider selling "escalated massively" as Enron's stock reached its highs. NCC at ¶403. But some simple math indicates that the actual number of shares sold each quarter from midyear 2000 through early 2001 – when the stock price was at its peak range -- is comparable to or <u>lower</u> than the shares sold in the first two quarters of 1999 when the share price was still generally in the $30s.

The chart above showed the percentage of the sales that occurred within the price ranges shown. Perhaps more telling is the chart below, showing the percentage of the Outside Directors *holdings* that were sold at each of these price levels.

Sales at Specified Price Levels as Percentage of Holdings

	$20 - $30	$30 - $40	$40 -$50	$50 - $60	$60 - $70	$70 - $80	$80 - $90
Robert Belfer	1.1%	1.1%	5.1%	6.5%	5.5%	0.8%	0.4%
All Other Outside Directors Accused of Fraud	2.6%	6.2%	3 3%	9.2%	2.9%	2.0%	4.5%
All Outside Directors (except Belfer)	1.8%	4.3%	2.3%	6.4%	2.0%	1.4%	3.1%

See Ex. D. Plaintiffs would have the Court draw a "strong inference" that the Outside Directors were motivated by a desire inflate the stock price to artificially high levels and sell their shares at those high levels. But the Directors sold only very tiny fractions (less than 5%) of their stock at those high prices ($70 or more), a fact that wholly undermines Plaintiffs' story, and thus undermines any potential strong inference of scienter. Since Enron stock frequently traded at $70 or more during a period of about fourteen months, *see, e.g,.* NCC Ex. B (Chart D) and Ex. C, the Outside Directors' minimal selling at higher levels negates an inference of scienter.

e. Plaintiffs' Own Statistical Trading Analysis Indicates that the Outside Directors' Trades are Not Unusual or Suspicious

Significantly, Plaintiff's own "tests" of whether the insiders' trading was unusual or suspicious actually exonerate the Outside Directors, and thus negate any inference of scienter. Plaintiffs base their allegations of "unusual" trading in large part on an "expert" report and statistical analysis that plaintiffs incorporate into their Complaint. NCC ¶ 401-15 and NCC Ex. B.[28] As explained more fully below, even Plaintiffs' own articulated criteria actually indicate that Outside Directors' sales were not suspicious or unusual at all.

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[28]Plaintiff contends that it obtained and analyzed statistical input information for all officers and directors. NCC Ex.B at 19, ¶17 (plaintiff "obtained all Form 3, 4, 5, and 144 filings for Enron share trading). The Outside Directors, however, do not concede in any way the validity or accuracy of Plaintiffs' statistical methods or results.

1. Plaintiffs' Statistical Analysis of Option Exercises Exonerates the Outside Directors

Plaintiff's Complaint acknowledges that, even based upon Plaintiffs' own expert analysis, normal, rational insiders acting without any improper "scienter" will have an economically rational motivation to exercise options well before their expiration date *if* the market price of the stock becomes significantly higher than the option's strike price. Though Plaintiffs claim that exercise of options that are *not* "deep-in-the-money" could be suggestive of trading on knowledge of undisclosed, adverse inside information, "exercises [that are] deep-in-the-money c[an] be explained by wealth diversification and risk aversion" -- motivations wholly independent of fraudulent intent. NCC Ex. B at, e.g., 23-24 n.27. The body of Plaintiff's Complaint initially defines "deep-in-the-money" for this purpose as being where "the market price is at least *four times* the strike price." NCC ¶ 408 (emphasis added), but Plaintiffs' more detailed report states that such trades would be rationally motivated by normal economic (not fraudulent) incentives "when the **stock price was at least three to four times greater than the exercise price**." NCC Ex. B at 16 n.21.

Three of the Outside Directors accused of fraud -- Messrs. Jaedicke, LeMaistre and Blake -- had no stock sales other than exercises of their stock options received as compensation from Enron.[29] All of those sales were at prices at least three to four times the strike price:[30]

[29]NCC Ex. C details all accused sales. The corresponding SEC filings for those directors for those days reveal whether the reported sale was associated with an option exercise. *See* Ex. E. The purchase price under that option exercise is also set forth on that same filing.

[30]Alleged sellers, dates and market sale prices are from NCC Ex. C. Option exercise (strike) purchase prices are from the SEC Forms referenced and relied upon by Plaintiffs at NCC Ex. B at 19; copies of these forms are attached as Exhibit E of this Motion. Ratios are simply computed by dividing the sales price by the option exercise price.

Director	Date	Market (Sale) Price	Option Exercise (Strike) Price	Ratio
Jaedicke	02/24/2000	65.94	7.16	9.2
	05/02/2001	61.00	7.03	8.7
LeMaistre	01/06/1999	29.72	5.34	5.6
	12/28/1999	42.62	7.16	6.0
	05/10/2001	58.64	7.03	8.3
Blake	10/31/2000	80.44	14.88	5.4
			17.38	4.6
			17.69	4.5
			20.44	3.9
			20.44	3.9

See Ex. E hereto (summarizing attached SEC Forms reflecting option exercise sales). Because the ratios on all these trades are 3.9 to 9.2 – easily "**at least three to four**" -- Plaintiff's own analysis establishes that no adverse inference of scienter can be drawn from any of the sales by these three Outside Directors.

As discussed below, Mr. Foy also had sales related to option exercises which are similarly exonerated by Plaintiff's own analyses of option exercises. Indeed, Plaintiffs identify 120 of the insiders' option exercises as irrational (and thus suspicious) under their analysis, but **none are by the Outside Directors**. NCC ¶ ¶ 23-24 25.[31]

2. Plaintiffs' Statistical Analysis of Trading Pattern Timing Also Negates Inferences of Suspicious Timing

Plaintiffs' Complaint recites a second "statistical analysis", done to determine whether, in Plaintiffs' view, the timing of various insiders' trading patterns were "independent of the possession

[31]Exhibit E lists trades by Outside Directors that were found, under Plaintiff's own test, to be "at least three to four" times the strike price and thus economically explained in absence of improper motivation, so that none of these sales can give rise to an inference of improper scienter.

and use of material non-public adverse information." NCC ¶415. Plaintiffs' reported results indicate that – even using the Plaintiff's own selected criteria -- the sales by six of the eight directors who sold *statistically cannot* be attributed to such improper motivations. *Id.* Thus, even Plaintiffs' own expert and analyses cannot draw any inference of scienter from these Outside Directors' trades. Plaintiffs thus effectively exonerate Directors Blake, Chan, Duncan, Foy, Gramm, and Jaedicke from any alleged inference of scienter based on their trading patterns. *E.g., Vantive* 283 F.3d at 1092 (no strong inference where timing and pattern are not suspicious).

In this analysis, Plaintiff does claim that the sales by Mr. Belfer and Dr. LeMaistre were "consistent with foreknowledge that the share price of Enron was inflated,"[32] NCC Ex. B at 10 ¶f, and thus Plaintiff concludes, with little explanation, that the trades were not "independent of the possession and use of non-public adverse information." NCC ¶ 415. Though Mr. Belfer's and Dr. LeMaistre's sales and "scienter" are discussed below in part III(B)(3)(g)(4&8), the following observations are offered about the Plaintiff's purported conclusions in this analysis:

1. <u>Computer-Generated Scienter Judgment</u>: Perhaps most importantly, reliance on Plaintiff's purported statistical determination of a scienter inference is necessarily inconsistent with the case law. The law is clear, as discussed above, that in assessing scienter, consideration must be given to, for example: (a) the proportion of the amount sold to the seller's total holdings; (b) factors personal to the seller, like a recent or impending retirement or an impending option expiration; (c) the effects of trading restrictions or the vesting or expiration of options; and (d) potential negating of the inference by the lack of sales of others similarly situated. Plaintiff's computer statistics do not purport to take into account any of these legally-required considerations and thus cannot substitute for the Court's judgment.

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[32]Even ignoring the infirmities in plaintiffs' statistical calculations, the assertion or conclusion simply that an individual's trading is "consistent with" improper scienter is insufficient. The test is not simply whether one's sales patterns are not inconsistent with the actions of one who has improper scienter. The test is whether one's selling is so unusual and suspicious that one could rationally conclude, based solely upon those trades, that the seller was knowingly acting improperly.

2. Level of Confidence: Plaintiff's own pleading acknowledges that its conclusions as to Messrs. Belfer and LeMaistre do not meet accepted standards for statistical validity. Unlike even the purported conclusions about certain of Enron's management, the conclusions offered about Messrs. Belfer and LeMaistre are only to a statistical "level of confidence" of **60%**.[33] NCC ¶415 and NCC Exh. B at 10-11 n. 6. Statistically, this is all but meaningless and surely does not support a "strong" inference; even the Plaintiffs explicitly acknowledge that the "scientific [statistical] acceptance standard" is 95%. NCC ¶ 415.[34]

A test using a 60% "level of confidence" necessarily implies an admitted 40% chance that the test will indicate a statistical relationship even where none actually exists – i.e., a 40% rate of false positives (and thus false accusations) each time the test is applied. *See, e.g., Hodges v. Dept. of Health and Human Services*, 9 F.3d 958, 965 n.4 (dissent) (95% confidence level means "a 5 percent chance of indicating a relationship which does not in fact exist."). Thus, **each time** such a test is applied to a wholly "innocent" trader, there is a **40% chance** it will erroneously identify him as having improperly traded on inside information. Applying the test to, say, eight Outside Directors who traded "innocently" would be expected to **falsely implicate** about three (40% x 8 directors = 3.2) of them. Accordingly, the fact that Plaintiffs' test has selected only two Outside Directors (out of eight who sold and seventeen in total) is far from damning – to the contrary, it is entirely

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[33]Plaintiff does claim that these gentlemen and others "avoided a loss with a high degree of confidence (99%)." 11 NCC Ex. B at 10 (¶f) and 36 (¶45). While this meaningless statement permits Plaintiff to put a high percentage onto the page, it does little else, since it is neither relevant nor disputed that all sales of stock ultimately "avoided a loss," at least as compared to holding that stock into the bankruptcy. Avoiding a loss cannot support an inference of scienter.

[34]To the extent that a declaration of an expert can have any effect at all, it can do so only if the expert states "facts" constituting some evidence of scienter. *See, e.g., Demarco v. Depotech Corp.*, 149 F. Supp. 2d 1212, 1222 (S.D.C al. 2001) ("Conclusory allegations [in a complaint] carry no additional weight merely because the plaintiff placed them within the affidavit of a retained expert.") *aff'd* 2002 WL 461217 *1 (9th Cir. Feb 21, 2002). The *Demarco* court held that consideration of expert opinions incorporated into a plaintiffs' complaint was improper, in part because it would require a *Daubert*-style hearing to determine whether the opinions could be considered at all. *Id.* at 1221. Such concerns are even more explicit where, as here, the Plaintiffs have acknowledged that the statistical "conclusions" they rely on are far below the standard of "scientific acceptance." *See* NCC ¶ 415.

consistent with the premise that all the directors' trades were "innocent" or random. Plaintiffs' analysis actually negates any inference of improper scienter.

3. Inconsistency with Plaintiffs' Other Statistical Analysis: As noted above, Dr. LeMaistre's sales were from option exercises which were analyzed, explained and exonerated under Plaintiffs' own specific analysis tailored to address option exercises. That analysis indicated that Dr. LeMaistre's decision to exercise those options when he did was rationally explainable economic behavior, not attributable to use of inside information. Plaintiffs' second statistical analysis apparently "forgets" – i.e., does not take into account – the prior conclusion that the reason and timing for each of Dr. LeMaistre's stock sales is explained and justified by other known causes (in that case the multiple by which the option was in the money). The model's obvious inability to incorporate facts that *even the Plaintiffs acknowledge* negate any inference of scienter is a fatal flaw in the model's utility – even for the two Outside Directors who were "accused" by it.

f. Plaintiff's Allegations of Prior Selling Practices are Insufficient

Plaintiffs apparently recognize that the prevailing case law clearly requires plaintiffs to plead prior selling history in order to establish whether an insider's sales are dramatically out of line with prior practice. *E.g.*, *BMC*, 183 F. Supp.2d at 901 (trading history pled "is too limited to give rise to an inference of intent"); *Vantive*, 283 F.3d at 1095 ("When a complaint fails to provide us with a meaningful trading history for purposes of comparison, we have been reluctant to attribute significance to the defendant's stock sales."); *Ronconi*, 253 F.3d at 436 ("plaintiffs have not alleged sufficient trading history for us to conclude her trading was dramatically out of line with prior trading practices").

Plaintiffs' charts and figures, however, compare trading in the thirty-seven month class period to only the prior twenty-seven months. Aside from the inherently misleading apples-and-oranges nature of Plaintiffs' comparisons of share and percentage sales between two unequal periods, Plaintiffs' use of a prior 'base' period a year shorter than the class period itself is insufficient to establish a base of comparison.[35] Plaintiffs' pleading deficiency bars, or at a minimum weakens, any possible inferences to be drawn from the trading history provided. *Cf. BMC* at 901 (analyzing 1997, 1998, 1999 and 2000 trading history against 11-month class period).

g. Individual Analysis of Each Outside Director's Trades Confirms the Lack of Any Basis for A Strong Inference of Scienter

As noted above, the Court must make its scienter judgments on an individual basis, and the Plaintiff must make sufficient scienter allegations for every accused defendant. *E.g., Allison v. Brooktree*, 999 F. Supp. 1342, 1352 (S.D.Cal. 1998) ("Since scienter must be pled as to each defendant, the court analyzes the stock sales of each defendant."); *Vantive*, 283 F.3d at 1092-96 (examining in detail "the specific circumstances of each of the defendant's stock sales"). The court must, therefore, examine each of the Outside Directors' accused sales. Fortunately, the task is fairly simple: Of the eight Outside Directors who sold in the class period, four (Blake, Chan, Duncan and Gramm) had only a single sale each;[36] one (Robert Jaedicke) had two sales in those three years, and two (Foy and LeMaistre) had three sales. Only Mr. Belfer – one of Enron's largest stockholders -- had more than three.

1. Joe Foy

Plaintiffs' Complaint acknowledges that Joe Foy retired from the Board in early 2000. NCC ¶ 83 (cc) (board member "until 6/00"); *see also* 1999 and 2000 Proxy (Foy no longer on Board listing in 2000; Foy's age was 72 in 2000). Plaintiffs claim, however, that Mr. Foy's sale during 1999 and 2000 of an alleged total of 48% of his Enron holdings (36.9% in 1999 and 11.6% in

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[35] Plaintiffs' analysis also fails to recognize, for example, that Mr. Chan was not a director for all of the prior comparison-period. He joined the board during 1996. *See* 2001 Proxy (SEC App. Tab 22) at 2.

[36] Though Plaintiff's Exhibits sometimes divide them up, split "transactions" on the same day at the same price are treated here as a single sale. (*See, e.g.*, NCC Ex. C, showing five entries for "Blake", at on the same day at the same price.) One inconsequential alleged sale by Dr. Gramm (72 shares sold for less than $2,000 in December 1998) is ignored.

