

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

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES
LITIGATION

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

CLASS ACTION

This Document Relates To:

MARK NEWBY, et al., Individually and On
Behalf of All Others Similarly Situated,

Plaintiffs,

vs.

ENRON CORP., et al.,

Defendants.

**PLAINTIFFS' OPPOSITION TO DEFENDANT KENNETH L. LAY'S
MOTION TO STRIKE DECLARATION OF SCOTT D. HAKALA**

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I. Introduction

Plaintiffs respectfully submit this memorandum in opposition to Kenneth L. Lay's Motion to Strike Declaration of Scott D. Hakala and all joinders to this motion to strike ("Motion to Strike"). Defendants do not ask this Court to strike the Complaint sections which incorporate the Declaration of Scott Hakala, and do not ask this Court to strike those allegations in the Complaint which repeat and summarize Dr. Hakala's findings. Hence, those Complaint sections, like other allegations of the Complaint, must be accepted as true for purposes of the motion to dismiss regardless of this Court's decision regarding this Motion. The sole purpose of the Motion to Strike is to reduce some specificity from plaintiffs' scienter allegations. Curiously, defendants simultaneously request that this Court dismiss plaintiffs' Complaint because of a lack of specificity with regards to plaintiffs' scienter allegations.

Dr. Hakala's statistical analysis of defendants' sales using the well-established event study methodology and option risk premium analysis are designed to address the pleading standards set forth by the Private Securities Litigation Reform Act of 1995 ("PSLRA") as interpreted by the Fifth Circuit in *Nathansen v. Zonagen, Inc.*, 267 F.3d 400, 407 (5th Cir. 2001).

Statistical analysis demonstrates that the transactions conducted by insiders were unusual and suspicious in nature because it would have been extremely unlikely, less than one chance in one thousand, that defendants would have traded in the manner they did absent inside information. This does not eliminate the possibility that all of the defendants could have been selling their stock to pay for their kids' college tuition; rather, it quantifies the possibility that this was the reason – less than one chance in one thousand – so unlikely an event that plaintiffs have clearly plead a strong inference of scienter in their Complaint.

The options risk premium analysis used by Dr. Hakala relies upon well accepted financial valuation techniques. Dr. Hakala's resume, Hakala Decl., ¶2 and Ex. A provides strong evidence of Dr. Hakala's qualifications to address such issues, including overseeing dissertations on option pricing, research on asset pricing and options, teaching courses at the doctoral level, testimony on options in divorce and wrongful terminations cases, and teaching a CLE course at New York University on option valuation. Dr. Hakala cites a peer reviewed article in footnote 21 of his

Declaration and provides other references in footnotes 19 and 20 of his Declaration. The technique details numerous option exercises that would have been extremely irrational and unlikely to have occurred absent the possession and use of inside information. It bases this analysis specifically on the option exercise behavior of each individual defendant. What he found was that certain premature exercises of stock options by individual officer defendants were specifically related to the allegations in the Complaint and were inconsistent with those individual's prior economic behavior. Hakala Decl., ¶¶9(c), (e), 20, 25, 30, 34, 37, 41, 44. The analysis also demonstrates how defendants' option exercises were very different during the Class Period than prior to the Class Period. Such allegations constitute detailed factual allegations which provide strong circumstantial evidence of scienter.

It is important to highlight that although defendants have moved to strike the Declaration of Dr. Hakala, they do not dispute the vast majority of facts or conclusions set forth in his Declaration. First, the matters set forth in his Declaration are supported by the extensive list of treatises and peer reviewed articles cited in his 38-page Declaration. *See, e.g.*, Hakala Decl., ¶¶10-20. Second, defendants do not seriously dispute his qualifications. Dr. Hakala has a Ph.D. in Economics and has testified previously about the techniques at issue in this Declaration. *See* Hakala Decl., ¶2 & Ex. A at 2-8. Defendants' sole quibble appears to be the suggestion that despite his Ph.D. in economics, Dr. Hakala should have proved his ability to carry out statistical analysis. Clearly, Dr. Hakala's Ph.D. from the University of Minnesota provides presumptive competence along these lines. As to those factual issues that are disputed, plaintiffs demonstrate below that defendants are wrong.

By moving to strike, defendants are attempting to short-circuit the proper evaluation of these theories and the clear procedural requirements of the PSLRA which requires that plaintiffs plead facts sufficient to support a strong inference of scienter. Dr. Hakala's Declaration establishes these facts and then provides plaintiffs a basis for a strong inference for purposes of plaintiffs' pleading requirements.

