United States Courts
Southern District of Texas
FILED

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Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated,	§	
	§	
Plaintiffs,	§	
	§	**CIVIL ACTION NO.: H-01-CV-3624**
v.	§	**CONSOLIDATED LEAD CASE**
	§	
ENRON CORP., et al.,	§	
	§	
Defendants.	§	

REPLY BRIEF IN SUPPORT OF
DEFENDANT KENNETH L. LAY'S MOTION TO
STRIKE THE DECLARATION OF SCOTT D. HAKALA

TO THE HONORABLE MELINDA HARMON:

Defendant Kenneth L. Lay submits this reply brief, and respectfully shows the Court the following:

I. Introduction

The Private Securities Litigation Reform Act of 1995 (the "PSLRA") requires a plaintiff to "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)(ii) (emphasis added). Plaintiffs attempt to satisfy this requirement as to Mr. Lay through conclusory and unsupported opinions contained in the Declaration of Scott D. Hakala, a purported expert witness. Accepting Hakala's Declaration as sufficient to plead a strong inference of scienter, however, would effectively render meaningless the elevated pleading standard for scienter established by Congress in the PSLRA and the stringent pleading standard for fraud set forth in FED. R. CIV. P. 9(b). Courts have routinely refused to accept as sufficient allegations that would effectively eliminate these pleading standards. *See, e.g., In re*

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Azurix Corp. Sec. Litig., No. H-00-4034, 2002 WL 562819, at *22 (S.D. Tex. Mar. 21, 2002) (plaintiffs' allegations held insufficient to plead scienter because, "if accepted, such allegations would essentially eliminate the state of mind requirement" in the PSLRA.); *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994) (plaintiff's method of pleading scienter, if accepted, would eliminate the pleading requirement in Rule 9(b)).

Similar to the allegations of scienter held insufficient in *Melder*, plaintiffs' scienter allegations represent "a nihilistic approach to Rule 9(b) [and PSLRA] jurisprudence." *Melder*, 27 F.3d at 1102. Not only do plaintiffs argue that their hired expert's opinions must be considered by the Court in deciding a motion to dismiss if they are presented in an affidavit attached to a complaint, but they also contend that the Court must accept as true all of their expert's opinions (which plaintiffs repeatedly and mistakenly label as "facts"). Thus, plaintiffs would sidestep altogether a pleading standard that, according to the Fifth Circuit, may only be satisfied by pleading *facts* with specificity. If they were successful in this maneuver, pleading scienter would become a simple process: hire Dr. Hakala or some other expert and automatically pass the "scienter" test.

For good reason, no court in the country has published a decision approving this approach. At least one court has expressly rejected it. *See DeMarco v. DepoTech Corp.*, 149 F. Supp. 2d 1212, 1222 (S.D. Cal. 2001). This Court must require more from the plaintiffs than the unsubstantiated and conclusory opinions of a paid expert to satisfy the PSLRA and Rule 9(b) pleading standards. Otherwise, purported experts like Hakala will be very busy rendering opinions on scienter. These experts' opinions, moreover, might never be subject to challenge because, once a motion to dismiss was decided, the plaintiffs would be free to terminate the expert's engagement. As discussed below, plaintiffs' desperate attempt to evade their obligation to plead facts with particularity through the use

of a purported expert's declaration is precluded by the PSLRA, federal pleading rules, and the *Daubert* line of cases.

II. The Opinions Contained in Hakala's Declaration Are Not "Facts" And Are Insufficient to Satisfy The Pleading Requirement For Scienter Under The PSLRA.

In *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 411 (5th Cir. 2001), the Fifth Circuit explained that the special pleading standard for scienter established by Congress "may only be met on the basis of 'facts' which are 'state[d] with particularity' in the pleading." Plaintiffs, themselves, acknowledge that this is the appropriate standard. *See, e.g.*, Plaintiffs' Opposition to Defendant Kenneth L. Lay's Motion to Strike Declaration of Scott D. Hakala ("Response," p. 7) ("For Plaintiffs to properly plead scienter, they must allege facts giving rise to a strong inference of scienter."); *id.* at p. 6 ("A better approach might be to include the expert's *nonconclusory assertions* within specific paragraphs of the complaint." (Emphasis added and citation omitted)).