2000)[37] is sufficient to establish a strong inference of scienter on Mr. Foy's part. Courts have recognized the obvious with respect to a person retiring from their position at a company: "It is not unusual for individuals leaving the company . . . to sell shares." *Greebel v. FTP Software*, 194 F.3d 185, 206 (1st Cir. 1999). The *Greebel* court ruled that even very significant sales that otherwise "could be suspicious" were readily explained by the fact that the seller had retired, and thus gave no inference of scienter. *Id.; see In re First Union Corp. Securities Litigation*, 128 F. Supp.2d 871, 898 (W.D.N.C. 2001) (concurrent resignation rebuts suggestion that stock sale was suspicious); *Acito v. IMCERA Group Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (outside director's sale of 350,000 shares was not "unusual" for purposes of establishing scienter where "complaint acknowledges that [he] had retired" at around that time). Mr. Foy's sales in 1999 and 2000 cannot support any inference of improper scienter, much less the required "strong" inference.

Even ignoring Foy's retirement, his sales are insufficient to establish an inference of scienter in any event. Foy's sales were also "so inauspiciously timed" that they cannot raise any strong inference of scienter. *Nathenson,* 267 F.3d at 421. Three quarters of his accused sales (29,040 of 38,160 shares sold) were in early 1999 at about $34 per share – missing by over a year and a multiple of nearly three the $90 peak the stock reached much later in the class period. NCC Ex. C. Plaintiff's Complaint also acknowledges that Foy had previously sold nearly 10,000 shares *before* the class period at a price of about $23 per share. NCC ¶83(cc) (showing $225,065 proceeds from 9,920 shares in late 1996). Since the scienter inference requires that sales be "at times calculated to maximize the personal benefit from undisclosed inside information," Foy's sale of the vast majority of his stock (both before and after the class period's start) long before the stock price soared negates any suggestion that Foy's trades could ever support an inference of improper scienter. *Cf. Vantive*, 283 F.3d at 1093-96 (sales at $20-25 do not imply scienter when stock's peak was months later at $40).

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[37]NCC ¶ 83(cc), 402. Percentages are derived using Plaintiff's detail of alleged sales (App. B, Ex. C) and Plaintiff's figure for total "Available Holdings" at ¶ 402 (chart).

As noted above, Plaintiffs' statistical analyses did not "flag" any of Foy's trades or trading patterns as unusual. To the contrary, the majority of Foy's accused sales (30,400 of the 38,160 shares) were exercises of options, where the market price was "at least three to four times" the strike price, a circumstance that Plaintiffs' Complaint acknowledges to be wholly rational economic behavior *in absence of* any improper motivations. See part III(B)(3)(e)(1) above and NCC Ex. B at n.21 and NCC Ex. C.[38]

Finally, Foy's substantial sale before the class period also indicates that his class period sales were not dramatically out of line with his prior practice. Plaintiffs acknowledge that Mr. Foy had sold nearly 10,000 shares in late 1996 – more shares than he sold in 2000 when prices were high. *See* NCC ¶(83(cc) (chart) (9,920 shares in 4Q1996).[39]

Mr. Foy's trading cannot support a strong inference of scienter.

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[38]Mr. Foy's sales include the following option exercises, totaling 30,400 shares, where the market price was at least three to four times the exercise price.

Shares	**Date**	**Market (Sale) Price**	**Option Exercise (Strike) Price**	**Ratio**
7,360	2/25/99	33.56	7.16	4.69
8,000	2/25/99	33.56	7.03	4.77
5,920	3/18/99	34.51	9.31	3.71
3,600	1/21/00	71.50	17.38	4.11
3,072	1/21/00	71.50	20.44	3.50
2,448	1/21/00	71.50	20.69	3.46

See Ex. E.

[39]Plaintiff's meager pleading of prior period sales practices reaches back only a little over two years and thus omits another sale by Foy in 1995 in the identical amount of nearly 10,000 shares. *See* Ex. F hereto.

2. Dr. Wendy Gramm

Plaintiffs assume a strong inference of scienter on the part of Dr. Wendy Gramm because she is alleged to have sold all or substantially all of her then-remaining stock during the Class period.[40] Plaintiff's own pleading, however, shows that Dr. Gramm's sale (around 10,000 shares) was in the first month of the class period – in November 1998 – at a price of $27 per share. The February 1999 proxy statement showed that she no longer held any Enron stock or options. 1999 Proxy (SEC App. Tab 20) at 8 (chart).

The fact that Dr. Gramm divested all her stock, at a low price, long *before* the alleged scheme ever came to fruition is a fact that *negates* -- rather than establishes -- any sensible inference of scienter. *See, e.g., Vantive*, 283 F.3d at 1093 (sale of majority of an insider's holdings in "*first month*" of the class period at price well before and below the "peak" is not suspiciously timed); *Ronconi* at 436 (sales made "too soon to be taking advantage" of the allegedly artificial run-up in price do not indicate scienter). The $27 selling price is substantially unchanged from the price a few days earlier when the class period began, *see* NCC Exh. C (listing 10/19/1998 price at $26.38), and less than a third of the stock's peak price reached about two full years later. There is nothing suspicious about such "inauspicious" timing. *Nathenson*, 267 F.3d at 421 (sales made well below stock's "class period high" were "so inauspiciously timed" they "d[id] not meet this test.").

In any event, Dr. Gramm's divestiture of her holdings is explained by the 1999 Proxy, a document relied upon by the Plaintiffs and properly before the Court on this motion. The 1999 Proxy disclosed that Dr. Gramm had, in late 1998, submitted an opinion of counsel indicating that as the "wife of Senator Phil Gramm" she "could have a material conflict of interest [if she] maintained ownership of Enron stock." 1999 Proxy (SEC App. Tab 20) at 12. The Proxy disclosed that as a result of this request, Dr. Gramm would no longer participate in the company's stock or

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[40]Plaintiff alleges a sale of 84% of her then-remaining stock. NCC ¶83(z), ¶ 402. The 2000 and 2001 Proxies reflect that by February 2000, Dr. Gramm owned no (0) shares. Note also that one inconsequential alleged sale by Dr. Gramm (72 shares sold for less than $2,000 in December 1998) is ignored in this discussion.

option plans. *Id.* Dr. Gramm's sale of shares in that late 1998 time frame, therefore, is not suspicious at all. *Cf. Greebel* at 206 (sell off of majority of holdings which otherwise "could be suspicious" were readily explained by other facts in the record – e.g., the seller's retirement).

Finally, it is impossible to suggest that Dr. Gramm's trades were out of line from her prior trading. Plaintiffs' own pleading demonstrates that Dr. Gramm had sold about 8,000 shares in 1998 before the class period. NCC ¶83(z) (chart). Thus, Dr. Gramm's accused sale of about 10,000 shares is not significantly out of line with her prior trading practice and thus cannot be considered unusual. Further, Dr. Gramm's trades were not even identified as suspicious by either of the Plaintiffs' own statistical analyses. Plaintiffs' allegations of scienter for Dr. Gramm are wholly inadequate.

3. Robert Jaedicke

Dr. Jaedicke had two sales in the class period. SEC forms relied upon by the Plaintiffs show clearly that both sales were the exercise of options at strike prices of around $7 per share. *See* Ex. E hereto (summarizing attached SEC Forms on sales that were option exercises). *Both* of these exercises are exonerated under Plaintiffs' own stated "test" that exercises are economically justified and non-suspicious whenever the market price is at least three to four times the strike price – indeed the market price on Dr. Jaedicke's option exercises were around *nine* times the strike price. *See* Ex E hereto (showing strike and sale prices); NCC Ex. B at 16 n. 21 (stating the "three to four times" test); see also NCC Ex B. at 24 ¶25 (omitting Jaedicke's sales from those flagged suspicious).

Dr. Jaedicke's sales also were also not suspicious in amount. His accused May 2000 sale was about 8.6 % of his holdings, and his May 2001 sale was about 12.8%. NCC ¶ 402 (chart) and NCC Ex. C (listing individual sales). Annual sales of such low percentages have been consistently found "non-suspicious." *E.g., Ronconi*, 253 F.3d at 435 (CFO's sale of 17% of holdings in a seven-month class period was so clearly "not suspicious in amount" that Court did not address other factors); *Vantive*, 283 F.3d at 1094 (precedent established that 13% sales in a fifteen month period were not suspicious). Plaintiff's allegations indicate that Jaedicke had available holdings of over 62,000 shares, and thus about 49,000 shares that he did *not* sell. NCC ¶ 402 (chart). As this Court has observed, "[r]etention of the vast majority of [one's] stock negates any inference of scienter." *Waste Management*, Slip Op. at 131.[41]

Plaintiffs acknowledge that a sale arising out of exercise of an option that was about to expire is wholly expected and not at all suspicious. NCC ¶ 408 (restricting discussion to exercises "well in advance of the expiration date"); NCC Ex. B (critique limited to exercises "more than six months prior to expiration"). Plaintiffs then fail, however, to exclude from their analysis those exercises that were tied to impending expirations. *See also BMC* 2000 at 30. The very SEC forms upon which Plaintiffs base their insider trading allegations (and relied upon by Plaintiffs' purported expert) reveal very clear that Mr. Jaedicke's transactions involved exercises of options that were about to expire. *See* Ex. E hereto. Both of Dr. Jaedicke's sales were exercises of six-year options that were due to expire within 90 days of the transaction. *Id.* (5/02/01 exercise of options expiring 5/13/01; 2/24/00 exercise of options expiring 5/14/00). Since the timing and amount were driven by the expiration date set ten years earlier, there can be nothing suspicious about this exercise.

Finally, despite his two sales, Dr. Jaedicke actually *increased* his Enron holdings consistently during 1998-2001. Review of the 1998-2001 proxy statements show increased holdings each year. Ex A. (holdings of 45,356 in 1998, increasing to 57,087 in 2001 proxy).[42]

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[41]Even at the pre-class period value of around $26 / share, Jaedicke's 62,000 shares would be valued at around $1.6 million – about *twice* the sum of his alleged $841,000 proceeds from his accused sales. NCC ¶ 402 (chart), ¶83(aa) (chart). The Court can make no sensible inference that Dr. Jaedicke was motivated by a preference for obtaining $841,000 of illicit proceeds rather than simply owning or selling stock worth $1.6 million.

[42]Even Dr. Jaedicke's May 2001 sale of 8,000 shares (NCC Ex. C), made after the 2001 proxy date, is insufficient to drop his holdings below where they were in the 1998 proxy.

For all these reasons,[43] Plaintiffs have failed to allege specific facts sufficient to establish that Dr. Jaedicke's sales are sufficiently suspicious to support a strong inference of scienter.

4. Charles LeMaistre

Like Dr. Jaedicke, all of Dr. LeMaistre's sales were exercises of options.[44] Dr. LeMaistre had three such exercises in the three year class period. As set forth in section part III(B)(3)(e)(1) above and Exh. E hereto, each of these exercise sales was at a market price that was "at least three to four times" the strike price of the option. Indeed they were all at market prices at least *five* times the strike price – a circumstance that Plaintiffs' own pleading acknowledges to be wholly justified economically, and thus entirely non-suspicious. NCC ¶ 408 and Ex. B.

As discussed above regarding Dr. Jaedicke's similar exercises, Plaintiffs' complaint acknowledges that exercising options that will soon expire is entirely non-suspicious. Through Plaintiffs' pleading fails to specifically allege this admittedly pivotal fact, the SEC forms on which Plaintiffs rely demonstrate that, like Dr. Jaedicke, Dr. LeMaistre's sales were spurred by impending option expirations -- a circumstance that negates any suspicious inferences to be drawn from the resulting sales. The three sales by LeMaistre were of three traunches of options expiring 5/8/99, 5/14/00, and 5/13/01, respectively. Ex. E. *See* discussion of Dr. Jaedicke at Part II(B)(3)(e)(3), *supra*.

Even ignoring the option expirations, Dr. LeMaistre's sales were not in suspicious amounts or at suspicious times. They were spaced about one year apart in January 1999, December 1999, and May 2001. The quantities represented 3%, 11% and 12% of the amount Plaintiffs alleges as his available holdings. *See* NCC Ex. C (1,984, 7,360 and 8,000 shares, respectively); NCC ¶402 (chart)

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[43] At some risk of belaboring the innocuousness of these trades, Dr. Jaedicke's trades were also not out of line from his prior practices. He had actually sold more shares, for example, in 1993-94 (17,856 + 3,984 = 21,840) (split-adjusted for 4-to-1 cumulative splits) at around $15 per share than he did in the entire three-year class period (13,360). *See* Ex. M hereto (figures split-adjusted) and NCC ¶83(aa).

[44] *See* Ex. E hereto and NCC Ex. C.

(holdings of 65,631). Annual sales of such small fractions of holdings are not suspicious in amount as a matter of law. *See, e.g.,Ronconi*, 253 F.3d at 435 (17% in seven months). Simple math reflects that Dr. LeMaistre retained nearly 75% of his stock. *Cf. Waste Management* ("Retention of the vast majority of their stock negates any inference of scienter."). Further, these sales were actually less than his prior practice: In 1993, he had sold 17,856 shares – more than his combined three-year total in the class period. Ex. G (split-adjusted for cumulative 4-to-1 split). Of equal importance, during the class period, his first two sales were in 1999 at prices of $29.72 and $42.62 – a year before and at half the price of the "peak." NCC Ex. C. The 2001 sale was at only $58.64, and was obviously very much in line with his prior history.

Finally, like Dr. Jaedicke, Dr. LeMaistre actually *increased* his holdings from 46,940 as reported in the 1998 Proxy to 56,287 as reported in the 2001 Proxy. Ex. A.

These facts cannot support the required strong inference of scienter.

5. Ronnie Chan

Plaintiffs' scienter allegation against Mr. Chan is based on a single sale of stock, in July 1999, at a price of $42.15. NCC Ex. C. Since the sale occurred months before the stock price soared and at a price less than half the class period high of $90, the sale is "so inauspiciously timed" that it cannot support an inference of scienter. *Nathenson*, 267 F.3d at 421; *see Ronconi*, 253 F.3d at 435 (sales at $55, months before price peak of $73, "miss the boat [so] dramatically [they] do not support an inference"); *Greebel*, 194 F.3d at 206 (timing not suspicious when not "at the high points of the stock price."); *Vantive*, 283 F.3d at 1093-96 (sales of even substantial percentages of stock at $20 to $25 were not suspicious since stock price peak was months later at $40). As noted above, Chan's sale was not flagged as suspicious even by Plaintiffs' own purported statistical analyses. NCC Ex. B. Chan's single trade was not suspiciously timed.

Chan's sales are exonerated for another reason as well: they are not suspicious in amount. According to Plaintiffs, he sold only 29% of his modest holdings. NCC ¶ 83(x), 402 (chart). Given the three-year class period, this amount is not suspicious. *Cf. Vantive*, 283 F.3d at 1094 ("not inherently alarming or unusual that an insider might sell a quarter [26%] of his holdings over the course of fifteen months."). Obviously, Chan retained a significant majority (71%) of his stock. Indeed, Chan actually spent cash to purchase stock and his holdings *increased* during the class period.[45] *Cf. Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1353 (S.D. Cal. 1998) (inference of scienter "particularly difficult" where individual was purchasing stock). The amount Chan sold – and the amount he acquired and retained – negate any inference of scienter.

6. John Duncan

The allegations against Mr. Duncan are also based upon inferences Plaintiffs try to draw from a single sale. Duncan sold what Plaintiffs allege to be 20% of his holdings in May 2001. NCC ¶ 83(y) and NCC Ex. C. Given the length of the class period, 20% is considered non-suspicious as a matter of law. *See, e.g., Ronconi*, 253 F.3d at 435 (sale of 17% of holdings during a *seven*-month period was so clearly "not suspicious in amount" that the Court did not even address whether the timing was suspicious.).