Indeed, defendants' Motion, though styled as a motion to strike, is in reality, a premature motion in limine. In particular, defendants' Motion involves a disputed issue of fact and law, as is demonstrated by a lengthy discussion of why defendants do not believe the allegations of the Complaint satisfy plaintiffs' scienter pleading requirements. To achieve defendants' goal of striking

these allegations, this Court must improperly make favorable factual inferences in defendants' favor and resolve substantial issues of law. If defendants believe they can prevail on the substantial issues of fact and law presented by these allegations, defendants should raise these issues as a motion in limine or before the jury. But they should not raise these issues at this stage – on a motion to dismiss – where the rule is that all facts alleged by plaintiffs are assumed to be true and all inferences are to be drawn in their favor. In sum, it is not "too early" to consider Dr. Hakala's Declaration as defendants suggest but rather "too early" to consider defendants' factual assertions about alternative statistical interpretations of defendants' stock sales.

Defendants contend that the Hakala Declaration should be stricken because: (a) the expert Declaration is not a written instrument that is part of the pleading; (b) consideration of an expert's opinion would require the Court to confront evidentiary and procedural issues; (c) the declaration would not be "fundamentally useful;" and (d) the declaration would not survive a *Daubert* analysis. As described below, none of these arguments is either correct or sufficient to permit striking Dr. Hakala's Declaration.

II. Argument

A. The Legal Standards for Striking Pleadings Does Not Allow Striking Relevant Allegations

Under Fed. R. Civ. P. 12(f), a party may move to strike "any redundant, immaterial, impertinent, or scandalous matter" from the pleadings. However, motions to strike are generally viewed with disfavor and are not frequently granted. 2 James Wm. Moore, *Moore's Federal Practice* §12.37[1], at 12-93 (3d ed. 1997); *Naton v. Bank of Cal.*, 72 F.R.D. 550, 552 (N.D. Cal. 1976). The rationale for this standard is that "a case should be tried on the proofs rather than the pleadings." *Rennie & Laughlin, Inc. v. Chrysler Corp.*, 242 F.2d 208, 213 (9th Cir. 1957).

Hence, motions to strike "are generally not granted unless it is clear that the matter to be stricken could have no possible bearing on the subject matter of litigation." *Lazar v. Trans Union LLC*, 195 F.R.D. 665, 669 (C.D. Cal. 2000) (quoting *LeDuc v. Kentucky Cent. Life Ins. Co.*, 814 F.

Supp. 820, 830 (N.D. Cal. 1992)).¹ Hence, in evaluating a motion to strike a pleading, a court must treat all facts pled by plaintiff as admitted and cannot consider matters beyond the pleadings. *Cherry v. Crow*, 845 F. Supp. 1520, 1524 (M.D. Fla. 1994); *U.S. Oil Co. v. Koch Refining Co.*, 518 F. Supp. 957, 959 (E.D. Wis. 1981).

One of the key issues of this litigation is defendants' scienter. Plaintiffs have submitted Dr. Hakala's Declaration as one part of their strong circumstantial evidence of defendants' scienter. Hence, it is impossible for defendants to assert that Dr. Hakala Declaration "could have no possible bearing on the subject matter of the litigation." *Lazar*, 195 F.R.D. at 669 (citation omitted). As such, Dr. Hakala's declaration is relevant as it both sets forth facts regarding the timing of option exercises and sales of Enron shares upon which the plaintiffs rely and then provides the basis for plaintiffs to allege that these inside sales provide a strong circumstantial inference of scienter. Thus, there is no legal basis for striking Dr. Hakala's Declaration under Rule 12(f).

B. Numerous Courts Permit the Consideration of Declarations in Motion to Dismiss Proceedings

Defendants fail to acknowledge that "in deciding a motion to dismiss for failure to state a claim, courts must limit their inquiry to the facts stated in the complaint and the documents either attached to or incorporated in the complaint." *Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1017 (5th Cir. 1996).² There is no question that the Hakala Declaration meets this test as it was an

¹See also *Lentz v. Woolley*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,498 (C.D. Cal. 1989); *Magnavox Company v. APF Elecs., Inc.*, 496 F. Supp. 29 (N.D. Ill. 1980) (allegations regarding actions are relevant and should not be stricken); 5A Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* §1382, at 681-716 (1990). In a motion to strike, the court must view the facts most favorably to the non-moving party. *American Agric., Inc. v. Shropshire*, No. 99-366-AS, 1999 U.S. Dist LEXIS 13972 (D. Or. Aug. 11, 1999).