Hakala's Declaration, however, is long on opinions but very short on facts. It is well-established that opinions are insufficient to defeat a motion to dismiss. *See Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994) ("We will thus not accept as true conclusory allegations or unwarranted deductions of fact."); *In re Azurix Corp. Sec. Litig.*, 2002 WL 562819, at *9 ("[C]onclusory allegations or legal conclusions masquerading as factual conclusions will not suffice to prevent a motion to dismiss." (Citation omitted)). Plaintiffs attempt to cover up

this fatal flaw by repeatedly referring to assertions in Hakala's Declaration as "facts."[1] Plaintiffs, however, cannot transform an expert's conclusions and opinions into "facts" by fiat.

The only fact presented in Hakala's Declaration in support of his theory that Ken Lay's option exercise behavior evidenced insider trading was Ken Lay's exercise of 25,000 employee stock options on August 20, 2001.[2] *See* Hakala Decl., ¶ 34. As demonstrated in Defendant Kenneth L. Lay's Motion to Dismiss Plaintiffs' Consolidated Complaint and Supporting Brief ("Motion to Dismiss"), Hakala makes the fatal and erroneous assumption that this was an exercise to sell shares. *See* Motion to Dismiss, pp. 9-11. Incredibly, plaintiffs continue to insist in their Response that this was an exercise to sell shares, and even accuse Mr. Lay of making a "patently false" contention to the contrary. *See* Response, p. 14.

The SEC filings show that it is the plaintiffs who are making the "patently false" contention. The Form 4 filed by Mr. Lay for August 2001 reflects that he acquired 25,000 shares of Enron common stock on August 20, 2001, for a family limited partnership, paying $519,530.50 to exercise

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[1] *See, e.g.*, Response, p. 2 ("Dr. Hakala's Declaration establishes these *facts* and then provides Plaintiffs a basis for a strong inference for purposes of Plaintiffs' pleading requirements."); *id.*, p. 4 (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 insider sales provide a strong circumstantial inference of scienter."); *id.*, p. 6 ("The Hakala Declaration contains exactly such *facts* Plaintiffs will attempt to prove at trial."); *id.*, pp. 6-7 ("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."); *id.*, p. 16 ("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.") (emphasis added in each example).

[2] Indeed, the only factual information presented by Hakala regarding Ken Lay is contained in Exhibit E of Hakala's Declaration, which purports to itemize Enron stock transactions reported by Lay in SEC filings.

the options.[3] The same filing shows that at the end of August, the family limited partnership beneficially owned 100,000 shares of Enron common stock. The next filing made by Mr. Lay was a Form 5 "Annual Statement of Changes in Beneficial Ownership" that reported that the family limited partnership still owned 100,000 shares of Enron common stock at the end of 2001. *See* Form 5, p. 3 of 3. Thus, the same SEC filings on which Hakala bases his conclusions conclusively show that Mr. Lay paid $519,530.50 to exercise employee stock options to acquire 25,000 shares for the family limited partnership, *and that he held those shares through the end of the year, when they were essentially worthless.*

Hakala nonetheless concludes that this option exercise was "inconsistent with rational economic behavior absent a belief that Enron shares would decline in absolute or relative value (in comparison with a diversified investment in equity securities) in the future." Hakala Decl., ¶ 34. It does not take a PhD in Economics to realize that an investor does not pay over $500,000 (and incur a tax liability) to acquire shares with an expectation that the shares will decline in value, unless that investor is economically insane. Thus, the only reasonable inference that the Court can draw from the sole fact presented by Hakala in support of his option exercise theory is that Ken Lay's option exercise behavior was consistent with an expectation that the price of Enron stock would increase.

Plaintiffs in their Response point to sales of Enron stock that Ken Lay personally made to Enron in discharge of loan indebtedness to the company on August 21, 23, and 24. Response, p. 14. These sales are duly reported on the Form 5 filed by Ken Lay in accordance with SEC rules.[4] The

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[3] The Forms 4 and 5 filed by Mr. Lay for 2001 are included in Tab 1 in the Appendix to Kenneth L. Lay's Motion to Dismiss Plaintiffs' Consolidated Complaint.

[4] Without attribution to any source, plaintiffs assert: "This sale and Lay's scheme to (continued...)