Plaintiffs' pleadings fail to directly acknowledge substantial *purchases* of stock by Mr. Duncan. Review of the 1998 - 2001 proxy statements (incorporated by the Plaintiffs) reveals that Mr. Duncan's holdings increased each year. Ex. A. SEC filings reflect purchases by Duncan in 1999, 2000, and 2001, in amounts of 9,920, 7,360, and 8,000 shares, respectively. Ex. I. If such purchasing does not wholly negate any inference of scienter, it surely mitigates any inference to be drawn from the isolated sale upon which Plaintiffs focus.

The Complaint and the case law reflect that selling is to be expected for "wealth diversification" or "estate planning" purposes. NCC Ex. B at ¶ 12 ("insiders will naturally tend to sell . . . over time for wealth diversification"); *Ronconi*, 253 F.3d at 435 ("corporate insider may sell

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45 The SEC Forms on which Plaintiff bases its case reflect a *purchase* by Chan in 1999. Ex. H. Chan's holdings were 4,536 in the 1998 Proxy and 14,876 in the 1999 Proxy, and had risen to over 19,000 by the 2001 Proxy. See Ex. A. Chan is accused of no sales after that 2001 Proxy date.

stock to . . . diversify his portfolio, or arrange his estate plan). The 2001 proxy verifies that Mr. Duncan was 74 years old at the time of the sale. SEC App. Tab 22 (2001 Proxy) at 2. Particularly given this context (and indeed, even without it), sales of an alleged 20% of holdings during a three-year class period is not at all suspicious in amount.

Neither is the timing of Mr. Duncan's sale at all suspicious. Enron's stock had generally been at prices above $70 per share for well over a year, and reached a peak of $90.00, yet Duncan made no sales at all. His sale at $57.42 in May 2001 so badly "miss[ed] the boat" that it cannot create an inference of scienter. *Ronconi*, 253 F.3d at 435. *See Nathenson*, 267 F.3d at 421 ("inauspiciously timed"); *Greebel*, 194 F.3d at 206 ("timing does not appear very suspicious" where insider sold only after price fell).

Duncan's modest and inauspicious sale – and his corresponding retention of 80% of his holdings -- permits a simple calculation that shows he did not even benefit from the run-up in share price that is central to the Plaintiffs' case. Plaintiffs plead his "available holdings" were about 174,000 shares. NCC ¶ 402 (chart). Even at the October 1998 pre-class-period price of about $26,[46] Duncan's holdings would have been worth **$4.5 million** ($26 x 174,000). The sales at issue in Plaintiffs' complaint yielded proceeds of **only $2 million**. NCC ¶ 402 (chart), ¶ 83 (y). It is nonsensical to imagine that Mr. Duncan's motivation was to start with holdings that were already worth $4.5 million and, through complicated deception, make off with proceeds of only $2 million. Duncan's minimal selling and resulting lack of profit negates any inference of scienter.

7. Norman Blake

Like Chan and Duncan, Mr. Blake has but one sale alleged in the class period. Like Jaedicke and LeMaistre, his only sale is from the exercise of options. As noted above in Part III(B)(3)(e)(1), his option exercise sales were at market prices "at least three to four times" the strike price, and thus are not suspicious even using Plaintiffs' own analysis and criteria. Even Plaintiffs' own statistical

[46]Plaintiff's allegations indicate share prices in October 1998 were approximately $26. *See, e.g.,* NCC Ex. B (alleged 10/98 sales by Frevert and Horton).

analysis of the timing of sales also did *not* identify Mr. Blake's trade as suspicious. NCC Ex. B; NCC ¶415 (chart).

Blake did have the good fortune of obtaining what in retrospect is a good price -- $80.44 -- for this stock sale. However, since Plaintiffs' pleadings show that Enron's stock traded at $75 or more for most of a period of **several months** (NCC Ex. C (detailing sale dates and prices)), it is impossible to consider it suspicious that this one director happened to sell in that time frame. In any event, Plaintiffs' pleadings acknowledge the obvious with respect to a company whose stock price rises to record heights: it is always the case that "insiders will tend to sell after a period when the company's stock price has substantially increased." NCC Ex. B at 14. *Cf. In re FVC Securities Litigation*, 2000 WL 1202065, *8 (Normal to expect sale of "significant sums of stock" when stock price swells after period of record profits."). The timing of Blake's sale is not at all suspicious.

In this instance, Plaintiffs' own analysis further explains the timing of Blake's sale, and explains as well why he had no prior sales of his stock. As noted, Plaintiffs assert that exercising options (except those about to expire) is not rational *until and unless* the market price of the shares hits at least three to four times the strike price, at which time the exercise and sale is warranted. *See* part III(B)(3)(e)(1) above. Since the options Mr. Blake exercised had strike prices of around $15-20 per share,[47] exercise of those options had never made sense under this analysis until well into the class period. Accordingly, Plaintiffs' have provided in their own pleading a valid explanation for both the timing of Mr. Blake's sale, and for the claimed "inconsistency"of this exercise with Mr. Blake's history of not having previously sold those shares.

Mr. Blake's sale of 46% of his available holdings is not suspicious in amount, given that this figure represents his total for a three-year (37 month) class period. *Cf. Vantive*, 283 F.3d at 1094 ("not inherently alarming or unusual that an insider might sell a quarter [26%] of his holdings over the course of fifteen months.").

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[47] *See* Ex. E.

Plaintiffs also omit a transaction by Blake that further negates any inference of scienter: he made a cash *purchase* of 5,000 shares during 2001. *See* Ex. J. Purchasing significant blocks of shares is wholly inconsistent with any inference that Mr. Blake believed that Enron had undisclosed problems that could lead to its collapse. *Cf. Allison*, 999 F. Supp. at 1342 ("particularly difficult" to infer scienter where insider was purchasing).[48]

Finally, the lack of suspicious sales by the other Outside Directors – indeed, the lack of *any* sales by most of the Outside Directors – negates any possible inference of scienter here. As the Fifth Circuit very recently stated, "the fact that other defendants did not sell during the class period undermines plaintiffs' claims." *Nathenson,* 267 F.3d at 421. "One insider's well timed sales do not support the 'strong inference' required by the statute where the rest of the equally knowledgeable insiders act in a way inconsistent with the inference that the favorable characterizations of the company's affairs were known to be false when made." *Ronconi*, 253 F.3d at 436. Mr. Blake's solitary sale cannot give rise to a strong inference of scienter.

8. Robert Belfer

Robert Belfer is not only one of Enron's biggest shareholders, he was also the biggest individual victim of Enron's collapse. Belfer *remained* Enron's biggest individual shareholder even as the value of his Enron holdings declined by about $700 million in the Enron collapse.[49] This fact alone casts significant doubt on any conceivable inference that his actions were part of a plan to profit improperly from trades in Enron stock.

Plaintiffs allege that Belfer's "available holdings" during the class period were over 10 million shares. It is not surprising, given those holdings, that Mr. Belfer had more transactions and thus more proceeds than the other Outside Directors did. Of course, as the Ninth Circuit wrote,

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[48] The same SEC Form shows another transaction by Blake in 2001: a gift to charity of stock then worth around $600,000. Ex. J.

[49] This number is based upon a 2001 proxy statement (SEC App. Tab 22) which shows a holding by Mr. Belfer of 8.4 million shares. The Enron shares went from a peak price of $90 to a price of $4 at the end of the class period.

"large numbers do not necessarily create a strong inference of fraud." *Vantive*, 283 F.3d at 1093. Critically, the Court must look at Mr. Belfer's accused sales as a percentage of his holdings, and those sales (even assuming for this purpose the reliability of Plaintiff's allegations) were only a small fraction of his available holdings:[50]

1999	5.2%
2000	8.1%
2001	7.2%

As discussed in part III (B)(3)(c) above, annual sales percentages at these levels and higher are uniformly considered "non-suspicious" as a matter of law and thus cannot permit an inference of scienter. *See, e.g., Silicon Graphics* at 985-87 (average of 10% in fifteen week period); *Ronconi*, 253 F.3d at 435 (17% in seven month period).

Similarly, it is impossible to say that Mr. Belfer's sales are "suspiciously timed," largely because the prices he obtained were, in general, well below the stock's peak prices. See part III (B)(3)(d) above. Importantly, even though Enron's share prices consistently topped $70 for a period of about 14 months, only 6% of Mr. Belfer's shares sold - about 1% of his available holdings – were sold at $70 or above. Ex. B C. The law is clear that Belfer's sales cannot be considered suspiciously timed. *See, e.g., Greebel*, 194 F.3d at 206 ("timing does not appear very suspicious" where stock was not "sold at the high points of the stock price."); *Nathenson*, 267 F.3d at 421 ("inauspiciously timed" sales well below "class period high" are not suspicious*); Ronconi*, 253 F.3d at 435 (sales not suspicious where insiders "miss the boat" of peak prices).

It should also be noted that Plaintiffs' alleged holdings figure of 10 million[51] for Belfer necessarily means he had stock that would have been worth around $250 million *before the start of*

[50] See Part II(B)(3)(c) above. Annual percentages are calculated from "available holdings" alleged at NCC ¶ 402 (chart) and alleged sales at NCC Exh C. Total of 20.5% sums to figure alleged for Belfer at NCC ¶ 402 (chart).

[51]This figure includes the assumed conversion of preferred shares into common.

any alleged artificial run-up during the class period. NCC ¶402(chart) (using $25 share). Belfer's alleged proceeds are only $112 million. NCC Ex. C. No "strong inference of scienter" could conceivably be drawn from a purported pump-and-dump scheme wherein the accused is allegedly motivated by a supposed plan to sell only enough shares (5-8% per year) to walk away with *less than half* of what he had to begin with.[52]

Plaintiffs' Complaint also acknowledges that most of Mr. Belfer's alleged sales were not market sales at all, but instead were either "costless collar" agreements or transfers to equity exchange funds or partnerships. NCC Ex. C (identifying specific trades); NCC ¶410. Even the Plaintiffs specifically allege and acknowledge the wholly non-suspicious reasons for entering into such arrangements:

> Asset liquidity or **diversification** can be achieved by financial instruments readily available and **commonly used** by executives. For example, executives **commonly protect themselves from risk** by the use of . . . **zero-cost collars and equity swaps**. These instruments are readily available [and] **commonly used** . . .

NCC ¶ 409.[53] Plaintiffs thus explicitly plead that the supposedly-illicit sales by Mr. Belfer are in fact common mechanisms for diversification.[54]

Moreover, an even closer examination of the pleading shows that the use of zero-cost collars is wholly inconsistent with an inference of scienter for another reason: proceeds are significantly less than they would be for simply selling the shares. NCC Ex B. For example, the zero-cost collar

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[52] If one applies the actual $90 peak value of Enron stock, the decline in the value of Mr. Belfer's Enron holdings would exceed $700 million, while the realized proceeds from all his sales, "collars," and transfers into private equity or exchange funds would be only $112 million. NCC Ex. C. Such a trading history is not merely inauspicious, it is catastrophic. Certainly such massive losses by definition negate any inference of fraudulent intent. Belfer's decision to hold and not sell 80% of his stock at the cost to him of $700 million negates any conceivable inference that his stock trading decisions were motivated by knowledge of material adverse information about the company.

[53] Ironically, Plaintiffs extol the virtues of these instruments and appear to condemn other defendants because they did <u>not</u> use such widely available devices for diversification and liquidity. NCC ¶ 409. Plaintiffs accuse Belfer because he <u>did</u>.

[54] Movement toward diversification should not seem surprising for someone who had come to own 10 million shares as a result of Enron's purchase of Mr. Belfer's company, with stock, in the 1980s.

transactions alleged in December 2000 show proceeds per share to Belfer of just over $55 (to be received three years later). NCC Ex. B; Ex. K. In contrast, if Belfer had believed that the share price was artificially inflated, he could simply have sold the shares at the current market price of $80. In total, Belfer's decision to collar rather than sell one million shares during the class period cost him over $20 million.[55] NCC Ex. B (see, e.g., sales by Mr. Lay on same dates); Ex. K.

An insider who knows or believes that the stock is artificially inflated and is therefore seeking to dump his stock would surely never select a mechanism that dramatically <u>reduces</u> his proceeds in exchange for retaining the stock's "upside" potential. Collars are not sales, but simply provide a floor and a ceiling (cap) on the value of the stock to the holder. By entering into a collar instead of selling, the seller suffers the risk of price declines down to the floor (well below the market price), so that, in exchange, he gets to hold onto his stock and benefit from future price appreciation, at least up to the ceiling or cap. Selection of such an arrangement rather than selling the shares outright makes sense only if the "seller" desires to hold onto the "upside" potential of the stock. This desire to retain the upside is inconsistent with a strong inference that the "seller" knew of undisclosed financial problems that would cause the stock to decline and that were prompting him to dump his stock before the price dropped. *Cf. Silicon Graphics*, 183 F.3d at 986 (sales do not

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[55] This is the calculated difference between the proceeds to be received after three years at the floor price of the collars ($60 million) and the proceeds that would have been received immediately from a straight sale of the shares ($81 million). The individual collars are detailed in the chart below:

Date	**Shares**	**Current Price**	**Hypothetical Sale proceeds**	**Floor Price**	**Floor Proceeds**	**Difference**
Nov 2000	200,000	$81.75	$16,350,000	$65.70	$13,140,000	$3,210,000
Nov 2000	200,000	$81.75	$16,350,000	$65.70	$13,140,000	$3,210,000
Dec 2000	150,000	$79.31	$11,896,500	$55.53	$8,329,500	$3,567,000
Dec 2000	75,000	$81.19	$6,089,250	$55.89	$4,191,750	$1,897,500
Dec 2000	75,000	$83.50	$6,262,500	$58.65	$4,398,750	$1,863,750
Jan 2001	150,000	$82.00	$12,300,000	$57.45	$8,617,500	$3,682,500
Feb 2001	50,000	$80.00	$4,000,000	$56.80	$2,840,000	$1,160,000
Feb 2001	100,000	$80.00	$8,000,000	$56.66	$5,666,000	$2,334,000
TOTAL			**$81,248,250**		**$60,323,500**	**$20,924,750**

See Ex. K. (SEC Forms 4) (proceeds figures and difference are calculated).

support inference if not "calculated to maximize the personal benefit from the undisclosed information").

While Mr. Belfer's absolute dollar sales appear substantial, a closer analysis reveals that Mr. Belfer held onto the vast majority of his stock. The tiny fractions he sold in each year of the class period are wholly non-suspicious, as is his failure to sell any significant portion of his shares at prices anywhere near the "peak." Belfer's stock trading and holding decisions and practices cannot give rise to any inference of scienter.

The foregoing analysis demonstrates that the sales of stock by the Outside Directors over the past three years do not raise any inference of scienter at all, let alone a strong inference. Because Plaintiffs' pleading depends on these sales as the sole basis upon which they allege scienter against the Outside Directors, Plaintiffs have failed to adequately plead scienter and the claims against those Directors should be dismissed.

C. Plaintiffs' Conclusory Allegations Are Not Sufficient to Establish a Strong Inference of Scienter

Aside from their discussions of inside trading, Plaintiffs' scienter allegations as to the Outside Directors are found in two pages of boilerplate allegations addressing supposed scienter for the "Enron Defendants" as a group. NCC ¶¶395 *et seq*. No distinctions are made among the approximately thirty individuals lumped into this group. Such generic allegations cannot support a strong inference of scienter against the Outside Directors.