²See also *Tyler v. Coumo*, 236 F.3d 1124, 1131 (9th Cir. 2000) ("In determining whether a plaintiff can prove facts in support of his or her claim that would entitle him or her to relief, we may consider facts contained in documents attached to the complaint."); *Roth v. Garcia Marquez*, 942 F.2d 617, 625 n.1 (9th Cir. 1991) ("if a complaint is accompanied by attached documents, the court is not limited by the allegations contained in the complaint. These documents are part of the complaint and may be considered in determining whether the plaintiff can prove any set of facts in support of the claim. . . . In this case, the documents were indeed attached to the complaint; we may thus consider them.") (quoting *During v. First Boston Corp.*, 815 F.2d 1265, 1267 (9th Cir. 1987)); *Chance v. Armstrong*, 143 F.3d 698 (2d Cir. 1998) ("complaint is deemed to include any written instrument attached to it as an exhibit or any statements or documents incorporated in it by reference") (quoting *Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47 (2d Cir. 1991)); the Seventh Circuit holds that a copy of a written instrument which is an exhibit to a pleading is part

exhibit to the Complaint, incorporated by reference into the Complaint, and was reiterated and summarized in the text of the Complaint.

Indeed, in *Mortensen v. AmeriCredit Corp.*, 123 F. Supp. 2d 1018, 1026 (N.D. Tex. 2000), the district court considered two expert opinions on a motion to dismiss a securities complaint. Although the court dismissed the complaint, its basis for doing so was the accounting experts provided evidence only the company had violated GAAP – which is not sufficient by itself to establish scienter under the federal securities laws. *Id.* at 1027. Here, by contrast, Dr. Hakala has established a statistically significant probability that the insiders traded on inside information – which is sufficient to establish scienter under the securities laws. Circuit courts have dealt explicitly with the issue of the use of declarations and affidavits in a motion to dismiss. For example, the Ninth Circuit has held that it is proper to consider an affidavit in ruling on a motion to dismiss. *Branch v. Tunnell*, 14 F.3d 449, 453 (9th Cir. 1994) ("material which is properly submitted as part of the complaint may be considered' on a motion to dismiss") (quoting *Hal Roach Studios v. Richard Feiner & Co.*, 896 F.2d 1542, 1555 n.19 (9th Cir. 1989)). The Eleventh Circuit has held that declarations submitted by plaintiffs may be considered at the motion to dismiss stage. *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1279 (11th Cir. 1999) ("[t]he prohibition against going outside of the facts alleged in the complaint protects against a party being caught by surprise when documents outside the pleadings are presented at that early stage"). Similarly, the Seventh Circuit permits consideration of affidavits at the motion to dismiss if the facts alleged therein are consistent with the allegations in the complaint. *Thomason v. Nachtrieb*, 888 F.2d 1202, 1205 (7th Cir. 1989). Finally, the Third Circuit in *Swin Resource Sys., Inc. v. Lycoming County*, 883 F.2d 245, 247 (3d Cir. 1989), held that a deposition presented by a plaintiff should be considered in ruling on a motion to dismiss "to the extent that [the facts set forth therein] fall within the ambit of the complaint, as illustrative of those facts which [the plaintiff] could prove if its complaint were [upheld]."

The ruling in *Swin* embodies the purpose of a motion to dismiss under Rule 12(b)(6), which is to determine whether there is a state of facts that could be proved consistent with the plaintiffs'

thereof for all purposes. *Schnell v. City of Chicago*, 407 F.2d 1084, 1085 (7th Cir. 1969).

allegations upon which relief could be granted. *Id.* While the PSLRA provides for heightened pleading requirements in an action for violation of §10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, and the assurance that the plaintiffs will be able to prove a set of facts upon which relief may be granted should be correspondingly greater, the purpose remains the same – to dismiss claims which the court believes are not likely to be proved. That means that a court, in ruling on a motion to dismiss, should consider any document within the ambit of the plaintiff's complaint that shows what the plaintiff would be able to prove. The Hakala Declaration contains exactly such facts plaintiffs will attempt to prove at trial.

C. Fed. R. Civ. P. 10(c) Cannot Stand for the Proposition that Expert Analysis Can Be Stricken or Excluded from Consideration on a Motion to Dismiss

Defendants rely solely upon one district court decision in California that held that an expert affidavit "does not qualify as a 'written instrument' within the meaning of Rule 10(c)" and therefore should be stricken. *DeMarco v. Depotech Corp.*, 149 F. Supp. 2d 1212, 1222 (S.D. Cal. 2001), *aff'd*, No. 01-55928, 2002 U.S. App. LEXIS 2993 (9th Cir. Feb. 21, 2002). As noted above, defendants' argument ignores this Circuit's clear holding that district courts are required to consider the complaint and "*documents* either attached to or incorporated in the complaint" in considering a motion to dismiss. *Lovelace*, 78 F.3d at 1017 (emphasis added).