Form 4 filing for August 2001 reflects that -- in addition to the acquisition of 25,000 shares for the family limited partnership -- Lay exercised stock options on August 21, 2001, at a cost of $1,479,618.75 to acquire an additional 68,620 shares for his personal account. At the end of the year, he directly owned for his own account 1,082,223.19 shares of Enron common stock, all of which were essentially worthless. *See* Form 5, p. 3 of 3. If Lay had not made the August 21, 2001, acquisition of an additional 68,620 shares, he would have owned 68,620 fewer worthless shares at the end of 2001, and he would have owned 1,479,618 more dollars. Thus, this acquisition is also inconsistent with Hakala's theory that Lay expected the price of Enron stock to drop. Rather, it is consistent with rational economic behavior only if Lay believed that Enron's stock price would increase in the future.

Plaintiffs describe Hakala's options analysis as "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." Response, p. 9. His Declaration does not present any *facts* demonstrating that Mr. Lay did so. In his Motion to Dismiss, Mr. Lay does present the facts contained in his Form 4 and Form 5 filings for 1996-2001 concerning the difference between the market price and the exercise price (in other words, the intrinsic value) whenever he exercised stock options.[5] *See* Motion to Dismiss, pp. 11-13. These facts demonstrate -- contrary to the conclusory,

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[4] (...continued)
avoid reporting those sales has been the recent subject of a congressional inquiry." It is instructive about plaintiffs' desperation to plead scienter against Mr. Lay that they would characterize his Form 5 filing in accordance with SEC rules as a "scheme to avoid reporting those sales." *See* SEC 16a-3(f); 17 C.F.R. § 240.169-3(f).

[5] Plaintiffs contend that Mr. Lay has presented an alternative statistical analysis. To the contrary, the charts included in Mr. Lay's Motion to Dismiss are simply graphic representations (continued...)

unsubstantiated opinions expressed by Hakala and by plaintiffs -- that Lay did not needlessly waste large amounts of wealth by undertaking transactions that would cause him massive financial losses. Instead, he exercised options throughout the class period only at times when the intrinsic value was large enough to be consistent with rational economic behavior, based on Hakala's own parameters. *See* Motion to Dismiss, pp. 12-13. Moreover, the *only* analysis of intrinsic values at which executives typically exercise stock options contained in the articles referenced by Hakala shows that the intrinsic values achieved by Lay far exceeded the intrinsic values typically achieved by executives-- regardless of how early they exercised the options. *See* Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, JOURNAL OF ACCOUNTING & ECONOMICS, 33 (2002) 3-42, p. 31, fig. 7; Lay App., Tab 4; discussed at p. 13, fn. 6 of Lay's Motion to Dismiss.

Plaintiffs clearly do not seek to introduce Hakala's Declaration to bring facts to the Court's attention. Instead, they want this Court to ignore the facts and accept in their place Hakala's unsubstantiated opinions -- opinions that are inconsistent with the very analysis that Hakala asks this Court to apply to the facts.

III. Hakala's Declaration Does Not Satisfy *Daubert.*

Courts require more from expert witnesses than unsubstantiated speculation and surmise. *See, e.g., In re Aluminum Phosphide Antitrust Litig.*, 893 F. Supp. 1497, 1506-07 (D. Kan. 1995) (expert's conclusions were scientifically unsound and irrelevant under *Daubert* because "plaintiffs called upon [the expert] not to supply specialized knowledge, but to plug evidentiary holes in plaintiffs' case, to speculate, and to surmise."). Moreover, whether a proffered witness is an

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[5] (...continued)
of the facts contained in SEC filings. The most advanced statistical analysis included in any of the charts is the computation of a weighted average.

adequately qualified expert is only the first step in the analysis. *Blue Dane Simmental Corp. v. American Simmental Ass'n*, 178 F.3d 1035, 1040 (8th Cir. 1999) (explaining that, while the district court did not dispute that the purported expert was adequately qualified, it found the methodology he employed was unreliable); *Securities and Exchange Commission v. Lipsom*, 46 F. Supp. 2d 758, 763 (N.D. Ill. 1998) ("As to reliability, all of [the expert's] years of training and experience as an accountant . . . do not specially equip him to divine what [d]efendant truly believed about the reliability of the reports. Any opinions [the expert] might offer in that regard are not based on the methodology and principles of accountancy."). The relevant inquiry is the reasonableness of using the expert's selected methodology combined with the expert's analysis of the data thereby obtained to draw a conclusion regarding the particular subject matter of the expert's testimony. *Blue Dane Simmental Corp.*, 178 F.3d at 1040. To conduct this evaluation, the expert must set forth specific detail about his analysis.