1. Rote Assertions of Intent or Knowledge are Insufficient

The Fifth Circuit has long held that "rote conclusory allegations that the defendants 'knowingly did this' or 'recklessly did that' fail to meet the . . . pleading requirements of Rule 9(b)." *Lovelace*, 78 F.3d at 1019 (citing *Melder*, 27 F.3d at 1102-03). The PSLRA reaffirms that Plaintiffs' boilerplate is insufficient to plead "with particularity" the "facts" giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). *See In re Advanta*, 180 F.3d at 539. Plaintiffs improperly rely on conclusory allegations, for example, that unnamed "Enron Defendants" purportedly "acted with scienter in that they knew that" the company's statements "were materially false and misleading." *See, e.g.*, NCC ¶ 400. That does not satisfy Rule 9(b) or the PSLRA. See *Waste Management,* Slip Op. at 18 n. 6 ("conclusory allegations or legal conclusions masquerading as factual conclusions do not defeat a motion to dismiss."); *Zishka,* 2000 WL 1310529, * 1 (lengthy complaint was insuficient where "allegations are undetailed and conclusory, . . . undifferentiated as to the various Defendants, and [it] repeats. . .vague and overly broad allegations.").

2. Plaintiffs' Presumption of Knowledge or Intent Based Upon Outside Directors' Routine Roles as Board or Committee Members is Insufficient to Support a Claim

Plaintiffs recite that the directors were on board committees, reviewed and approved transactions, had or signed copies of Enron's SEC filings, and had access to non-public information. NCC ¶¶ 395-99. But these "accusations" simply define the typical role of a director, and provide no basis for a "strong inference" of scienter. *See*, e.g., *Waste Management,* Slip Op. at 88 ("conclusory allegations that the defedants, because of their membership and/or their executive and managerial positions with the defendant company, knew or had access to information that was adverse and nonpublic do not plead scienter adequately.") (citing *Melder*, 27 F.3d at 1103); *Id.* at 127 (plaintiff cannot "rely on defendant's receipt of purported internal, non-public financial information without stating facts, including the contents of the reports, who prepared them, who reviewed them, and from whom the information was obtained.); *Lemmer v. Nu-Kote Holding, Inc.*, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001) (allegation that directors' "functions required them to be informed", coupled with unspecific assertion that "Defendants knew the representations . . . were false" is insufficient.).

Plaintiffs' heavy reliance on committee membership and on the Outside Directors' access to non-public information is wholly misplaced. *See, e.g., Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp.2d 910, 916 (N.D. Tex. 1998) (plaintiff "cannot . . . rely on the individuals' . . . committee memberships"); *Azurix* 2002 WL 562819 *23 (S.D. Tex. March 21, 2002) (allegation that "the defendants knew or had access to information by virtue of their board or managerial positions is not sufficient to plead scienter."); *Branca v. Paymentech, Inc.*, 2000 WL

145083 * 10 (N.D. Tex., Feb. 8, 2000) ("Allegations that a party knew or should have known that false representations were being made merely by virtue of his position within a company are, as a matter of law, insufficient to plead scienter."); *Jacobs v. Coopers & Lybrand*, 1999 WL 101772 (S.D.N.Y. 1999) (audit committee membership and signing of 10Ks insufficient to create strong inference).

The conclusory assertion that committee memberships made the directors more involved in "day to day operations than is usually the case," NCC ¶ 398, is similarly insufficient.[56] First, Plaintiffs fail to offer even a single fact to support this conclusory allegation. Nowhere in the Complaint do Plaintiffs allege any instance or example where the Board, any committee, or any Outside Director, either individually or collectively, went beyond the usual function of an outside director. Allegations of frequent contact with senior management[57] and receipt of financial reports demonstrates only that the board and committee members performed their oversight role. Such conclusory allegations simply do not raise any inference of scienter, let alone a strong inference.[58] Allegations that the directors review financial statements or have access to non-public information also describe wholly normal functions of a director which cannot give rise to a strong inference of wrongdoing. *Waste Management*, Slip Op. at 127 (plaintiff cannot "rely on defendant's recipt of

[56] Since every Outside Director is alleged to have been on some committee, NCC ¶ 86-87, the suggestion that committee membership makes one atypical of Outside Directors generally rings particularly hollow.

[57] Contact with senior management is hardly sufficient. Indeed, even if the movants *were themselves* the senior management, individualized allegations of scienter would be required.

[58] *See In re Oak Tech. Sec. Litig.*, 1997 WL 448168 *10 (N.D. Cal. 1997) (allegation that outside director "was involved in the day to day operations . . . does not satisfy the strict pleading requirements of Rule 9(b) and the Reform Act."). *See also Cheney v. Cyberguard*, 2000 WL 1140306 *7 (S.D. Fla. July 31, 2000) (allegation that outside director was involved in day to day operations because he was chairman of the Audit Committee and "was responsible for review[ing] the Company's annual financial statements and the independent auditors report, including significant reporting or operational issues[,] corporate policies and procedures as they relate to accounting and financial reporting and financial controls" are "insufficient to support a strong inference that [the outside director] acted with scienter.") .

purported internal, non-public information" without specifying which reports were given to the individual).

Plaintiffs also cannot simply point to the fact that the transactions at issue are large and complex, and insist that "it is logical" to presume that *all* Enron's officers and directors therefore knew of mistatements and acted with fraudulent intent. *See Advanta*, 180 F.3d at 539 ("[A]llegations that a securities-fraud defendant 'must have known' a statement was false or misleading are 'precisely the types of inferences which [courts], on numerous occasions, have determined to be inadequate . . . . General imputations of knowledge do not suffice, regardless of the defendants' positions within the company.") (citations omitted). *Lirette v.Shiva Corp*, 27 F. Supp. 2d 268, 283 (D. Mass. 1998) ("[I]nferences that the defendants, by virtue of their positions within the company, 'must have known' about the company's problems" are "the types of inferences which this court, on numerous occasions, has determined to be inadequate"); *In re Credit Acceptance Corp Sec. Litig.*, 50 F. Supp. 2d 662, 677 (E.D. Mich. 1999). ("Nowhere does the complaint state which defendants knew what; or how and why they knew it. Simply alleging that the defendants knew or should have known of a problem...because of their position in the company and the fact that documents were available to them does not raise a strong inference of fraudulent intent.") (citations omitted).

Even where there has been a restatement of financial results and there are highly-publicized allegations of fraud, as Plaintiffs allege here, Outside Directors must be dismissed if a plaintiffs fails to allege scienter *against each of them* with particularity. For example, after Sunbeam Corporation announced that it would be required to restate certain of its past financial statements, Outside Directors who served on Sunbeam's audit committee were dismissed from the subsequent securities lawsuit because of a "complete lack of any particularized allegations of scienter on the part of the Audit Committee members." *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1341 (S.D. Fla. 1999). Similarly, in *Jacobs v. Coopers & Lybrand*, 1999 WL 101772 (S.D.N.Y. 1999), plaintiffs attempted to plead the scienter of Outside Directors in much the same way as Plaintiffs do here -- by alleging that they had general knowledge of the company's finances from their role as a directors and members of the audit committee and that they signed the company's 10Ks. The *Jacobs* court, following the lead of courts around the country, found that such allegations are insufficient to plead scienter because "Plaintiffs do not state with particularity what [the Outside Directors were] aware of and when [they were] so aware or otherwise specify the nature of [their] conscious disregard of a known risk." *Id.* at 15-16.

Conclusory allegations of scienter against Outside Directors, practically identical to the allegations made by Plaintiffs in this case, have thus been specifically and routinely rejected as insufficient to plead scienter by courts around the country.[59] These allegations are insufficient as a matter of law to plead the requisite scienter, and Plaintiffs' 10(b) claims against certain Outside Directors should be dismissed.

3. Plaintiffs' Complaint in Fact Demonstrates that the Outside Directors Did Not Act with Severe Recklessness

Although it contains scant detail concerning the Outside Directors generally, the Complaint, does contain particularized allegations of one critical set of facts: what the Outside Directors were told by Arthur Andersen, and when they were told it. The Board of Directors was specifically and repeatedly told each year by Arthur Andersen that Enron's audits were done in accordance with GAAS, that Enron's financial statements were prepared in accordance with GAAP, and that they "present[ed] fairly, in all material respects, the financial position of Enron Corp." NCC ¶ 903.

This specific allegation of what the Board was told, by whom, and when -- the only particular allegation in the entire Complaint regarding the knowledge of the Outside Directors -- raises a strong inference that the Outside Directors of Enron did **not** act with severe recklessness. From beginning to end, Plaintiffs' Complaint alleges improper accounting and misleading financial statements, yet

[59] *See, e.g. Lemmer v. Nu-Kote Holding, Inc.*, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001); *In re Oak Tech. Sec. Litig.*, 1997 WL 448168 (N.D. Cal. 1997); *Cheney v. Cyberguard*, 2000 WL 1140306 (S.D. Fla. July 31, 2000); *In re Sunterra Corp. Sec. Litig.*, 2002 WL 480620 (M.D. Fla. Mar. 12, 2002); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326 (S.D. Fla. 1999); *Jacobs v. Coopers & Lybrand*, 1999 WL 101772 (S.D.N.Y. 1999).

the only specific allegation in the Complaint about what the Directors knew is that Arthur Andersen told them, repeatedly, that Enron's accounting was proper and its financial statements were accurate and fair. In the face of this specifically alleged fact demonstrating a lack of scienter on the part of all of the Outside Directors, Plaintiffs' allegation that certain individual Outside Directors acted with the requisite scienter (based solely on the their status as Outside Directors) rings especially hollow.

D. Plaintiffs have not properly alleged scienter against the individual Outside Directors they accuse of fraud

It is telling that under the unique circumstances of this case, with thousands of documents already in the public domain, daily investigative newspaper reports, frequent congressional hearings, testimony from key witnesses, and countless ongoing investigations, all of which were available to Plaintiffs in preparing their Complaint, the particularized allegations against the individual Outside Directors are few, superficial, and wholly lacking in any facts showing fraudulent intent on their part. Plaintiffs have simply pled no facts indicating that at the time any allegedly false statements were made, any Outside Director had actual knowledge of contradictory facts.

The law is well-settled that Plaintiffs sparse and conclusory allegations of recklessness do not raise a strong inference of scienter. As demonstrated in detail in part III(B), *supra*, the stock sales of these individuals simply do not raise an inference of scienter, let alone a strong inference. Plaintiffs' Complaint therefore does not raise a strong inference of fraudulent intent, and does not state a claim for securities fraud against these individual Outside Directors. Accordingly, Defendants Belfer, Blake, Chan, Duncan, Foy, Gramm, Jaedicke and LeMaistre are entitled to dismissal of the §10 and Rule 10b-5 claim asserted against them.

IV. PLAINTIFFS FAIL TO ALLEGE A SECTION 20A CLAIM

Plaintiffs' "Second Claim for Relief," for alleged violation of §20A of the 1934 Act (NCC ¶ 998-1004) also fails to state a claim.

A. Plaintiffs' Failure to Adequately Plead an Independent Violation of the 1934 Exchange Act Requires Dismissal of the Section 20A Claims

Plaintiffs' failure to state a claim for violation of Section 10 (and Rule 10b) also defeats Plaintiff's Section 20(A) claim. Section 20A claims are limited to persons who have violated some other provision of the 1934 Act:

> Any person who violates any provision of this chapter or the rules or regulations thereunder by . . . selling a security while in the possession of material nonpublic information shall be liable . . . to any person who, contemporaneously with the . . . sale of securities that is the subject of such violation, has purchased . . . securities of the same class.

15 U.S.C. § 78t-1(a). "The reference to 'this chapter' is to the '34 Act, and the language of the statute is thus quite plain that to state a claim under §20A, a plaintiff must plead a predicate violation of the '34 Act or its rules and regulations." *Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co.*, 32 F.3d 697, 703 (2d Cir. 1994).[60]

Accordingly, a plaintiff's failure to adequately plead a claim under other provisions of the 1934 Act will warrant dismissal of the 20A claim as well. Alleged violations of the *1933 Act*[61] do not support §20A claims. *Id.* at 703-04 (rejecting 1933 Act violations as predicate for §20A claims); *Advanta*, 180 F.3d at 541 ("Liability under section 20(A) is predicated upon an independent violation of 'this chapter or the rules or regulations thereunder.' Hence, claims under section 20(A) are derivative, requiring proof of a separate underlying violation of the Exchange Act."); *Thornton v. Micrografx, Inc.*, 878 F. Supp. 931, 938 (N.D. Tex. 1995) (dismissing 20A claim becaue "Plaintiffs have failed to adequately plead a violation under the Exchange Act "); *In re Verifone Securities Litigation*, 11 F.3d 865, 872 (9th Cir. 1993) ("fail[ure] to allege an actionable independent underlying violation of the '34 Act" warrants dismissal of §20A claim).

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[60] 15 U.S.C. § 78t-1(c) is similarly limited to persons "who violate any provision of [the Exhchange Act] or the rules or regulations thereunder," and is thus similarly dependent upon adequate pleading of an independent violation.

[61] *see, e.g.*, §§11 or 15, as alleged at ¶¶ 1016.

Plaintiffs apparently acknowledge 20A's derivative nature and invoke the alleged violations of §§10(b) and 20(a)[62] and Rule 10b-5 as their predicate acts. NCC ¶1003. As discussed earlier, however, Plaintiffs' complaint fails to state a claim under those provisions. Because those claims must be dismissed, Plaintiffs' §20A claims must be dismissed as well. *See, e.g., Advanta*, 180 F.3d at 541 ("Because plaintiffs have failed to adequately plead a predicate violation of Section 10(b) or Rule 10b-5, the section 20(A) claim must also be dismissed."); *Thornton*, 878 F. Supp. at 938 (holding that §20A claim fails because plaintiffs failed to adequately plead primary violation of §10(b)).

Further, the statute makes clear that not every violation of a provision of the Exchange Act will suffice to support a 20A claim. A 20A claim exists only if the insider violates the act "by purchasing or selling" -- i.e., that the insiders' sale was itself the independent violation of the act. Though Plaintiffs attempt to use trading as evidence of scienter, the 10b violations they allege are not violations that occur "by purchasing or selling." Rather, they are violations that occur because of alleged misrepresentations or omissions in connection with *Plaintiffs'* purchases or sales. *See* 15 U.S.C. 78j.

Because Plaintiffs failed to adequately allege that the Outside Directors' sales constituted an independent violation of the 1934 Act, Plaintiffs' §20A claim must be dismissed.

B. Plaintiffs Have Failed To Adequately Plead Contemporaneous Trading

The statute provides a claim only to those who bought Enron's stock "contemporaneously" with some Defendant's sales. 15 U.S.C. § 78t-1(a). "[A] plaintiff must establish that he traded 'contemporaneously' with the defendant." *Copland v. Grumet*, 88 F. Supp.2d 326, 337 (D.N.J. 1999). Failure to plead facts showing that the plaintiff in fact traded contemporaneously with the accused defendant requires dismissal of the 20A claim. *Id.* at 338 (dismissing §20A claim for failure to plead contemporaneous trade); *In re AST Research Sec. Litig.*, 887 F. Supp. 231, 234 (C.D. Cal.

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[62] Of course, as discussed below, control person liability under §20(a) is itself derivative, requiring proof of an underlying violation. Thus, failure to plead a §10 claim will defeat both 20(a) and 20A.