However, even if this Court were to consider *DeMarco*, there are several reasons why *DeMarco* should have little application to this case. Most importantly, although the *DeMarco* court struck the expert's declaration in that case it explicitly ruled that:

A better approach might be to include the expert's nonconclusory assertions within specific paragraphs in the complaint. This would reduce needless redundancy and simplify pleadings in federal securities cases.

149 F. Supp. 2d at 1222. There is no suggestion that anything contained in the Hakala Declaration which was specifically incorporated and summarized in the Complaint would be stricken under the rationale of *DeMarco*.

However, there is a significant downside to striking the Hakala Declaration under the facts of this case. In particular, the PSLRA requires that plaintiffs plead specific facts in support of their scienter allegations and defendants have based their motions to dismiss on this ground. Hence,

striking Dr. Hakala's Declaration would have no impact in this case other than to eliminate some of the very factual details that provide the specificity required by the PSLRA. 15 U.S.C. §78u-4(b)(2). Such a result would permit defendants to simultaneously argue that plaintiffs have not plead specific facts regarding scienter because the Court granted their Motion to Strike. This cannot be a correct result and the principles of judicial estoppel should preclude such a test.

D. Defendants Cannot Base Their Motion to Strike on Immateriality

Defendants argue that the Hakala Declaration is not "fundamental[ly] useful[]," artfully avoiding the term "immaterial." Lay Brf., ¶4. By avoiding the term "immaterial," defendants apparently hoped to avoid discussion of the extremely high standards for striking allegations on this basis. In particular, for this Court to strike the allegations on the basis of immateriality, the Court must find that the allegations can have no possible bearing on the issues of trial. *Fed. Dep't Stores v. Grinnell Corp.*, 287 F. Supp. 744, 747 (S.D.N.Y. 1968).

Defendants cannot possibly meet these standards. The PSLRA requires a plaintiff to plead facts "giving rise to a strong inference" of "the required state of mind." 15 U.S.C. §78u-4(b)(2). As described in the following sections, Dr. Hakala's study is directly material to these issues.

1. Dr. Hakala' Statistical Study Is Material Circumstantial Evidence of Scienter

For plaintiffs to properly plead scienter, they must allege facts giving rise to a strong inference of scienter. *Nathensen*, 267 F.3d at 407. Stock transactions can provide this inference where they are "unusual." *Id.* at 421. As with all civil and criminal standards, the demonstration of strong inference that an occurrence is "unusual" is essentially a showing of probability. *Victor v. Nebraska*, 511 U.S. 1 (1994):

[T]he beyond a reasonable doubt standard is itself probabilistic. "In a judicial proceeding in which there is a dispute about the facts of some earlier event, the factfinder cannot acquire unassailably accurate knowledge of what happened. Instead, all the factfinder can acquire is a belief of what probably happened."

Id. at 14 (citation omitted).³

³See also *United States v. Chaidez*, 919 F.2d 1193, 1200 (7th Cir. 1990) ("All inferential processes are probabilistic ... [a]cknowledging the statistical nature of inferential processes may well make them more accurate."); *Branion v. Gramly*, 855 F.2d 1256, 1263-64 (7th Cir. 1988) (even eyewitnesses are testifying only to probabilities (though they obscure the methods by which they

The use of statistics to plead and prove a defendant's state of mind is well established in the law, in particular in discrimination cases where statistics are the primary method by which to plead the intent to discriminate. *See, e.g., Mayor of Philadelphia v. Educational Equal. League*, 415 U.S. 605, 620 (1974) (discrimination); *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 805 (1973) (same); *Turner v. Fouche*, 396 U.S. 346, 360-61 (1970) (discrimination in jury selection); *United States v. Ironworkers Local 86*, 443 F.2d 544, 551 (9th Cir. 1971) (same).

In light of the essential statistical nature of this subject matter, Dr. Hakala's study asks the crucial question: Were Enron insiders' sales, analyzed as a group or individually, statistically associated with the bad news that was later disclosed? Hakala Decl., ¶¶4, 9, 11, 15, 17-19, 22, 27, 45-46. Dr. Hakala examines this question using the state-of-the-art techniques of financial economic event studies. Hakala Decl., ¶¶6, 21. After considering all of the stock sale evidence and conducting his event study, Dr. Hakala has concluded, with a scientifically determined degree of certainty exceeding any civil or criminal standard of proof, that the possibility that defendants conducted their trades based upon some alternative explanation other than the use of inside information is so unlikely that it should be rejected as a plausible explanation for their behavior. Complaint, ¶415; Hakala Decl., ¶¶9(b), (c), (f), (h). This is not speculation but rather a straightforward application of the scientific method.