> It will not do to say that it must all be left to the skill of experts. Expertise is a rational process and a rational process implies expressed reasons for judgment. An opinion has a significance proportioned to the sources that sustain it. An expert who supplies nothing but a bottom line supplies nothing of value to the judicial process.

Mid-State Fertilizer Co. v. Exchange Nat'l Bank of Chicago, 877 F.2d 1333, 1339 (7th Cir. 1989) (internal quotations and citations omitted).

Plaintiffs try to obscure the gaping holes and inconsistencies in Hakala's analysis by repeatedly invoking his conclusion that he found insider trading with "scientific precision," supposedly within a probability of 99.99%. This purported conclusion is completely meaningless because it is impossible to decipher how it was reached. Hakala might as well have predicted with 99.99% certainty that the Houston Texans will win the Super Bowl. More importantly, Hakala's conclusion is decidedly un-scientific. Plaintiffs contend that he has scientifically excluded numerous

alternative explanations for decisions by Ken Lay to sell Enron shares -- the adoption of a 10b5-1 selling program; the impending expiration of options; his steps towards retirement; liquidity problems incurred when Enron's stock price fell steeply; payment of taxes; and others -- *without ever examining them*. Hakala admits that his only knowledge about Ken Lay comes from studying his option exercises and transactions in Enron stock. *See* Hakala Decl., ¶¶ 5, 28. Grade school teaches us that it is impossible to arrive at a scientific conclusion about a matter without first examining all of the relevant facts and then conducting a careful examination and performing tests that can be replicated. It is therefore absurd for plaintiffs to contend that Hakala has scientifically quantified at less than one chance in one thousand the possibility that Mr. Lay and other defendants sold Enron stock for reasons other than to capitalize on non-public, adverse material information when Hakala admittedly did not study any other explanations. Response, p. 1.

At the very most, Hakala may have performed some statistical analysis -- unknown to us -- that yielded a correlation that he believes, with a high degree of confidence, was not produced by chance. What that correlation may be is not disclosed. All that we can tell from Hakala's Declaration is that he appears to be certain that some time during the three-year class period, Ken Lay sold shares before the stock price collapsed. The Court does not need an expert to provide that information. It is obvious from the facts. Nor must the Court accept Hakala's unsupported leap from this obvious fact to a conclusion that Ken Lay engaged in insider trading.

Hakala does not adequately describe his methodology so that it can be replicated and tested, or provide the actual input, output, or calculations used in the analysis. In short, he does not provide the statistical analysis. Instead, he outlines his general approach and then leaps to his ultimate conclusion. Plaintiffs ask this Court to accept his conclusions because he has a PhD. *See* Response,

p. 2. The *Daubert* gate-keeping role would be meaningless if alleged qualifications alone were sufficient to satisfy a plaintiff's burden to demonstrate that an expert's opinion is relevant and reliable. *See Olinger v. United States Gulf Ass'n*, 52 F. Supp. 2d 947, 949-50 (N.D. Ind. 1999). Nor does Hakala's resume reflect any particular expertise in analysis of employee stock options, or divination of insider trading.

In defense of Hakala's indisputable failure to provide sufficient information to understand and test his methodologies and conclusions, plaintiffs repeatedly observe that he cited to dozens of journal articles. Response, pp. 12, 13, 15. It is easy to string-cite journal articles for general propositions. What plaintiffs never do is bring to the Court's attention *any particular portion* of those articles that contain a statistical methodology for finding insider trading. The reason is simple: they contain no such methodology. The articles describe a variety of different event study methodologies used for a variety of purposes, and option valuation techniques used to explore executive option exercise behavior. None of the studies suggest or use these methodologies to draw conclusions about insider trading.[6] Because these articles describe a variety of event study methodologies, and Hakala describes his methodology in vague, confusing, and inconsistent terms,[7]

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[6] Indeed, one of the law review articles cited by plaintiffs in their Response discusses event studies solely in the context of damages and notes for purposes of its analysis that scienter and the other elements of 10b-5 liability are assumed. Bradford Cornell & R. Gregory Morgan, *Using Finance Theory To Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 891 n.25 (1990) ("Cornell & Morgan").