1995) (same); *Colby v. Hologic*, 817 F. Supp. 204, 216 (D.Mass. 1993) (same, dismissing with prejudice).[63] Plaintiffs must establish contemporaneous trading for each defendant individually. *E.g., In re Microstrategy Sec. Litig.*, 115 F. Supp.2d 620, 663-64 (E.D.Va. 2000) (dismissing claims against individual defendants where plaintiff had not traded on same day as that defendant).

1. Plaintiffs Make No Contemporaneous Trading Allegations At All with Respect to Sales by Dr. Gramm or Mr. Chan

The inadequacy of Plaintiffs' contemporaneous trading allegations with respect to two of the Outside Directors is simple and obvious, because the Plaintiffs make no attempt to make such allegations at all. Plaintiffs' specific allegations of contemporaneous trades are set forth in Exhibit A to the Complaint. NCC Ex. A. Exhibit A does not list the sales of either Dr. Wendy Gramm or Ronnie Chan, nor does it even attempt to set forth any purchasing by any plaintiff that is contemporaneous with those sales. Though Plaintiffs' general, cursory §20A allegations purport to include all defendants who sold stock in the class period, the allegations are insufficient -- indeed, nonexistent -- with respect to Dr. Gramm and Mr. Chan. Plaintiff's §20A claims against those two individuals must be dismissed for complete failure to state a claim.

2. For Widely Traded Stocks, Only Same-Day Trades Can be Contemporaneous

To satisfy the "contemporaneous" requirement, "a plaintiff must . . . plead that he or she bought stock on the same day on which the defendants sales took place. *Copland*, 88 F. Supp.2d at

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[63] The supposition that some unnamed members of the class must have traded on a particular date is insufficient when, as here, the named plaintiff lacks standing and cannot purport to represent the class against particular defendants. *See, e.g., In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1489-90 (N.D.Cal. 1992) (rejecting class action claims where named plaintiffs did not trade contemporaneously, because "[w]here a plaintiff lacks standing to bring a claim personally, that plaintiff cannot represent the class.") *affd.* 11 F.3d 865, 872 (9th Cir. 1993); *Colby v. Hologic*, 817 F. Supp. 204, 216 (D. Mass. 1993) (plaintiff failing "contemporaneous" test "lacks standing herself to bring this claim and is not a suitable representatives of others who might press it."); *Microstrategy*, 115 F. Supp.2d at 620 (same); *see also Copland* at 338 (dismissing class claim where no "named plaintiff" traded on same date as defendant). Plaintiffs' attempt to name individual plaintiffs who traded near the time of the accused sales obviously reflects their understanding that they must establish contemporaneous trading (and thus standing) by the named plaintiffs. However, the Complaint is insufficient in this regard.

338 (citing cases); *AST Research*, 887 F. Supp. at 234 ("[T]he sale by an insider and subsequent purchase by an aggrieved party must occur on the same day".).

Though some early cases sometimes permitted a few days' latitude in defining the time periods considered contemporaneous, "the growing trend . . . is to adopt a restrictive reading of the term 'contemporaneous' at least with respect to shares heavily traded on a national exchange." *Microstrategy*, 115 F. Supp.2d at 664 (quoting *AST Research* at 233 (citing cases)).[64] For widely-traded stocks on public exchanges, it is impossible that buyers and sellers who trade on different days were trading with one another. *AST Research* at 234. Though notions of privity have been relaxed and the Plaintiff does not bear the burden of proving he actually traded with the defendant, claims cannot survive where is it a certainty that the plaintiff did not do so. The same day requirement serves to limit §20A claims to trades "where it appears that the plaintiff might, in fact, have traded with the defendant" and bars claims where "it is clear that plaintiffs did not trade with defendants." *Id.* at 233 (quoting *Buban v. Obrien*, 1994 WL 324093 (N.D. Cal. 1994) at *2-3, and *In re Aldus Sec. Litig.*, 1993 WL 121478 (W.D.Wash. 1993). Accordingly, Plaintiffs' failure to plead purchases on the same days as each of the accused sales makes Plaintiffs' pleadings insufficient to state a §20A claim on those sales.

Plaintiffs' §20A claims must be dismissed with respect to any accused sales for which Plaintiff has failed to allege a same-day trade by a named Plaintiff. The same-day requirement mandates dismissal of Plaintiffs' 20A claims with respect to the following trades by Outside Directors: Joe Foy: March 18, 1999; Robert Belfer: Sept. 2, 1999, Nov. 8, 9, & 11, 1999, May 11& 16, 2000, Robert Jaedicke: Feb. 24, 2000.

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[64] Even early Courts that might have permitted a few days' window for trades to be considered contemporaneous denied standing to a plaintiff who trades *before* the defendant's trades. "No liability can attach for trades made by plaintiffs before the insider engages in trading activity." *E.g.*, *Verifone*, 784 F. Supp. at 1489 (citing cases).

3. Mr. Belfer's "Costless Collars" and Transfers To Private Exchange Funds or Investment Partnerships are not Sales, and No Plaintiff Traded Contemporaneously with Belfer in those Markets.

This court has held that 20A claims are appropriately limited to Plaintiffs who traded "on the same market" with the seller. *BMC* at 916 n.53. "Only such individuals 'who stand to be exploited by the insider trading -- for example by trading personally with the insider or, in the context of the federal law, by trading on the same market with the insider -- can be said to have individual interests . . .for which they may seek direct redress.'" *Id.* (citing and quoting *Microstrategy*, 115 F. Supp. 2d at 662 & n.8).

The Complaint acknowledges that many of Mr. Belfer's purported "sales" are not market sales at all, but are in fact transfers of shares into an "Investment Partnership" and an "Exchange Fund." NCC Ex. C (special legend describing notations on Belfer's alleged sales). Other alleged "sales" are acknowledged to be, instead, "costless collar" agreements entered into by Belfer wherein Belfer *retained* ownership of his stock but had acquired contractual puts and calls that put a floor and cap on his losses and profits. *Id.*; *see also* NCC ¶ 409. If these are to be considered sales at all, and they should not be, they are clearly not on the same market, and it is admitted that no Plaintiff could conceivably have traded with Mr. Belfer on these transactions. *Cf. BMC* at 916 n. 53 (trades "on the same market with the insider" are "directly implicated" so as to permit such "direct redress").

Because plaintiffs did not trade contemporaneously in the same market with Belfer on these transactions, the related 20A claims should be dismissed.[65]

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[65] As designated in the "Belfer" section of NCC Ex. C, the Belfer "sales" that are in fact costless collars or transfers to investment partnership or exchange funds are those on the following dates: 9/2/99; 11/2/00; 12/21/00; 12/22/00; 12/26/00; 1/26/01; 2/8/01; 2/14/01; 3/9/01; 5/53/01; 7/27/01; and 9/21/01.

4. Claims Must Be Dismissed Where Plaintiffs' Pleading Makes Clear That The Plaintiffs Could Not Have Traded With the Defendants

Restricting 20A standing to those plaintiffs who at least "may have" traded with the insider, as discussed above, calls for further limitation of standing to those who also purchased at the same price at which the insider sold. A buyer who purchased at, for example, $25 per share certainly did not trade with a seller who sold at $26 or $24. *See, e.g., Research* at 233 (quoting *In re Aldus Sec. Litig.*, 1993 WL 121478 (W.D.Wash. 1993) (dismissal proper where "it is clear that plaintiffs did not trade with defendants"). Plaintiffs' pleadings reveal that, with one exception, none of the named Plaintiffs could have in fact traded with the Outside Directors in any of the accused sales, because Plaintiffs' trades are at prices different than the price of the directors' sales.

The Outside Directors urge the Court to dismiss all 20A claims in which the named plaintiff's purchase is at a different price than the alleged insider sale.[66]

V. PLAINTIFFS SECTION 11 CLAIMS AGAINST THE OUTSIDE DIRECTOR DEFENDANTS SHOULD BE DISMISSED

Plaintiffs next assert a claim under §11 of the Securities Act of 1933. Plaintiffs' bring these claims based on four note purchases: three were in public offerings; one was in a private placement. As is explained in greater detail below, Plaintiffs' claims must be dismissed because:

(i) There is no § 11 liability in connection with a Rule 144A private placement;

(ii) Plaintiffs have asserted claims against some directors who were not on the Enron Board at the time of the offering or who did not sign the registration statements in question;

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[66] Comparison of the sales prices for the Outside Directors alleged at NCC Ex. C to the purchase prices alleged in the Plaintiffs' certifications (*See* Lead Plaintiff's Appendix of Certifications in Support of Cons. Complaint) reveals that in only one instance has any named plaintiff alleged a trade which actually may have been a trade with the Outside Director (i.e., same day, same price). That January 6, 1999 purchase by the San Francisco City & County Employees' Retirement System is alleged to be on the same day and at the same price as Dr. LeMaistre's sale that day. Since none of the other plaintiffs could conceivably have purchased from the Outside Directors, Section 20A claims must be dismissed on every other sale by an Outside Director.

(iii) Plaintiffs have pled facts that conclusively establish an absolute defense to liability on the part of the directors; specifically, Plaintiffs have pled facts showing that the directors signed the registration statements in reliance on the opinions of experts whose opinions they had no reason to doubt;

(iv) Certain Plaintiffs bought after annual earnings statements were issued by Enron and are required to plead, but have not pled, reliance; and

(v) Plaintiffs' claims "sound in fraud" and, as a result, have not been pled with the particularity required under Rule 9(b).

A. The Elements of a Section 11 Claim

Section 11 provides a remedy for individuals who purchase securities offered pursuant to a "registration statement." 15 U.S.C. § 77k(a); *see also Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 234 (S.D.N.Y. 1999) ("[T]he plain language of § 11 limits claims to those arising from the printed text of the registration statement"). Under Section 11,

> In case any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements herein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue every person who signed the registration statement . . .

15 U.S.C. § 77k(a). In *Gustafson*, the Supreme Court made clear that the term "registration statement" applies *only* to purchases in a public offering. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 577-578 (1995). Private placements, which are made pursuant to an express exemption from the registration requirements, are not included among the class of offerings actionable under § 11. *See infra*, part V.B.

Section 11 explicitly provides a safe harbor for directors who sign a registration statement in good faith reliance upon expertised disclosures. 15 U.S.C. § 77k(b)(3)(C). Directors are not liable if, on the facts pleaded, Plaintiffs have established the elements of the defense. *Cf. Kaiser Aluminum & Chem. Sales v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) ("[A] complaint that shows relief to be barred by an affirmative defense ... may be dismissed for failure to state a cause of action."). Here, as is set out below, the offering documents upon which plaintiffs have sued establish that they were issued "in reliance upon expert opinions" from Arthur Andersen. Plaintiffs have also pled that these offering documents were signed in reliance upon financial statements certified by Arthur Andersen and expert accounting and legal advice from Andersen and others. *See infra*, pp. ___. Of equal significance, Plaintiffs have explicitly disavowed any claim of fraud or bad faith against seven directors whom they have sued for violations of § 11,[67] and have failed to plead with specificity any claim of bad faith as it pertains to the remaining directors[68] whom plaintiffs also plead signed these registration statements in reliance upon expertised disclosures. *See infra*, pp. ___. As a result, Plaintiffs' pleadings conclusively establish the directors' affirmative defense so their claims must be dismissed.

Plaintiffs' § 11 claims are based on four specific offerings:

1. May 1999 offering of Enron Corporation 7.375% notes due 05/15/2019 ("the May 1999 offering")

This claim is filed against the following director defendants: Belfer, Blake, Chan, J. Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Wakeham, Walker and Winonkur.

2. August 1999 offering of Enron 7% exchangeable notes due 7/31/2002 ("the August 1999 offering");

This claim is filed against the following director defendants: Belfer, Blake, Chan, J. Duncan, Foy, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Wakeham and Winokur.

3. May 2000 offering of 8.735% and 7.875% notes due 6/15/2003 ("the May 2000 offerings"); and

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[67] "Certain defendants named herein, including Mendelsohn, Meyer, Pereira...Wakeham, Walker, Winokur [and] Savage...<u>are not sued for fraud, but rather, only under non-fraud provisions of the 1933 and 1934 Acts. No allegations of fraud are made against or directed at these defendants</u>." NCC at pg. 3, n.1.

[68] The remaining directors sued for alleged violations of §11 are Messrs. Blake, Belfer, Chan, Duncan, Jaedicke, LeMaistre and Dr. Gramm.

This claim is filed against the following director defendants: Belfer, Blake, Chan, J. Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Wakeham, Walker, and Winokur.

4. July 2001 private placement of Enron Corporation zero coupon convertible senior notes due 2021 ("the July 2001 Placement").[69]

This claim is filed against the following director defendants: Belfer, Blake, Chan, J. Duncan, Foy, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Pereira, Savage, Wakeham, and Winokur. NCC at ¶ 1006-07.[70]

Plaintiffs assert only signatory liability against these defendants under § 11. They plead no other basis of liability.

B. Plaintiffs' Claims Regarding the July 2001 Placement Should Be Dismissed

Plaintiffs' § 11 claim based on the July 2001 private placement must be dismissed. The July 2001 Placement was made "only to qualified institutional buyers (as defined under Rule 144A under the Securities Act)." See SEC App., Tab 81 p.1.[71] Rule 144A is an express *exemption* from the requirement to file a registration statement in connection with an offering of securities, so this placement is "deemed not to have been offered to the public." 17 C.F.R. § 230.144A & 230.144A(c). The existence of a registration statement is the *sine qua non* of a § 11 claim. "In case any part of the registration statement . . .contained an untrue statement of material fact or omitted to state a material fact . . .any person acquiring such security . . .[may] sue every person who signed the registration statement". 15 U.S.C. § 77(k). A private placement is not made pursuant to a registration statement, so no § 11 claim may be brought in connection with it.

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[69] Plaintiffs specifically limit their § 11 claim to these four offerings. NCC at ¶ 1006; *see also* NCC at ¶ ¶ 1007, 1009, 1013, 1014 (each stating that the offerings on which the claims are based are "as detailed in NCC at ¶ 1006 above").

[70] By amendment filed on April 12, 2002, Plaintiffs removed Meyer and Foy from their complaint based on the July 2001 Placement. Lead Plaintiffs' Notice of Eratta and Motion for Entry of Order to Replace Pages in Consolidated Complaint. This motion remains pending.

[71] Citations to "SEC App" are to the Master SEC Appendix filed in connection with Certain Officers' Joint Brief Regarding the Adequacy of Enron's disclosures.

Any number of federal courts have held that § 11 applies only to initial public offerings. *E.g., Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 94,445, at 95,541 (S.D.N.Y. Mar. 15, 1974) ("Those who purchased stock directly from the underwriter <u>on the basis of the registration statement</u> and prospectus possess a right of action under Sections 11 and 12 of the 1933 Act. Those who purchased on the open market have a right of action under Section 10(b) of the 1934 Act and Section 17 of the 1933 Act."); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691 (3d Cir. 1991) (noting that sections 11 and 12(1) are "concerned solely with initial distributions of securities"); *In re Delmarva Sec. Litig.*, 794 F. Supp. 1293, 1309 (D. Del. 1992) (dismissing § 11 claims for lack of standing where plaintiffs failed to allege they purchased "newly issued shares in an initial offering"); *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607, n.1 (S.D. Ill. 1978) (same), *aff'd*, 598 F.2d 1109 (7th Cir. 1979). This is consistent with the narrow character of the 1993 Act. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) ("The 1933 Act is a far narrower statute [than the 1934 Act,] chiefly concerned with disclosure and fraud in connection with offerings of securities -- primarily . . . initial distributions of newly issued stock from corporate issuers.") (citing, *Securities Regulation* 130-31 (2d ed. 1961)). Because someone asserting claims under § 11 can recover "without proof of fraud or reliance," it is improbable that Congress "would have extended that liability to every private or secondary sale without a whisper of explanation." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 582 (1995). The language of the statute makes plain, of course, that it <u>does not apply</u> to private placements.