Dr. Hakala's results are extremely material to this case by providing significant circumstantial evidence to establish with a degree of certainty between 95% and 99.9% that defendants traded on inside information (and provides additional evidence that other insiders traded on insider information with a certainty of greater than 90%). Hakala Decl., ¶46. This level of certitude far exceeds any civil, or even criminal, proof required and is in excess of the stringent standards developed for scientific acceptance.

Although no court has yet defined mathematically the pleading standard of a "strong inference" under the federal securities laws, a formal survey of judges has equated the civil proof standards of a "preponderance of the evidence" or "more probable than not" with a finding of a

generate those probabilities) often rather lower probabilities than statistical work "insists on").

probability of liability of just more than 50%. *United States v. Fatico*, 458 F. Supp. 388, 403 (E.D.N.Y. 1978) (detailing results of the study), *aff'd*, 603 F.2d 1053 (2d Cir. 1979). Similarly, a survey of judges has equated the "clear and convincing" standard with a finding that the fact at issue is true with a probability of between 60% and 70%. Even in the criminal context, the standard "beyond a reasonable doubt" does not exceed 76% to 95% certainty before a jury should find a suspect guilty. *Id.* at 404. Such evidence clearly meets plaintiffs' pleading burden.

2. Dr. Hakala's Options Analysis Is Material Circumstantial Evidence of Scienter

As described in the Complaint, analysis of the timing of an insider's exercise of stock options and sale of the underlying shares can provide circumstantial evidence that these transactions were based on non-public information. Complaint, ¶¶407-409; Hakala Decl., ¶¶17-20. The analysis is based on the common sense notion that executives will not needlessly waste large amounts of their wealth by undertaking transactions that would cause them massive financial losses. *Id.* Indeed, it would be extremely unusual and suspicious that financially sophisticated executives would act so foolishly.

The Ninth Circuit has recently provided substantial guidance regarding the valuation of non-marketable options in *Custom Chrome v. Commissioner*, 217 F.3d 1117, 1124 n.10 (9th Cir. 2000). In considering the value of options, the court set forth and explained the different value components of an option that must be evaluated by a trial court: "An option has two values: an intrinsic value and a time value." *See, e.g.*, Charles J. Woelfel, *Encyclopedia of Banking & Finance* 874 (10th ed. 1994). The intrinsic value of an option is the difference between the actual value of a share and the exercise price of the option. *Id.* Thus, if ABC stock is trading at \$50 a share, and the exercise price of the option is \$40 per share, then the intrinsic value of the option is \$10. *Id.*

The time value of an option "refers to whatever value the option has in addition to its intrinsic value." *Id.* at 1125 (citation omitted). The time value "reflects the expectation that, prior to expiration, the price of ... [the] stock will increase by an amount that would enable an investor to sell or exercise the option at profit." *Id.* (citation omitted).

In *Custom Chrome*, the district court was faced with an option that contained no intrinsic value – the market value equaled the exercise price – but contained substantial time value. The district court ignored the substantial time value of the option and held that, since there was no intrinsic value in the option, the option was valueless. The Ninth Circuit found this valuation technique to constitute reversible error. The Ninth Circuit held that it was reversible error for a court to evaluate options without using a sophisticated financial option formula. *Id.* at 1124 n.10. Dr. Hakala's analysis is based upon commonly accepted and used sophisticated option valuation techniques. Hakala Decl., ¶¶13 nn.19-21, 34 n.32.

Options valuation theory demonstrates that assuming the option owner has access only to public information, premature exercise of an option needlessly leaves money on the table. Hakala Decl., ¶34. Should the holder of an executive option exercise her options early, options valuation techniques quantify the resulting risk premium inferred from such a transaction. *Id.* Of course, the premature exercise of vested options can still be the best strategy for certain options where the defendant is in possession of inside information regarding undisclosed bad news. *Id.* Under such circumstances, insider defendants can maximize their profit on certain options by exercising early, even though such transactions would appear to be irrational based upon public information. *Id.*

While most premature exercises result in the modest risk premiums, what makes this case remarkable is the massive extent of the risk premiums inferred from defendants' transactions during the Class Period and in particular during 2000 and 2001. *See* Hakala Decl., ¶¶9(d), (e), 13, 33-34 (Lay); ¶37 (Skilling); ¶41 (Pai); ¶44 (Rice); ¶45 (others). Such transactions would not have been undertaken by even the most risk-adverse executives absent some inside information. However, these irrational transactions were in fact profit maximizing when one takes into account Enron's dramatic price declines. Hakala Decl., ¶36.