[7] For example, in paragraph 6 of the Declaration, Hakala states:

> To analyze the issue of statistical association, I applied a statistical test to determine whether Enron-specific stock price movements (after accounting for market-wide movements) in a test period after the Insider Sales were within the range of normal price variation

(continued...)

it is impossible to tell just what methodology he did use to conduct an event study, and whether that methodology complied with accepted economic practice.

Hakala suggests that after completing an event study on Enron stock price movements, he then performed some statistical analysis designed to associate sales by insiders with movements in Enron's stock price. Hakala Decl., ¶¶ 9(b), 35. He does not provide this additional statistical

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[7] (...continued)
exhibited by Enron stock in an estimation period from January 3, 1995, to October 19, 2001.

In paragraph 16, he states:

> I studied the volatility and returns of Enron's stock price from January 3, 1995, through October 9, 2001, and through December 31, 2001, relative to a general market index (the S&P 500 index) and relative to an equally-weighted index created from five peer-group companies . . . and in the context of company-specific disclosures to determine the extent to which certain returns were abnormal in nature and the returns provided by Enron during the Class Period were inconsistent with market and peer-group company returns.

At paragraph 22, Hakala states:

> I used the estimation period data from January 3, 1995, to October 9, 2000, to analyze the association of Enron's stock price movements with the general market movements and peer-company price movements, in order to isolate Company-specific price movements (including those associated with Enron-specific disclosures).

Because Hakala does not provide any of the statistical tests he refers to, it is impossible to tell from the Declaration just what test periods and estimation periods he used and just what statistical tests he actually applied. Test periods and estimation periods can easily be manipulated to yield a desired result. Some flaws nevertheless emerge from Hakala's general description. It appears that the test period and the estimation period overlap, contrary to accepted economic practice. John Koslow, Note: *Estimating Aggregate Damages in Class Action Litigation Under Rule 10b-5 For Purposes of Settlement*, 59 FORDHAM L. REV. 811, 821 (1991) ("Koslow"). He also appears to have analyzed the data on a weekly basis instead of the daily basis described in the economic literature. *See* Hakala Decl., ¶ 5; Cornell & Morgan, 822; Koslow, 898-903.

analysis in his Declaration. Nor does he provide much of a clue about his methodology or its use to conclude that Ken Lay engaged in insider trading, other than his bald assertion that he performed a test. Hakala Decl., ¶ 35. Thus, it is impossible to determine what particular sales by Lay were included in his analysis; what stock price movements he examined; what assumptions he made, if any, about the amount of time between a sale and a stock price movement; what test periods and estimation periods he used for his analysis; and how he determined whether there was a statistical association between a sale and the movement in Enron's stock price. The articles cited by Hakala do not provide any help because none of them discusses a methodology resembling such a test.

Without this information, the Court cannot make an independent, objective evaluation of his methodology, which is a critical component of the *Daubert* analysis. *See Michaels v. Avitech, Inc.*, 202 F.3d 746, 753 (5th Cir. 2000), *cert. denied*, 531 U.S. 926 (2000); *Moore v. Ashland Chem., Inc.*, 151 F.3d 269, 276 (5th Cir. 1998) (determination of reliability requires "some objective, independent validation of the expert's methodology. The expert's assurances that he has utilized generally accepted scientific methodology is insufficient."), *cert. denied*, 526 U.S. 1064 (1999). Hakala's conclusion from this statistical test -- whatever it was -- could well have been dictated by the assumptions he made in constructing it. As noted above, the test may not have generated any more meaningful conclusion than Hakala's certainty that Lay sold shares some time in the class period before the price of Enron's stock declined steeply in the fall of 2001.