Plaintiffs' claims on July 2001 placement also fail because they do not allege that they purchased their notes <u>in their initial placement</u>. In the absence of an "initial" purchase, a plaintiff lacks standing to assert a § 11 claim. *See Gustafson v. Alloyd Co.*, 513 U.S. 561, 578 (1995). Under § 11, secondary market purchasers do not have standing to bring a claim. *See, e.g., Azuriz*, at 58-59 (H-00-4034) (S.D. Tex. March 21, 2002); *McKowan Lowe & Co. v. Jasmine, Ltd.*, 127 F. Supp. 2d 516, 544 (D.N.J. 2000); *In re Summit Med. Sys., Inc. Sec. Litig.*, 10 F. Supp. 2d 1068, 1070 (D. Minn. 1998); *Warden v. Crown Am. Realty Trust*, 1998 WL 725946, at *2-3 (W.D. Pa. Oct. 15, 1998), *aff'd*, 229 F.3d 1140 (3d Cir. 2000), *In re WRT Energy Sec. Litig.*, 1997 WL 576023, at *6 (S.D.N.Y. Sept. 15, 1997); *Gannon v. Cont'l Ins. Co.*, 920 F. Supp. 566, 575 (D.N.J. 1996). Relying on the legislative history of the 1933 Act, the pre-*Gustafson* cases, and sound policy, these courts hold that standing to assert a § 11 claim depends on the purchase of shares during an initial public offering.[72] If Plaintiffs who did not buy in the initial offering were to have standing, it would be "a proposition that effectively guts [t]he cabining of § 11 to initial offerings and gives that section essentially the same reach as the Exchange Act, but without its scienter requirement." *Warden*, 1998 WL 725946 at *3 n.2. Therefore, the § 11 claims based on the July 2001 Placement should also be dismissed for lack of standing.

C. Plaintiffs' Claims Against Directors Who Did Not Sign Registration Statements, or Who Were Not Members of the Board at the Time of the Offerings Must Be Dismissed

Plaintiffs allege that certain directors "were responsible for the contents and dissemination of the Registration Statements because they signed the registration statements [for them]...thereby causing their filing with the SEC." NCC ¶ 1009. Section 11 is clear, however, that an individual is not liable if "before the effective date of the *part* of the registration statement . . . he had resigned from . . . office." 15 U.S.C. § 77k(b)(1). As is set out below, Plaintiffs have asserted claims against a number of directors who either did not sign the shelf registration statements in question or who were not directors at the time of particular offerings, or both. The claims against those directors should be dismissed for failure to state a claim.

[72] While a split of authority exists on the issue, *see Dartley v. Ergobilt Inc.*, 2001 WL 313964 (N.D. Tex. Mar. 29, 2001) (citing one other unpublished district court case from this Circuit and offering no analysis for its holding), the Fifth Circuit has remained silent on the issue. The stronger arguments are found in the cases holding that a § 11 plaintiff must purchase in an initial offering.

1. Walker should be dismissed entirely from the § 11 claims, including those based on the May 1999 and May 2001 Offerings, because he was not a member of the Board at the time of these offerings

Plaintiffs allege a § 11 claim against Walker for the offerings made on May 19, 1999 and May 18, 2001. NCC at ¶ 1006. Walker, however, was not a member of the Board of Directors on May 19, 1999. *See* Enron's 1999 10-Q for the Second Quarter, [Part II, Item 4]; *see also* SEC App. Tab. 8 (noting at the May 4, 1999 Annual Meeting, Walker was no longer on the Board). Because Walker was not a member of the Board when "such part [of the Registration Statement] became effective" any § 11 claim against him in connection with the 5/19/1999 5/18/2001 offerings must be dismissed.[73] 15 U.S.C. § 77k(a) and 77k(b)(1).

2. Meyer and Winokur should be dismissed from the § 11 claim based on the August 1999 offering as they did not sign the registration statement

Plaintiffs allege a § 11 claim against Meyer and Winokur for the offering made in August of 1999. NCC ¶ 1006. Plaintiffs allege liability because they claim that Meyer and Winokur signed the offering papers. NCC ¶¶ 1006, 1009-12. Meyer and Winokur, did not, in fact, sign the shelf registration statement in connection with the August 1999 offering. *See* 8/10/1999 Prospectus Supplement, SEC App. Tab. 79; *see also* 7/23/1999 Registration Statement, SEC App. Tab. 51. Plaintiffs have therefore failed to state a claim of signatory liability against Meyer or Winokur. These claims, too, must be dismissed.

3. Foy and Meyer should be dismissed from the § 11 claim based on the July 2001 Placement as they were neither members of the Board nor did they sign the registration statement

As indicated earlier, the § 11 claim pertaining to the July 2001 private placement should be dismissed against <u>all</u> of the Outside Directors because it was not a public offering. These claims

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[73] Dismissal is appropriate here where a complete defense appears on the complaint. *Kaiser Aluminum & Chem. Sales v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) ("[A] complaint that shows relief to be barred by an affirmative defense . . . may be dismissed for failure to state a cause of action.").

should also be dismissed, in particular, against Messrs. Foy and Meyer because neither was a member of the Board of Directors at the time of this offering and neither signed any offering document in connection with that offering. *See* Enron's 2000 10-Q for the Second Quarter, Part II, Item 4, SEC App. Tab. 13 (noting at the May 2, 2000 Annual Meeting, Foy was no longer a member of the Board); *see also* NCC ¶ 86 (Plaintiffs aver Foy was no longer a member of the Board in 2001); Second Quarter 2001 10-Q, SEC App. Tab. 18, (noting at the May 1, 2001 Annual Meeting, Meyer was no longer a member of the Board). Because neither Foy nor Meyer were Board members when "such part [of the Registration Statement] became effective," by the plain language of § 11 any claim against them in connection with the July 2001 Placement should be dismissed. 15 U.S.C. §§ 77k(a); 77k(b)(1). In addition, although plaintiffs allege liability on the basis that Foy and Meyer signed the offering papers in connection with the July 2001 Placement, NCC ¶ ¶ 1006, 1009-12, neither Foy nor Meyer did so. *See* July 2001 Prospectus, SEC App. Tab. 60; *see also* 6/1/2001 Registration Statement, SEC App. Tab. 65. Accordingly, the § 11 claims against them on the basis of the July 2001 Placement should be dismissed.

D. Plaintiffs' § 11 Claims Should Be Dismissed Because Plaintiffs' § 11 Claims Do Not Adequately Allege Any Misstatements Or Omissions That Were Allegedly Material.

Plaintiffs have in any event failed to plead a claim under § 11 as to <u>any</u> of the four offerings on which they base their claim. Under § 11, plaintiffs must, at the very least, plead that persons liable under § 11 made some "untrue statement of a material fact or omitted to state a material fact required to be stated therein" in the "part of the registration statement" on which they rely for their claims. 15 U.S.C. § 77k(a); *see also In re Landry's Seafood Rest., Inc. Sec. Litig., C.A. H-99-1948* at p. 59(S.D. Tex. Feb. 20, 2001). Plaintiffs' § 11 claims are subject to the requirements of the PSLRA. *See* 15 U.S.C. Section 78u-4(b); *See also, In re No. Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1 (D. Mass. 1999) (finding that even where "Rule 9(b) does not apply, the [pleading] requirements of the PSLRA still do"). The requirements of the PSLRA are quite clear. For <u>all</u> allegations "of an untrue statement of material fact," the PSLRA requires the plaintiff to "specify each statement alleged to have been misleading and the reason why it is misleading." If a complaint fails to comply with this requirement, the court "shall dismiss the complaint." 15 U.S.C. Section 78u-4(b)(3)(A).

Plaintiffs make no effort to discharge their pleading burden. In jigsaw fashion, they have incorporated 72 non-consecutive paragraphs (out of more than a thousand) that they claim support their § 11 claim. *See* NCC ¶ 1005. None of these paragraphs pleads any omission or misstatement by any director in connection with any offering, and none pleads that any claimed omission or misstatement by someone else was material. *Id.* The complaints do not even identify in which portions of the registration statements any alleged misstatements appear, much less what it is within them that was misleading. *Id.* Rule 8 and the PSLRA require dismissal in the face of vacuous pleadings like these.[74]

E. Certain Plaintiffs' Section 11 Claims Fail Because They Have Not Pled Reliance

Section 11 imposes a very limited window in which a Plaintiff may recover for misrepresentations in a registration statement without the need to prove reliance. The window closes if, between the registration statement and the plaintiff's purchase, the issuer files "an earnings statement covering a period of at least twelve months beginning after the date of the registration statement." 15 U.S.C. 77k(a). If a Form 10-K earnings statement is filed after the registration statement on which the plaintiff basis his claim, and before the plaintiff's purchase, then the plaintiff must prove <u>reliance</u> on the alleged misrepresentation or omission.

Four of the plaintiffs' § 11 claims founder, in whole or in part, on the rocks of this reliance requirement. One of Amalgamated Bank's purchases, made on June 29, 2001, occurred after Enron filed its Form 10-K for 2000. *See* Certificate of Amalgamated Bank. Amalgamated must, therefore, prove reliance.

[74] Should the court grant the Officer Defendants' motion with regard to the adequacy of Enron's disclosures, dismissal of the § 11 claims against the directors would be required on that basis as well.

Plaintiff Van de Velde bought securities offered pursuant to a July 23, 1999 registration statement. *See* Van de Velde Certificate. Enron's 10-K for 1999 was issued in March 2000. Van de Velde did not buy his notes until November 2001, so he too must prove reliance.[75] The Hawaii Laborers claim to have purchased pursuant to a registration statement filed on February 5, 1999. *See* Hawaii Laborers' Certificates. They did not buy their notes, however, until an offering in May 2000. Importantly, this offering occurred after Enron filed its Form 10-K for 1999. The Archdiocese of Milwaukee has the same difficulty: it bought securities offered pursuant to the February 5, 1999 registration statement, *see* Archdiocese Certificate, but did not do so until an offering in May that was made <u>after</u> Enron filed its Form 10-K for 1999. Both the Hawaii Laborers and the Archdiocese must, therefore, prove reliance.

Although required by the statute to plead reliance, none of these plaintiffs has done so. As a result, these Plaintiffs' claims under § 11 must be dismissed. *See* 15 U.S.C. § 77(k)(a).

F. The Plaintiffs' § 11 Claims Should Be Dismissed Against The Outside Director Defendants As The Complaint Itself Proves Them Barred By An Affirmative Defense.

The Fifth Circuit has held that on a 12(b)(6) motion to dismiss, "a complaint that shows relief to be barred by an affirmative defense . . . may be dismissed for failure to state a cause of action." *Kaiser Aluminum & Chem. Sales v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) (citing numerous Fifth Circuit precedent).[76] Plaintiffs here have established, on the face of their complaint, that the outside director defendants reasonably relied on expertised opinion when they signed the registration statements. This concedes the elements of the directors' statutory

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[75] It is highly unlikely that Van de Velde can actually allege reliance in good faith, because he made his first purchase after Enron announced its $1.2 billion reduction in shareholder equity. Even more remarkable is Van de Velde's second purchase, which was made the day <u>after</u> Enron's restatement.

[76] *See also*, *Torrie v. Cwayna*, 841 F. Supp. 1434, 1440 (W.D. Mich. 1994) (quoting 2A James W. Moore, *Moore's Fed. Prac.*, ¶ 12.07[2.5] (2d ed. 1991)) ("Dismissal is also proper if . . . 'an affirmative defense or other bar to relief is apparent from the face of the complaint.'")

affirmative defense under § 11. As a result, Plaintiffs are barred from bringing their § 11 claim against the outside director defendants.

Under § 11, a defendant will not be liable for any part of a registration statement "purporting to be made on the authority of an expert" on which he reasonably relied. 15 U.S.C. § 77k(b)(3)(C); *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 369 (5th Cir. 2001) (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (noting it is a "hornbook principle[ ] of securities law," that "'Defendants other than the issuer can avoid liability by demonstrating due diligence'"); *see also*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 n.26 (1976) (finding "individuals who sign the registration statement . . . are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading"); *In re Software Toolworks, Inc.*, 50 F.3d 615, 624 (9th Cir. 1994) (quotations omitted) (finding where the "defendants relied on *accounting decisions*" according to the Court of Appeals, "[t]hose expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of 'certified' information on which § 11 permits non-experts to rely") (emphasis in original); *Laven v. Fanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988) (finding Outside Directors who relied on independent audits of outside auditors, and assurances of management were not liable under § 11); *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 688-89 (S.D.N.Y. 1968) (finding Outside Directors had a due diligence defense to § 11 based on portions of the offerings audited by the independent auditors).

Taking as true the allegations in the Plaintiffs' complaint, *see Zephyr Aviation, LLC v. Dailey*, 247 F.3d 565, 573 (5th Cir. 2001), Plaintiffs' *sole* attempt to allege misstatements in the offering documents is their general assertion that they contained false "financial statements and results." NCC at ¶ 121(a);[77] *see also*, *id.* at ¶ 164 ("these financial results were false"); *id.* at ¶ 610

[77] Indicative of Plaintiffs' hypnotic puzzle pleading, the statements referred to in ¶ 121's three pages of allegations, however, each relate to registration statements not even purportedly sued on under § 11. Moreover, the registration statements alleged in this paragraph are dated prior to October 1998, and fall outside of § 11's three year statute of limitations. 15 U.S.C. § 77m ("In no event shall (continued...)

(alleging the "financial results . . . violated GAAP"); *id.* at ¶ 613 (alleging the 10Ks were "false"). Plaintiffs go on to plead, however, that prior to the issuance of each registration statement, Andersen represented to the Outside Directors that "Enron's financial statements . . . were presented in accordance with GAAP and that Andersen's audits of Enron's financial statements had been preformed in accordance with . . . GAAS." NCC ¶ 899. Plaintiffs' allege, moreover, that:

> Andersen also consented to the incorporation of its reports on Enron's financial statements in Enron's Form 10-Ks . . . and in Enron's Registration Statements . . . [and] consented to the use of its name as an **expert** in each Prospectus filed and issued pursuant to these offerings, including the Prospectus for the Zero Coupon Notes filed on 7/25/01.

NCC ¶ 899 (alleging further that Andersen "consented to the incorporation of its reports" in each of the specific offerings alleged under § 11). Plaintiffs also judicially admit in their pleadings that the Outside Directors received "'clean' audit opinions" throughout the class period.[78] NCC ¶ 926. Indeed Plaintiffs allege that the 1997 and 1998 financials were "certified by Andersen and [had] an unqualified report thereon," NCC ¶ 141, that Andersen had issued a "clean opinion" as to the 1998,

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[77] (...continued)
any such action be brought to enforce a liability created under section 77k or 77l(a)(1) of this title more than three years after the security was *bona fide* offered to the public.").