It is readily apparent that Dr. Hakala's declaration cannot be "immaterial" to the issues of this case.

3. Defendants Cannot Strike Plaintiffs' Allegations on Materiality Grounds Absent a Showing of Prejudice

Even if the Hakala Declaration were considered to be immaterial, a motion to strike allegations should be denied unless the allegations demonstrate prejudice to the party. *Circuit Sys. v. Mescalero Sales*, 925 F. Supp. 546, 548 (N.D. Ill. 1996); *United States v. Sea Winds*, 893 F. Supp. 1051, 1056 (M.D. Fla 1995); *Tonka Corp. v Rose Art Indus.*, 836 F. Supp. 200, 217 (D.N.J. 1993); *Giuliano v. Everything Yogurt*, 819 F. Supp. 240, 246 (E.D.N.Y. 1993); *J & A Realty v. Asbury Park*, 763 F. Supp. 85, 87 (D.N.J. 1991). Defendants have made absolutely no attempt to demonstrate any prejudice in this case as required by law. Such a showing is imperative given the rationale of immateriality that is that the allegations are *not material* to any issue in the case. If the allegations really are not material, then there is no motivating reason to strike the allegations and a substantial risk in doing so.

Indeed, the purpose of this Motion appears to be to resolve a factual issue with respect to whether Dr. Hakala's analysis constitutes evidence of scienter. Such allegations clearly raise disputed and substantial questions of fact that cannot be determined on a motion to strike. *Augustus v. Bd. of Pub. Instruction*, 306 F.2d 862 (5th Cir. 1962) (disputed questions of fact or law cannot be decided on motions to strike pleadings).

E. Dr. Hakala's Declaration Clearly Satisfies the *Daubert* Standard

Implicitly realizing the importance of Dr. Hakala's findings and methods, defendants attempt to circumvent these allegations by raising a *Daubert* challenge to Dr. Hakala's Declaration. Lay Brf., ¶¶3, 6-13. This challenge cannot prevail.⁴ *Daubert* is an evidentiary challenge which is not applicable at this time.

⁴Defendants' argument that consideration of Dr. Hakala's Declaration would cause the Court to confront a "myriad of complex evidentiary and procedural issues" is misguided. Lay Brf., ¶3. All of the facts alleged in the Declaration which was explicitly incorporated, summarized and recited in the Complaint must be admitted as true. Hence, the only issue at hand is the legal issue as to whether this Court should, in isolation strike Dr. Hakala's Declaration based upon the legal argument made by defendants. To make any alternative evidentiary finding would be contrary to the purposes of a motion to dismiss where courts are required to "accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiffs." *Nathensen*, 267 F.3d at 406 (citation omitted).

Even if *Daubert* were applicable, Dr. Hakala's Declaration meets the test. The guiding principle for expert testimony is Federal Rule of Evidence 702 which permits an expert to testify if his or her "specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue." *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579, 589 (1993); accord *United States v. Bonds*, 12 F.3d 540, 557 (6th Cir. 1993). Indeed, the Advisory Committee Notes state that: "There is no more certain test for determining when experts may be used than the common sense inquiry whether the untrained layman would be qualified to determine intelligently and to the best possible degree the particular issue without enlightenment from those having specialized understanding of the subject involved in the dispute." Fed. R. Evid. 702, Advisory Committee Notes (citation omitted). Here untrained laypersons are not generally qualified to determine intelligently and to the best possible degree issues of statistics and financial valuation techniques. Hence, the fact finder in this case will require enlightenment from an expert, such as Dr. Hakala, who has a specialized understanding of this subject.

Despite the clear need for Dr. Hakala's testimony, defendants rely upon the five facts discussed in *Daubert* for their challenge to Dr. Hakala's Declaration, namely:

1) whether the expert's theory can be or has been tested; 2) whether the theory has been subject to peer review and publication; 3) the known or potential rate of error of a technique or theory when applied; 4) the existence and maintenance of standards and control; and 5) the degree to which the technique or theory has been generally accepted in the relevant economist community.

Lay Brf., ¶7. As described below, Dr. Hakala's analysis easily passes a *Daubert* challenge.