Hakala's use of option pricing techniques to draw conclusions about insider trading is similarly flawed. Although Hakala describes how he valued options in general (*see* Hakala Decl., ¶ 34, n.32 quoted in Response, p. 13), he provides only the vaguest information about how he used that option valuation to draw conclusions about alleged insider trading by the defendants as a group

or by any particular defendant. He provides no statistical tests performed on Lay's option exercises. He does not even describe the conclusion of any test performed on Lay's exercises other than the August 20, 2001, exercise by Ken Lay of employee stock options to acquire 25,000 shares for the family limited partnership. *See* Hakala Decl., ¶ 34. For reasons discussed in detail above, Hakala's conclusion that this exercise sacrificed excessive option value does not yield any inference about insider trading because Ken Lay exercised these options to hold the shares.[8]

Hakala also opines that Lay's exercises of options in 2001, especially in June 2001 and August 2001, were economically and statistically inconsistent with his prior economic behavior. Hakala Decl., ¶ 33. True to form, he fails to provide a statistical analysis, or even conclusions from a statistical analysis, to substantiate this general assertion. Since Ken Lay exercised options to hold shares in June, July, and August 2001, Hakala's opinion may very well rest on the same erroneous assumption -- that Lay exercised those options to sell shares -- as his analysis of Lay's August 20, 2001, exercise. *See* Motion to Dismiss, p. 24. In light also of the inconvertible fact that Lay realized intrinsic value from these option exercises consistent with expected executive behavior, it is extremely doubtful that Hakala's analysis -- whatever it was -- would stand up to scrutiny. The Court need not speculate, however, about whether Hakala's analysis is invalid; his failure to provide any substantiation for these conclusions requires that they be disregarded. *See General Elec. Co. v. Joiner*, 522 U.S. 136, 146 (1997) (district court not required "to admit opinion evidence that is connected to existing data only by the *ipse dixit* of the expert.").

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[8] As explained in the Motion to Dismiss, Ken Lay's exercise of these options was calculated to generate tax benefits upon *appreciation* of the stock that made it economically beneficial to exercise them early. *See* Motion to Dismiss, p. 10, n.5.

Finally, Hakala's Declaration, on its face, violates a fundamental principle of statistical analysis by confusing correlation with causation. *See Munoz v. Orr*, 200 F.3d 291, 301 (5th Cir.), *cert. denied*, 531 U.S. 812 (2000). As discussed above, it is one thing to find a statistical correlation between one event and another. It is another thing altogether to establish causation. Statisticians have noted for years that there is a strong correlation between performance of the stock market and whether an original NFL or AFL team wins the Super Bowl. This correlation does not prove that a Super Bowl win by an NFL team causes the stock market to go up. For a statistical correlation to have any meaning, the statistician must identify and eliminate all alternative causes. *See id.* Hakala's Declaration provides no evidence that Hakala has done so. Indeed, he acknowledges that he did not make any factual inquiry, apart from reviewing the SEC filings reflecting his Enron stock transactions, into the numerous reasons why Lay may have sold Enron shares during the class period. Hakala Decl., ¶¶ 5, 28.

Courts have confirmed that there is much more to proving causation than simply identifying a statistical correlation or association. The important issue is whether the association is causal. To make this determination, the expert must consider and exclude alternative causes, because the real cause of the observed outcome may be the result of other factors. *See Michaels*, 202 F.3d at 753. Without collecting data on other factors that may influence the outcome, an expert cannot draw any conclusions about causation from the associations identified. *See Blue Dane Simmental Corp.*, 178 F.3d at 1040-41 ("although [the expert] utilized a method of analysis typical within his field, that method is not typically used to make statements regarding causation without considering all independent variables that could affect the conclusion."); *Stelwagon Mfg. Co. v. Tarmac Roofing Sys., Inc.*, 63 F.3d 1267, 1275 (3rd Cir. 1995) (finding expert's opinion insufficient because the

expert failed to consider reasons other than price discrimination that may have led to a decline in sales), *cert. denied*, 516 U.S. 1172 (1996). Ultimately, statistics may establish only correlation and not causation. *Munoz*, 200 F.3d at 301. Here, Hakala neither identifies the particular correlation he has made nor explains how he could possibly have identified and excluded alternative explanations for trading on the facts known to him.