[78] Plaintiffs' complaint is replete with admissions of Andersen's expert advice. *See, e.g.*, NCC ¶ 14 ("Andersen certified" the financials in 1998, 1999, and 2000); *id.* ¶ 32 (claiming the LJM transactions were "structured, reviewed, and *approved* by Andersen, Vinson & Elkins, Kirkland & Ellis, and certain of Enron's banks"); *id.* ¶ 67 (claiming "misleading disclosures were crafted and *approved* by Enron's outside auditors and its outside counsel"); *id.* ¶ 70(a) (claiming Andersen "actually actively engaged and participated in structuring transactions"); *id.* ¶ 219 (the 1999 "financial statements [were] certified by Andersen"); *id.* ¶ 296 ("Enron's 00 Annual Report also contained Enron's 00 financial results and statements, as audited and certified by Andersen"); *id.* ¶ 903-04 (alleging Andersen's audit reports were presented to the "Board of Directors of Enron Corp."); *id.* ¶ 903-04 (alleging Andersen reported in 1997-2000 to the Board that "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Enron Corp . . . in conformity with accounting principles generally accepted in the United Sates"); *id.* ¶ 935 ("Andersen was consulted on, and reviewed, . . . [and] signed off on Enron's mark-to-market accounting"); *id.* ¶ 942 ("The accounting decisions relating to the SPEs *were made at the highest levels of Andersen*"); *id.* ¶ 953 ("Andersen in fact offered Enron advice *at every step*, from inception through restructuring and ultimately terminating the Raptors"); *id.* ¶ 959 ("Andersen . . . did not issue a qualified or adverse opinion on Enron's financial statements"); *id.* ¶ 1012 ("Andersen consented to the inclusion or incorporation of its report on Enron's false financial statements in each of the Registration Statements and Prospectuses issued in connection with the offerings").

1999, and 2000 financials, *id.* ¶¶ 221, 292, 931, and that the report in early 2001 was "certified by Andersen"), *id.* ¶ 54.[79]

Having plead the directors received and relied upon the certified expert opinions of Andersen and others, Plaintiffs have conclusively established the directors' defense under § 11. Based on Andersen's unqualified certifications, and the multiple expert accounting and legal opinions cited by Plaintiffs, the Outside Directors had "no reasonable ground to believe and did not believe at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert." 15 U.S.C. § 77k(b)(3)(C). Certainly, Plaintiffs have plead *no facts* to

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[79] Plaintiffs' have also alleged that Vinson & Elkins, and other legal experts, provided further expert opinion regarding the financial information. *See, e.g.*, NCC ¶ 70(b) ("Vinson & Elkins participated in writing, reviewing, and *approving* Enron's SEC filings, as well as its shareholder reports and financial press releases"); *id.* ¶ 141 ("Vinson & Elkins reviewed and collaborated in writing the Form 10-K report"); *id.* ¶ 221 ("Vinson & Elkins reviewed and helped write the [1999] Form 10-K report"); *id.* ¶ 292 ("Vinson & Elkins reviewed and participated in writing the [2000] Form 10-K report"); *id.* ¶ 801 ("Vinson & Elkins participated in the negotiations for, prepared the transaction documents for, and structured Enron's LJM and Chewco/JEDI partnerships and virtually all of the related SPE entities and transactions"); *id.* ¶ 801 ("Vinson & Elkins also wrote the disclosures regarding the related party transactions"); *id.* ¶ 802 ("Vinson & Elkins provided advice in structuring virtually every one of Enron's off-balance-sheet transactions and prepared the transaction documents (including opinions)"); *id.* ¶ 803 ("Vinson & Elkins issued opinions *to Enron*, Mahonia and JP Morgan representing that billions of dollars in forward sales contracts of natural gas and oil by Enron were legitimate"); *id.* ¶ 807 (alleging Vinson & Elkins provided "'true sale' opinions" for Chewco/JEDI); *id.* ¶ 811 ("The LJM1 and LJM2 transactions were structured, reviewed, and *approved* by Vinson & Elkins"); *id.* ¶ 814 ("Vison & Elkins structured each of these transactions for Enron"); *id.* ¶ 815 (describing LJM1 and LJM2 transactions as "structured, reviewed, and approved by Vinson & Elkins"); *id.* ¶ 832 ("[R]elated-party disclosures drafted and approved as adequate by Vinson & Elkins"); *id.* ¶ 833 ("Vinson & Elkins . . . provided legal advice in structuring the LJM and Raptors transactions"); *id.* ¶ 855 (alleging Vinson & Elkins provided Enron, and an outside director, and a committee of the board with the opinion that "Enron may also take comfort from AA's audit opinion and report to the Audit Committee which implicitly approves the transactions"); *id.* ¶ 862 ("Kirkland & Ellis issued numerous legal opinions in connection with the formation and later transactions of the LJMs, and other related SPEs"); *id.* ¶ 896 ("Kirkland & Ellis reviewed and approved Enron's SEC filings as they related to Enron's Chewco and LJM partnerships and related party SPE transactions").

support any claim that the directors believed, at the time, that the certifications they received from Andersen were false.

As Plaintiffs concede that the Outside Directors signed these registration statements in reliance on opinions received in good faith from Andersen and other experts, the § 11 claims against the Outside Directors should be dismissed.

G. Plaintiffs' § 11 Claims Should Also Be Dismissed Because They Sound In Fraud And Do Not Meet The Pleading Requirements of Rule 9(b) Or The PSLRA.

Despite plaintiffs' contention to the contrary, Plaintiffs' § 11 claims, as do all of their claims, sound in fraud. In their complaint, Plaintiffs' attempt to plead around their claims of fraud by "exclud[ing] and disclaim[ing] any allegation that could be construed as alleging fraud or intentional or reckless misconduct." NCC ¶ 1005. In the same paragraph, however, Plaintiffs incorporate numerous paragraphs of the complaint which sound in fraud. *See e.g.*, NCC ¶ 621 (alleging "those on the inside *knew* that the stock price issuance triggers were toxic for Enron"); NCC ¶ 624 (alleging "the banks and Vinson & Elkins *knew* then because they had structured and prepared the documents for the bogus hedging transactions); NCC ¶ 627 (alleging "[t]he banks, in particular, *knew* this from their own risk analyses and because they negotiated, structured and acted as counterparties to Enron's bogus hedging transactions); NCC ¶ 628 (alleging "[t]he bankers and Vinson & Elkins *knew* ").[80] Moreover, at the core of Plaintiffs' entire complaint are their conclusory allegations of fraud. See e.g., NCC "Preamble," "Overview," and "Summary" at ¶¶ 1-75.

As the Fifth Circuit recently noted, "Rule 9(b) applies by its plain language to all averments of fraud, whether they are part of a claim of fraud or not." *Lone Star Ladies Inv. Club v. Schlotzsky's*

[80] While knowledge itself may be averred generally, Fed. R. Civ.. P. 9(b), allegations of knowing behavior are averments of fraud requiring satisfaction of the pleading requirements of 9(b). *Weiss v. Blech*, 1995 WL 1137498, *2 (S.D. Tex. 1995) (finding that complaints using terms such as "'knowingly, recklessly, intentionally,' etc." are sufficient averments of fraud in a § 11 claim and require satisfaction of Rule 9(b)) (citing *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272 (3d Cir. 1992)).

Inc., 238 F.3d 363, 368 (5th Cir. 2001).[81] In the Fifth Circuit, where inadequate claims of fraud are made in support of a claim for which fraud is not an element, "[t]he proper route is to disregard averments of fraud not meeting Rule 9(b)'s standard and then to ask whether a claim has been stated." *Lone Star Ladies Inv. Club*, 238 F.3d at 368. Here, if the Court disregards the inadequately pled allegations of fraud, all that remains are Plaintiffs' conclusory allegations that somewhere in four separate offering documents, Enron's "financials were misrepresented." *See* NCC ¶¶ 121(a), 164, 610, 613. This conclusory allegation wholly fails to place any of the defendants on notice of what facts were allegedly misrepresented or by whom. Accordingly, the claim is not pled in compliance with Fed. R. Civ.. P. 8 and fails to state a claim for relief under Fed. R. Civ. P. 12(b)(6). Moreover, the claim fails in every respect to satisfy the PSLRA's requirement that "the complaint shall specify each statement alleged to be misleading [and] the reason why the statement is misleading," and, therefore, the PSLRA requires the § 11 claim be dismissed. 15 U.S.C. § 78u(4)(b).[82]

In addition, to the extent fraud is implicated in Plaintiffs' claims, they have failed to state a claim for relief, having raised in their own pleadings the existence of the Outside Directors' due diligence defense, *Ernst & Ernst v. Hockfelder,* 425 U.S. 185, 208 (1976); *Glassman v. Computervision Corp.*, 90 F.3d 617, 628 n.12 (1st Cir. 1996) (finding in the § 11 context, "[d]ue diligence is equivalent to non-negligence"), Plaintiffs are required to plead that the Outside Directors

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[81] *See also In Re Stac Elecs. Secs. Litig.*, 89 F.3d 1399, 1405 n.2 (9th Cir. 1996) (finding where the plaintiff "argues that it specifically disclaimed any allegations of fraud with respect to its Section 11 claims[,] [t]hese nominal efforts are unconvincing where the gravemen of the complaint is plainly fraud and no effort is made to show any other basis for the claims levied at the Prospectus"); *Ferber v. Travelers Corp.*, 785 F. Supp. 1101, 1111 n.17 (D. Conn. 1992) ("[W]hen fraud lies at the core of an action under Sections 11 and 12, Rule 9(b) must be satisfied."); *In Re N2K Inc. Secs. Lit.*, 82 F. Supp. 2d 204, 207 n.10 (S.D.N.Y. 2000) (citing numerous cases applying 9(b) pleading requirements to § 11 claims).

[82] Even where there are no allegations of fraud, and Rule 9(b) does not apply, a plaintiffs' section 11 allegations must nevertheless satisfy the PSLRA's pleading requirements. *See, e.g., In re No. Nine Visual Tech. Corp. Secs. Litig.*, 51 F. Supp. 2d 1, 14 (D. Mass. 1999) (finding that even where "Rule 9(b) does not apply, the [pleading] requirements of the PSLRA still do"); *Cooperman v. Individual, Inc.*, 1998 WL 953726, *7 (D. Mass. 1998) (same); *but c.f., In re Harmonic Inc. Sec. Litig.*, 163 F. Supp. 2d 1079, 1088 (N.D. Cal. 2001).

acted with some state of mind, whether bad-faith, recklessness, or fraud. 15 U.S.C. § 77(k). Any such allegation of fraud would, of course, have to be plead with particularity. 15 U.S.C. § 78u-4(b)(2) (requiring claims of "state of mind" to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

Plaintiffs have not, however, plead any facts giving rise to a strong inference that the Outside Directors were "severely reckless" (or even merely reckless) in relying on Andersen's financials or on other expert opinions. *Nathenson*, 267 F.3d at 408. Plaintiffs have also failed to plead any facts to support an inference that a "prudent man in the management of his own property," 15 U.S.C. § 77k(c), would not rely upon audited financial statements issued by a Big Six accounting firm, or a respected outside law firm's disclosure advice, as plaintiffs have alleged the directors did here.

In fact, as to Mendelsohn, Meyer, Pereira, Wakeham, Walker, Willison, Winokur, and Savage, Plaintiffs specifically have *not* plead fraud. NCC ¶ 2 n.1 (stating as to these defendants, "[n]o allegations of fraud are made against or directed at these defendants"). As to those Outside Directors, Plaintiffs' have no claim that their reliance on the expert opinion of Andersen and other experts was in bad faith – so all § 11 claims against them must be dismissed. As to the remaining directors, Plaintiffs fail to comply (as has been illustrated earlier) with their obligation to plead fraud with particularity so as to establish these defendants' fraud and bad faith and thus to defeat the expertised opinion defense.

As to all of the Outside Directors, moreover, Plaintiffs have failed to plead their claims of fraud with sufficient particularity to satisfy Rule 9(b). With respect to any alleged fraudulent misstatements or omissions in the offering documents, Plaintiffs' have failed to specify as to any misstatements or omissions, the "specific time, place, and contents of the false representations, along with the identity of the person making the misrepresentations and what the person obtained thereby" required under Rule 9(b). *Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir. 1994). Plaintiffs have certainly not done so with respect to the individual director defendants who are named only as signatories to certain financial documents. Plaintiffs' claims therefore should be dismissed for failure to satisfy Rule 9(b).

Whether under 9(b), *Lone Star Ladies Inv. Club*, 238 F.3d at 368 ("The price of impermissible generality is that the averments will be disregarded"), or under the terms of the Plaintiffs' complaint, NCC ¶ 1005 ("[P]laintiffs expressly *exclude* and disclaim any allegation that could be construed as alleging fraud or intentional or reckless conduct"), those portions of the Plaintiffs' § 11 claim which sound in fraud must be ignored, leaving nothing behind to support Plaintiffs' § 11 claim. Plaintiffs' § 11 claims should therefore be dismissed.

VI. PLAINTIFFS HAVE FAILED TO ALLEGE A "CONTROL PERSON" CLAIM

A. Elements of Control Person Liability

Plaintiffs have also brought claims against the Outside Directors as purported control persons of Enron. NCC ¶¶ 992-1000, 1005-16.[83] Plaintiffs' allegations are insufficient to state a control person claim against Enron's Outside Directors. Plaintiffs have failed to plead facts establishing (1) a primary violation of the Securities Acts by Enron; (2) the Outside Directors' exercise of "control" over Enron; or (3) facts showing that any Outside Directors was "in some meaningful sense a culpable participant" in any alleged fraudulent misconduct by others. *In re BMC*, 183 F. Supp. at 869 ("[A] plaintiff may allege a primary § 10(b) violation by a person controlled by the defendant <u>and</u> culpable participation by the same defendant in the perpetration of the fraud") (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir.1996)). *See also Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990). Absent these allegations, Plaintiffs' "control person" claims should be dismissed.[84]

[83] To the extent the Plaintiffs have pleaded control person liability against the Outside Directors under the Texas Securities Act, this section applies to the TSA claim as well. *See Quest Med. Inc. v. Apprill*, 90 F.3d 1080, 1091 n.16 (5th Cir. 1996) ("Because of the obvious similarities between the TSA and the federal securities acts, Texas courts look to decisions of the federal courts to aid in the interpretation of the TSA.").

[84] Both this Court and the Fifth Circuit have interpreted the control person provisions of the 1933 (continued...)

B. Plaintiffs Failure to Plead a Primary Violation of the Securities Laws Is Fatal to their Control Person Claims

It is clear that where a plaintiff fails to plead a primary violation of the applicable act, control person claims under that act should be dismissed. *See, e.g.*, *Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1021 (5th Cir. 1996) ("Because the Plaintiffs have failed to state a claim for any predicate securities fraud offense under § 10(b), Plaintiffs have necessarily failed to state a claim . . . for 'controlling person' liability under § 20(a)"); *Dennis,* 918 F.2d at 509 (where plaintiff can maintain no Section 12 or Section 10 violations, none of the defendants can possibly be held liable under Section 15 since there are no actual violators of the securities laws to be held liable with.). As outlined in this brief, Plaintiffs have failed to plead a primary violation of either the 1933 Act or the 1934 Act. Accordingly, Plaintiffs' control person claims under § 15 of the 1933 Act and § 20(a) of the 1934 Act should be dismissed.

C. Plaintiffs Have Not Pleaded Facts Showing Actual Control by the Outside Directors Over Enron

Plaintiffs have also failed to plead facts establishing control by each of the Outside Directors over Enron's business and affairs. Plaintiffs allege that the Outside Director Defendants were members of Enron's Board, served on various Board committees, and had the "power to control the contents" of Enron's SEC filings by virtue of their positions as directors and committee members. *See* NCC ¶ 83(ff), 85, 90 & 397. Identical allegations have been repeatedly rejected as a basis for imposing "control person" liability.