1. Dr. Hakala's Methodological Techniques Can and Have Been Tested

Defendants argue that Dr. Hakala does not provide the data and information used by him in conducting his analysis and therefore cannot be tested. Lay Brf., ¶8. This is both incorrect and a misapplication of the test. In particular, paragraphs five and 10-20 of Dr. Hakala's Declaration detail the exact data and literature which Dr. Hakala relies upon for his conclusions and cite to numerous articles upon which his methodology has been empirically tested. All of these data sources are publically available and the vast majority of the data was created by defendants themselves and filed with the SEC. Hakala Decl., ¶5. Further, Dr. Hakala describes at length his methodology for

conducting his tests and cites as his basis the widely respected treatise on the subject by Campbell, Lo and Mackinlay. Hakala Decl., ¶21 n.24. Indeed, a technical description of his methodology is found at footnote 32 where Dr. Hakala notes that:

The methodology uses log-normal distribution but with a correction for risk-aversion in a two-period model. The implied volatility is obtained from Bloomberg L.P. for publicly traded Enron call options. The test looks at the rate of return sufficient to yield the conclusion that the investor would be indifferent between exercising an option today for its intrinsic value as compared with waiting one year to exercise the option for its expected intrinsic value one year from now. This collapses the analysis to a two-period option with an approximately log-normal distribution and yields as a result of the solution the implied non-systematic risk premium that is implied by the premature exercise of the option. Normal required returns were calibrated to the current stock price and adjusted for the effective leverage of each option examined.

Dr. Hakala's Declaration at ¶13 nn. 19-21, provides other citations and support for his methodology. This description is a succinct and scientific explanation of Dr. Hakala's methodology. Defendants can use these data sources at trial in rebuttal or to present their own statistical analysis of their sales.

2. Dr. Hakala's Methods Have Been Subject to Peer Review Publication

Defendants argue that it is impossible to determine whether Dr. Hakala's methods have been subjected to peer review or publication. Again this is patently false. Dr. Hakala has provided lengthy citations in the footnotes to ¶¶10-13 of his Declaration citing to dozens of peer reviewed articles relating to event studies and options analysis.

Along this same vein defendant Lay attempts to suggest that Dr. Hakala's analysis is inconsistent with a handful of academic articles which suggest that executive officers often exercise their options prior to expiration. Lay Brf., ¶10. However, Dr. Hakala's study explicitly accounts for this and points rather to how Enron executive's option exercises are conducted in a manner which exceeds the bounds of this behavior and exceed each individual defendant's prior practices. Hakala Decl., ¶¶19-20. The articles cited by defendants do not alter the conclusion that inconsistent behavior by the same individual in the choice to exercise or not to exercise options over time can be a basis for a strong inference of scienter. Indeed, Dr. Hakala directly addressed defendants' argument regarding Lay's option exercises by demonstrating how Lay's option exercise choices directly correlated with the bad events that were occurring internally at Enron and directly conflicted with

Lay's own statements. Hakala Decl., ¶¶28-36. For these reasons, there is no conflict between Dr. Hakala's analysis and the academic articles cited by defendants.

3. Dr. Hakala's Declaration Directly Provides the Error Rate and Other Data Suggestive of Reliability

Relating to the third and fourth *Daubert* factors, defendants argue at ¶¶11-12 that "it is impossible to determine the error rate in Hakala's work and the extent to which he has established and maintained standards and controls, because he does not disclose what he did or how he did it." This completely misses the mark. Since Dr. Hakala's Declaration relies upon statistical analysis, the error rate constitutes the possibility that Dr. Hakala's study fails to demonstrate that there was insider trading. This figure is an explicit part of Dr. Hakala's result. Indeed, Dr. Hakala notes explicitly that:

Thus, as a group, the statistical significance was greater than 99.9% level of confidence that these net sales were not by chance and were associated with the relative inflation in Enron's share price.

Hakala Decl., ¶46. Hence the error rate is less than .1% – far in excess of standards required for scientific acceptance, or criminal or civil proof.⁵

Defendants also make the assertion that Dr. Hakala's analysis is unreliable because he erred by assuming that Lay exercised 25,000 options on August 20, 2001 and thereafter sold shares. Lay Brf., ¶12. Instead, defendants argue that Lay exercised these options and held the stock. This is patently false. As described by Lay's Form 5 and as detailed in Exhibit E to Dr. Hakala's Declaration, on August 21, 2001 Lay sold 110,706 shares of stock, on August 23, 2001, Lay sold 108,254 shares of stock, and on August 24, 2001 Lay sold an additional 110,041 shares of stock. Hakala Decl., Ex. E.⁶

⁵With regard to the option analysis there is no rate of error as all of the variables and data are known and observable.

⁶This sale and Lay's scheme to avoid reporting those sales has been the recent subject of a congressional inquiry.

4. **Dr. Hakala's Method Has Been Generally Accepted by the Relevant Economist Community**

Defendants argue that Dr. Hakala's methods have not been generally accepted by the relevant economist community. In support of that argument, they claim that Dr. Hakala's work conflicts with certain case law which suggests that statistics cannot demonstrate causation. This is incorrect.