Whether event studies, as plaintiffs claim, "have a long history in academia and the law" is beside the point, because that history does not include the use of such studies to determine whether a corporate officer traded on inside information. Response, p. 15. As a result, this history does nothing to support Hakala's analysis. *See General Elec. Co.*, 522 U.S. at 144-45; *Concord Boat Corp. v. Brunswide Corp.*, 207 F.3d 1039, 1055 (8th Cir. 2000), *cert. denied*, 531 U.S. 979 (2000); *Blue Dane Simmental Corp.*, 178 F.3d at 1040 (the relevant inquiry is the reasonableness of using the selected methodology to draw a conclusion regarding the particular subject matter of the expert's testimony). None of the cases cited by the plaintiffs support the use of expert testimony regarding statistical analysis and event studies to establish scienter through alleged insider trading in a securities fraud case. In *In re Oracle Sec. Litig.*, 829 F. Supp. 1176 (N.D. Cal. 1993), the relevant issue was the calculation of damages and the effect of various influences on the price of a publicly-traded stock. The court suggested, in *dicta*, that an event study or similar analysis may more accurately isolate the influence of information on the stock's price movement. *See Oracle*, 829 F. Supp. at 1181. The event study in *In re Gaming Lottery Sec. Litig.*, 2001 WL 204219, *18 (S.D.N.Y. 2001), was also used to determine the effect of public statements on a company's stock price in order to calculate damages. Neither of the cases cited by the plaintiffs (or any other reported

decision) approves of plaintiffs' use of event studies to plead scienter based on alleged insider trading.

IV. Hakala's Declaration Is Irrelevant to The Court's Consideration of Mr. Lay's Motion to Dismiss And Should Be Struck Pursuant to FED. R. CIV. P. 10(c) And 12(f).

According to the plaintiffs, any document attached to a complaint (regardless of its content or relevance) is a "pleading" that may be considered in connection with a motion to dismiss. *See* Plaintiffs' Response, pp. 4-5. Plaintiffs, once again, are incorrect. An expert's affidavit is not a "written instrument" within the meaning of Rule 10(c) , and therefore is not a pleading to be considered in ruling on a motion to dismiss. *See DeMarco*, 149 F. Supp. 2d at 1222; *Three D Departments v. K-Mart Corp.*, 670 F. Supp. 1404, 1406 (N.D. Ill. 1987). The *DeMarco* court and others have explained that the types of exhibits that are considered to be "written instruments" and therefore part of a complaint pursuant to Rule 10(c) typically evidence legal rights or duties, and include documents such as a deed, will, bond, lease, insurance policy, security agreement, or contract. *DeMarco*, 149 F. Supp. 2d at 1220; *see also Rose v. Bartle*, 871 F.2d 331, 339-40 n.3 (3rd Cir. 1989); *Murphy v. Cadillac Rubber & Plastics, Inc.*, 946 F. Supp. 1108, 1115 (W.D.N.Y. 1996). In contrast, an affidavit attached to a complaint is a matter outside the pleading that is excluded from consideration in connection with a Rule 12(b)(6) motion. *See, e.g., Rose*, 871 F.2d at 339-40 n.3; *DeMarco*, 149 F. Supp. 2d at 1222 (granting a motion to strike an expert's affidavit under Rule 10(c)).

The cases cited in plaintiffs' Response do not support a different result. *Thomason v. Nachtrieb*, 888 F.2d 1202 (7th Cir. 1989), which plaintiffs cite for the proposition that the Seventh Circuit permits consideration of affidavits at the motion to dismiss stage, does not even mention the

word "affidavit." Instead, this case stands for the unremarkable proposition that a party may not amend its complaint through its brief in opposition to a motion to dismiss -- an issue irrelevant to this case. *See Thomason*, 888 F.2d at 1205. Similarly, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1279 (11th Cir. 1999) does not stand for the proposition that "the Eleventh Circuit has held that declarations submitted by plaintiffs may be considered at the motion to dismiss stage." *See* Plaintiffs' Response, p. 5. In *Bryant*, the court dealt with the issue of whether documents filed with the SEC may be considered in connection with a motion to dismiss. *See Avado Brands*, 187 F.3d at 1278. The court expressly stated that the defendants were challenging on appeal only the district court's ruling excluding publicly-filed documents. *Bryant*, 187 F.3d at 1275 n.6.