Board membership is insufficient to plead "control" for purposes of "control person" liability. *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990); *Burgess v. Premier Corp.*, 727

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[84] (...continued)
Act and the 1934 Act as identical. *In re BMC*, 183 F. Supp. 2d at 866 n.17; *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1114 (5th Cir. 1980) ("In Pharo v. Smith, 621 F.2d 656, 673-674 (5th Cir. 1980), this court concluded that section 15 of the Securities Act and section 20(a) of the Securities Exchange Act are analogous provisions that should be interpreted similarly.").

F.2d 826 (9th Cir. 1984). Importantly, courts dismiss "control person" allegations against *outside directors* of corporations on the basis that such a position is insufficient to establish "control" for purposes of the statute. *E.g., In re Livent, Inc. Securities Litigation*, 78 F. Supp. 2d 194, 221 (S.D.N.Y. 1999) ("Officer or director status alone does not constitute control."). "A person's status as an officer, director, or shareholder, absent more, is not enough to trigger liability under § 20." *Hemming v. Alfin Fragrances, Inc.*, 690 F. Supp. 239, 245 (S.D.N.Y.1988)." *See also Sloane Overseas Fund, Ltd. v. Sapiens Intern. Corp., N.V.*, 941 F. Supp. 1369, 1378 (S.D.N.Y. 1996); *Kimmel v. Labenski*, 1988 WL 19229 *5 (S.D.N.Y. 1988) (complaint dismissed where allegations relating to Outside Directors, including audit committee members did not "allege specifically how each director 'possessed the power to direct or cause the direction of the management' of [the corporate defendant]."). For the same reasons, courts have rejected the notion that a director's mere service on a Board committee--such as an audit committee or executive committee--is sufficient to plead "control" for purposes of sections 15 and 20(a). *See Kimmel*, 1988 WL 19229 at *5; *Bomarko, Inc. v. Hermodynamics, Inc.*, 848 F. Supp 1335, 1339 (W.D. Mich. 1993). In short, courts have rejected the notion that a person's title or status as a Board member or committee member is all that a plaintiff need allege to establish "control person" liability.

Plaintiffs also allege that the directors, by virtue of their position, had the ability to "control the contents" of the company's financial statements. NCC ¶ 90 & 397. This wholly conclusory allegation has also been rejected. As the Court explained in *Copland v. Grummet*, 1998 WL 256654 (D.N.J. 1998), such allegations do "nothing more than restate the legal standard for control person liability; it does not provide adequate facts to support these allegations." *Id.* at *15.

Given the insufficiency of the facts pleaded to support a claim for "control person" liability against Enron's Outside Director Defendants, these allegations should be dismissed.

D. Plaintiffs Have Not Pleaded "Meaningful Culpable Participation" by the Outside Director Defendants in the Alleged Fraud

Finally, the Complaint should be dismissed because Plaintiffs have failed to plead facts sufficient to give rise to an inference that the Outside Director Defendants were "in some meaningful sense, culpable participants" in the alleged fraud. *See BMC*, 183 F. Supp. 2d at 869; *see also Dennis*, 918 F.2d at 508.

As the Court explained in *In re CINAR Corp. Sec. Litig.*, 2002 WL 334734 (E.D.N.Y. Feb. 25, 2002), a plaintiff is required to plead "both fraudulent conduct and a culpable state of mind." *See also Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, 2001 WL 1111508, at *10 (S.D.N.Y. Sept. 20, 2001). Predictably, courts have equated the requirement that a plaintiff plead facts showing "culpable participation" with the *scienter* required for primary liability under section 10(b) and Rule 10b-5. See *Mishkin*, 1998 WL at *25; *see also Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 426 (S.D.N.Y. 2001) (holding that *scienter* must be pleaded to state a claim for control person liability); *In re Equimed, Inc.*, 98-CV-5374, 2000 WL 562909, at *10 (E.D.Pa. May 9, 2000) ("[A] plaintiff must plead particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud.") (quoting *In re Cendant Corp. Securities Litigation*, 76 F. Supp.2d 539, 549 n. 5 (D.N.J.1999)).

For the reasons outlined in Section III of this Motion, Plaintiffs have pleaded nothing that would give rise to a "strong inference" that Enron's Outside Director Defendants acted with *scienter* in discharging their duties a corporate directors. As a result, Plaintiffs have also failed to plead with particularity the required element of "culpable participation" necessary to sustain their claim of control person liability against all of the directors – and have specifically <u>disclaimed</u> any fraudulent intent on the part of Messrs. Mendelsohn, Meyer, Pereira, Urquhart, Wakeham, Walker, Winokur and Savage. *See* NCC n.1. Plaintiffs' claims under Section 20(a) and Section 15 must be dismissed.

In conclusion, Plaintiffs have failed to plead specific facts supporting any of the elements required to state a claim for controlling person liability. Plaintiffs have failed to plead with particularity a primary violation of the 1933 Act or the 1934 Act. Plaintiffs have not pleaded facts sufficient to give rise to an inference that any Outside Director Defendant possessed the "power to control" the day-to-day business of Enron. Finally, Plaintiffs have failed to plead facts giving rise to a "strong inference" that any Outside Director Defendant was a "culpable participant" in the alleged fraud. The control person claims under section 15 of the Securities Act of 1933 and under section 20(a) of the Securities Exchange Act of 1934 should therefore be dismissed.

VII. Plaintiff Washington Board's Sub-Class Claim Under the Texas Securities Act Must Be Dismissed Because it Relies on Representations Made <u>After</u> its Purchase and it Purchased Before the Alleged Class Period

Plaintiff Washington State Investment Board ("Washington Board") brings a sub-class claim under the Texas Securities Act ("TSA"), Tex. Rev. Civ. Stat., Art. 581-33, against outside directors Belfer, Blake, Chan, J. Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Wakeham, Walker, and Winokur. Washington Board's claim must be dismissed, because: (i) it purchased its securities <u>before</u> the alleged misrepresentations were made; (ii) none of the allegations or purchases on which Washington Board's claim is based occurred during the class period; (iii) it fails under Rule 9(b); (iv) Plaintiffs do not allege any untruths, omissions, or materiality in connection with the offering in which they actually bought; and (v) Plaintiffs have not pleaded the outside director defendants are sellers under the TSA.

A. The Texas Securities Act Requires A Plaintiff to Allege He Was Induced to Purchase Securities "By Means Of" a Misrepresentation or Omission.

Any claim under the Texas Securities Act requires a plaintiff to prove one of two things: (a) that he was induced to buy a security from a seller "by means of" an untruth or material omission; or (b) that he was induced to buy a security based upon a misleading registration statement. *See* Tex. Civ. Stat. Ann. Art. 581-33A(1) and (2). Washington Board does not specify under which section it is asserting its claim, but it fails under either one.

The Washington Board alleges that it bought securities on July 7, 1998[85] in connection with two note offerings: Enron 6.95% Notes and Enron 6.4% Notes. In its complaint, however, the Washington Board does not identify any misrepresentation or omission in the July note offering documents. Instead, it simply incorporates by reference more than 1000 paragraphs of the *Newby* complaint. *See* NCC at 1017 (incorporating paragraphs 1-1016 of the complaint). Those paragraphs, however, relate to offerings and events that occurred after October 1998. By definition, any plaintiff who alleged misstatements in notes in July 1998 was not induced to purchase them "by means of" representations that were not made until months later. Nor do alleged misstatements in subsequent filings suffice to allege that an earlier registration statement was misleading. Plaintiffs claims under the TSA must therefore be dismissed. *See* Tex. Civ. Stat. Ann. Art. 581-33(A)(2) (requiring an allegation that the purchase be induced "by means of" an untruth or omission); and (A)(1) (requiring an allegation of a misstatement in the registration statement). *Cf. Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, (S.D.N.Y. 1999) (dismissing "all claims pertaining to statements made by Defendants after the time of the Offering").

The Washington Board's claims are, in any event, outside the alleged class period. Their purchase was allegedly made in July of 1998; but the class period in the *Newby* complaint begins in October of 1998. *Id.* at 2. As a matter of law, any alleged pre-class period statements cannot constitute actionable securities fraud. *In re: Int'l Bus. Mach. Corp. Secs. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998) (finding an alleged misrepresentation made one day before the class period began not actionable because "[a] defendant . . . is liable only for those statements made during the class period"); *see also In re: Clearly Canadian Sec. Lit.*, 875 F. Supp. 1410, 1420 (N.D. Cal. 1995) (striking alleged statements made before and after class period). In fact, none of the relevant events alleged in the Washington Board's securities claim actually occurred during the class period. It purchased in July 1998 and the notes' offering document was dated in July 1998 as well. SEC App.

[85] *See* Certification of Washington State Board, Sched. A. Filed December 20, 2001.

Tab 82. Given that it has alleged no purchase within the class period, the Washington Board's sub-class claim must be dismissed.

B. Plaintiffs' Claims Have Not Been Plead in Compliance with Rule 9(b).

Plaintiffs' TSA claim must also be dismissed for failure to plead as required by Rule 9(b). Rule 9(b) applies even to claims grounded in state law. *See* Rule 9(b) (covering "all averments of fraud") *Williams*, 112 F.3d at 177 (applying Rule 9(b) to state law claims alleging fraud); *Rubinstein*, 20 F.3d at 165-66 (same). Plaintiffs expressly incorporate and rely upon the fraud allegations in the preceding 1,016 paragraphs of the *Newby* Complaint. NCC at ¶ 1017. As has been demonstrated earlier in this brief, however, those allegations are wholly inadequate to comply with 9(b) or to state a claim of fraud against the Outside Directors. If those allegations are inadequate, and they are, they are not saved by being rehashed in a separate claim under the state securities laws. *See D'Addio v. L.F. Rothschild, Inc.*, 697 F. Supp. 698, 706 (S.D.N.Y. 1988) (where plaintiff merely incorporates by reference, nothing new is added when the incorporated paragraphs are reasserted to support a state common law claim).

C. Plaintiffs Do Not State A Claim for Relief Because They Do Not Allege Any Misrepresentations in the Offering Documents Pertinent to their Purchases.

Plaintiffs have also failed to plead with particularity the specific untruths or omissions in the offering documents on which they sue. NCC ¶ 1017 *et. seq*. Plaintiffs also do not explain how these unspecified mis-statements were material.[86] As the Fifth Circuit has found, conclusory allegations that the offering documents are "materially misleading" should not be accepted. *Assoc. Builders,*

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[86] Both an untrue statement or omission, and materiality are required elements of Plaintiffs' TSA claim. Liability of sellers under the TSA extends to:

> Untruth or Omission. A person who offers or sells a security(whether or not the security or transaction is exempt under Section 5 and 6 of this Act) by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in the light of the circumstances under which thy are made, not misleading, is liable to the person buying the security from him.

Tx. Civ. St. Art. 581-33(A)(2).

Inc. v. Ala. Power Co., 505 F.2d 97, 100 (5th Cir. 1974) ("On a motion to dismiss . . . [w]e do not, however, accept [the Plaintiffs'] conclusory allegation that the prospectus was materially misleading. Conclusory allegations and unwarranted deductions of fact are not admitted as true."); *see also Panda Brandywine Corp. v. Potomac Elec. Power Co.*, 253 F.3d 865, 869 (5th Cir. 2001) (finding that accepting the plaintiffs' allegations as true does not require acceptance of conclusory allegations); *Kaiser Aluminum*, 677 F.2d 1045, 1050 (5th Cir. 1982) (same); *Azurix*, at 52 (S.D. Tex. Mar. 21, 2002) ("Because plaintiffs have put forth only conclusory allegations in support of their claims, their claims fail. . . [C]onclusory allegations or legal conclusions masquerading as factual conclusions will not suffice to prevent a motion to dismiss") (citations omitted); *Eizenga v. Stewart Enterprises, Inc.*, 124 F. Supp. 2d 967, 978 (E.D. La. 2000) (finding "conclusory allegations . . . insufficient to allege that there were material omissions"). As an "untrue statement of a material fact or an omission to state a material fact" is a required element of Plaintiffs' TSA claim, and Plaintiffs' have wholly fail to plead it, Plaintiffs TSA claim should be dismissed.

D. Plaintiffs Do Not Plead Defendants Are Sellers, A Required Element Of Their TSA Claim, Their Claim Against the Director Defendants Should Be Dismissed.

Finally, the outside director defendants are not sellers of the securities purchased by Washington Board, and therefore are not liable for a primary violation of the TSA. To impose seller liability under the TSA, a defendant must have been in privity with Plaintiffs. *Frank v. Bear Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App. -- Houston [14th Dist.] 2000, pet. denied) (rejecting argument that claims of primary violation of the TSA extend beyond those in contractual privity with plaintiffs). In the comments to the 1977 revisions to the TSA, the commentators noted that the untruth or omission liability provision "is a privity provision, allowing a buyer to recover from his offeror or seller." Tex. Rev. Civ. Stat., Art. 581-33, cmt. (1977). In reaching its decision in *Frank*, the Fourteenth Court of Appeals noted that "commentators at the time of the revision [to the TSA in 1977] had little doubt that the revision was intended to contain a privity provision." *Frank*, 11 S.W.3d at 383. The TSA does not extend to "those who merely participate in preparing an offering."

Huddleston v. Herman & MacLean, 640 F.2d 534, 551 (5th Cir. 1981) (en banc) (reversed in part on other grounds). Under these guiding principals, the outside director defendants are not sellers liable under the TSA.

Plaintiffs also bring their TSA claim on the basis of a firm commitment offering. SEC Tab 82.[87] In other words, neither Enron -- and certainly not its outside directors --passed title to these Notes to the plaintiffs. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1215 (1st Cir. 1996)[88] ("[T]he issuer in a firm commitment underwriting does not pass title to the securities"); *Dartley v. Ergobilt*, 2001 WL 313964, *2 (N.D. Tex. March 29, 2001) ("Where there is a firm commitment underwriting . . . the issuer sells the stock to be offered to the group of underwriters for the offering. . . . Here, Plaintiffs do not allege any facts to support the conclusion that [the defendants] were statutory sellers as to any of the Plaintiffs."). Plaintiffs admit as much in their TSA claim, as the only sellers they identify are JP Morgan and Lehman Brothers. NCC ¶ 1023. ("JP Morgan and Lehman Brothers together **offered for sale and sold**" the securities "**purchased** by the Washington Board.")

Plaintiffs do not--and could not--allege that any individual director sold them the notes. Because Plaintiffs' fail to allege the outside director defendants were sellers -- a required element of their TSA claim -- their claims of seller liability against the outside director defendants named must also be dismissed.

CONCLUSION

For the foregoing reasons, Plaintiffs' claims against the Outside Directors should be dismissed in their entirety with prejudice.

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[87] By the terms of the offering, "Enron has agreed to sell to each of the Underwriters named below . . . . Under the terms and conditions of the Underwriting agreement, the Underwriters are committed to purchase all of the Notes, if any are purchased." SEC App. Tab 82 at S-5.

[88] "Because of the obvious similarities between the TSA and the federal securities acts, Texas courts look to decisions of the federal courts to aid in the interpretation of the TSA." *Quest Medical, Inc. v. Apprill*, 90 F.3d 1080, 1091 n.16 (5th Cir. 1996).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the forgoing was served on all counsel of record on this the 8th day of May, 2002, via e-mail, certified mail, return receipt requested, federal express and/or facsimile.

Jeremy L. Doyle