The purpose of event studies is to demonstrate causality. Event studies have a long and rich history in academia and the law.⁷ The sole purpose of an event study is to prove or disprove causality. For example, in *Oracle*, Judge Walker held that event studies were required to determine whether fraud-related influences caused plaintiffs' damages. *See also In re Gaming Lottery Sec. Litigation*, No. 96 Civ. 5567 (RPP), 2001 U.S. Dist. LEXIS 2034, at *55 (S.D.N.Y. Feb. 27, 2001) (granting summary judgment on behalf of plaintiffs in federal securities case where class plaintiffs' damages expert event study proved that a particular event "caused" the company's stock price to decline and therefore "[n]o reasonable juror could find that a genuine issue of material fact exists regarding loss causation"). It is almost certain that defendants will rely upon the event study methodology to defend their claims at trial. Indeed, securities defendants routinely rely upon event studies to challenge whether false statements made by a corporation "caused" plaintiffs' damages.

Hence, Dr. Hakala cites to literally dozens of academic articles confirming his methodological approach and provides his exact method and data sources. Hakala Decl., ¶¶6-8, 10-14, n.32. As demonstrated by this literature and Dr. Hakala's analysis, there is nothing wrong with using statistical analysis to reject the conclusion that Lay's sales of shares were by mere chance or for the purposes suggested by defendants.

⁷See, e.g., 11 John Binder, *Review of Quantitative Finance and Accounting: The Event Study Methodology Since 1969*, at 111-37 (1998) (noting that event study that was introduced by Fama, Fisher, Jensen and Roll "started a methodological revolution in accounting and economics and finance"). *See also In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1368 (N.D. Cal. 1994); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176 (N.D. Cal. 1993) (use of event study necessary in securities case to evaluate impact of false statements); Jon Koslow, *Note, Estimating Aggregate Damages in Class Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 Fordham L. Rev. 811 (1991); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. Rev. 883 (1990); Amy Zipkin, "Stock Options Take Prominent Role in Divorce Courts," *The Business Lawyer* (Feb. 1994).

F. Defendants' Further Objections to Hakala's Option Valuation Techniques Are Unfounded

Defendant Lay attempts to raise a factual dispute about the reasons defendants sold their stock by suggesting that defendants' sales may have occurred as a result of a need for liquidity, aversion to risk or the need to diversify. Lay Brf., ¶13. Lay does not even assert that defendants *actually* exercised their options for any of the reasons proposed but simply hypothesizes that these reasons may provide a defense to account for defendants' suspicious exercise and sale of options at extremely suspicious and unprecedented risk premiums. However, plaintiffs have pled numerous suspicious transactions undertaken by defendants during the Class Period that exceed the levels of the highest risk premiums of extremely risk-averse and extremely liquidity-constrained executives. Hakala Decl., ¶13 n.21. Plaintiffs have also pled that any concerns by defendants regarding liquidity or need to diversify, if they were real concerns, could have been achieved by readily available methods, such as collars. Hakala Decl., ¶12. These instruments are readily available to executives and are commonly used. *Id.* Since courts must view the pleadings under attack on a motion to strike in the light most favorable to the pleader, these facts must be taken as true.

Defendants' arguments must be rejected because they require this Court to make a finding of fact that would be explicitly contrary to the specific factual allegations detailed in the Complaint. Further, the Court would be required to make a finding of fact contrary to the allegations of the Complaint with no evidentiary basis whatsoever. This would be improper at the pleading stage of this litigation.

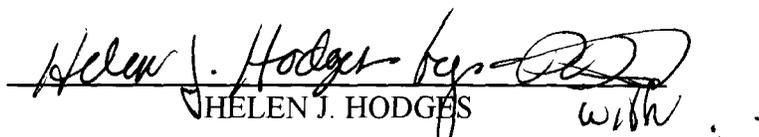
III. Conclusion

For the reasons set forth above, Dr. Hakala's Declaration was properly submitted in connection with plaintiffs' Complaint, and defendants' Motion to Strike should be denied.

DATED: May 28, 2002

Respectfully submitted,

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DECLARATION OF SERVICE BY E-MAIL, FACSIMILE OR UPS

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interest in the within action; that declarant's business address is 401 B Street, Suite 1700, San Diego, California 92101.

2. That on May 28, 2002, declarant served the foregoing document by sending via e-mail, facsimile or UPS overnight to the parties as indicated on the attached Service List, pursuant to the Court's April 10, 2002 Order Regarding Service of Papers and Notice of Hearings.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 28th day of May, 2002, at San Diego, California.


DEBBIE GRANGER

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