Plaintiffs' remaining cases are factually distinguishable. In *Branch v. Tunnell*, 14 F.3d 449 (9th Cir. 1994), *cert. denied*, 512 U.S. 1219 (1994), a *Bivens* action, the plaintiff alleged that the defendant, a governmental agent, violated his Fourth Amendment rights by misleading a magistrate judge in an affidavit supporting warrants to search the plaintiff's home and business. *Branch*, 14 F.3d at 450. The affidavit at issue, therefore, was the basis of the plaintiff's claim. In *Swin Resource Sys., Inc. v. Lycoming County*, 883 F.2d 245, 247 (3rd Cir. 1989), *cert. denied*, 493 U.S. 1077 (1990), a plaintiff, whose original complaint had been dismissed under Rule 12(b)(6), attempted to amend his complaint by attaching deposition testimony. *Swin*, 883 F.2d at 248. The appellate court held that *facts* contained in the deposition that the plaintiff submitted could only be considered "to the extent they fall within the ambit of the complaint, as illustrative of those facts which [the plaintiff] could prove if its complaint were reinstated." *Id.* at 247. In sharp contrast, in the case before this Court plaintiffs ask the Court to adopt the *opinions* of a paid expert when deciding a motion to dismiss.

In *Mortensen v. Americredit Corp.*, 123 F. Supp. 2d 1018 (N.D. Tex. 2000), *aff'd*, 240 F.3d 1073 (5th Cir. 2000), the plaintiffs attempted to correct a deficiency in their scienter allegations by attaching to their amended complaint the declaration of an expert witness addressing accounting issues. *Id.* at 1026. Importantly, there is no indication that the defendants moved to strike the expert's affidavit. Holding that the plaintiffs' amended complaint failed to plead facts raising a strong inference of scienter, the court stated that even if the purported expert's opinion provided the necessary specificity to the plaintiffs' allegations, the plaintiffs nonetheless had failed to adequately plead scienter because it did nothing more than attempt to establish GAAP violations as *ipso facto* proof of intentional fraud, which is insufficient to plead scienter. *Id.* at 1026 (dismissing plaintiffs' claims with prejudice). Thus, *Mortensen* can hardly be cited as authority mandating the consideration of an expert declaration at the pleading stage.

For the reasons set forth above, the Court should also strike Hakala's Declaration pursuant to FED. R. CIV. P. 12(f). A document that does not qualify as a "written instrument" under Rule 10(c) may not be considered in connection with a motion to dismiss because it is a matter outside of the pleading. As a result, it is immaterial to the Court's consideration of a motion. Furthermore, as explained in *DeMarco*, "[c]onclusory allegations and speculation carry no additional weight merely because a plaintiff placed them within the affidavit of a retained expert." *DeMarco*, 149 F. Supp. 2d at 1221. Accordingly, the Court may exercise its discretion pursuant to Rule 12(f) to grant Mr. Lay's motion to strike. *See In re Beef Industry Antitrust Litig.*, 600 F.2d 1148, 1168 (5th Cir. 1979) ("The district court [has] ample discretion, under Rule 12(f) of the Federal Rules of Civil Procedure, to order stricken from the complaint any redundant or immaterial matter."), *reh'g denied*, 616 F.2d 569 (5th Cir. 1980); *United States v. Union Gas Co.*, 743 F. Supp. 1144, 1150 (E.D. Penn.

1990) ("[T]he district court has broad discretion in disposing of motions to strike."). Moreover, contrary to plaintiffs' contention, it is not necessary for Mr. Lay to demonstrate prejudice in order for his motion to be granted. *See* DAVID HITTNER ET AL., PRACTICE GUIDE: FEDERAL CIVIL PROCEDURE BEFORE TRIAL, 5TH CIR. ED. ¶ 9:376 (2002) (explaining the courts are split on whether the moving party must show that it will be prejudiced and identifying the Fifth Circuit as holding that prejudice is not required because the matter lies entirely within the trial court's sound discretion). In any event, it is apparent that Mr. Lay will be prejudiced if he is compelled to continue as a defendant in this litigation based only on the unsupported and conclusory allegations of scienter contained in Hakala's Declaration.

V. Conclusion

WHEREFORE, for the reasons stated above, Mr. Lay requests that his Motion to Strike the Declaration of Scott D. Hakala be granted.

Respectfully submitted,

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Certificate of Service

The undersigned certifies that a copy of the foregoing instrument was served upon the attorneys of record of all parties to the above cause in accordance with Rule 5, Federal Rules of Civil Procedure, on this 7th day of June, 2002, as indicated on the attached Service List.

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