UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	§	Civil Action No. H-01-3624 **(Consolidated)**
This Document Relates To:	§	CLASS ACTION
MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated,	§	
Plaintiffs,	§	
vs.	§	
ENRON CORP., et al.,	§	
Defendants.	§	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated,	§	
Plaintiffs,	§	
vs.	§	
KENNETH L. LAY, et al.,	§	
Defendants.	§	

PLAINTIFFS' MOTION TO STRIKE CERTAIN DEFENDANTS' JOINT DISCLOSURE BRIEF AND RESPONSES TO DEFENDANTS' INAPPROPRIATE FACT ARGUMENT

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I. INTRODUCTION

In flagrant disregard of the letter and spirit of Federal Rule of Civil Procedure Rule 12(b)(6) and prevailing authority in the Fifth Circuit and other jurisdictions, defendants have filed a voluminous "joint disclosure" brief containing contentions of purported "fact."[1] Chock full of defendants' spin on the Enron fraud, the "joint disclosure" brief's core purpose is to dispute, contradict and challenge the merits of plaintiffs' well-pleaded allegations. Early on, defendants candidly admit their brief is an expansive factual discourse: "What has been lost in this storm are the facts."[2] Also missing is defendants' appreciation for the standards governing a Rule 12(b)(6) motion: a plaintiff's factual allegations ***must be accepted as true***. Defendants simply are ***not*** permitted to contest fact allegations or make factual assertions.

Defendants know that by filing a motion to dismiss, they have triggered the automatic discovery stay of the PSLRA. Defendants hamstring plaintiffs by forcing them to comply with the discovery stay, while at the same time asking the Court to determine substantive factual issues in their favor in the context of a strictly procedural motion. This will not wash.

Defendants' strategy offends the very purpose of a Rule 12(b)(6) motion. Defendants' allegations of "fact" containing their spin on public and non-public documents and hearsay contentions therein – irrespective of whether they are true or false – is grossly improper. Fed. R. Civ. P. 12(b)(6). Defendants' entire "joint disclosure" brief must be stricken.

Further, defendants have submitted non-public transcripts and PowerPoint slides that are neither referenced nor incorporated in the Consolidated Complaint ("CC"). Defendants also make numerous – and laughably implausible – factual assertions in their brief without citation to ***any*** evidentiary record. Their submissions not only violate Rule 12(b)(6) but also fail to make the

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1 *See Jackson v. Procunier*, 789 F.2d 307, 309 (5th Cir. 1986) ("A motion to dismiss for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) is to be evaluated only on the pleadings."); *Lovelace v. Software Spectrum*, 78 F.3d 1015, 1017-18 (5th Cir. 1996) (courts must limit their inquiry to the facts stated in the complaint and the documents either attached to or incorporated in the complaint); *Cooper v. Pickett,* 137 F.3d 616, 622 (9th Cir. 1998) ("In ruling on a motion to dismiss, a district court generally 'may not consider any material beyond the pleadings.'"). All emphasis is added and all citations and footnotes are omitted.

2 Certain Defendants' Joint Brief Relating to Enron's Disclosures ("Joint Brf.") at 2.

requisite showing under Fed. R. Evid. 201 that these "factual" contentions, denials, and submissions of non-public, unauthenticated documents may properly be judicially noticed or admitted. On a motion to dismiss, such factual argument and evidence are not permitted.[3]

Finally, if the Court does entertain defendants' factual arguments, plaintiffs have prepared a succinct response to defendants' wildly erroneous claims. *See* §V *infra*. As plaintiffs' exposition demonstrates, defendants "disclosure" brief is ***even more misleading*** than Enron's restated financials, highlighting the lengths to which defendants will go to avoid liability.

II. STATEMENT OF FACTS

In the interest of brevity, plaintiffs respectfully refer the Court to the "Statement of Facts" in its Memorandum of Points and Authorities in Opposition to the Outside Directors' Motion to Dismiss. Summarizing briefly, defendants issued a series of false and misleading statements about Enron between 10/19/98, and 11/27/01 (the "Class Period"), pursuant to a fraudulent scheme and implementation of manipulative devices to inflate Enron's reported profits and financial condition. ¶2.[4] The fraud enabled defendants to pocket billions of dollars at the expense of innocent shareholders who purchased Enron stock on the secondary market throughout the Class Period – or in numerous equity and debt offerings during the Class Period.

As a result of defendants' fraudulent scheme and implementation of deceptive devices, Enron suddenly reported $1 billion in write-offs and a billion dollar shareholder equity writedown. ¶3. On 11/8/01, Enron restated its operating results from 97-00 and interim 01 results, restating over ***four years*** of earnings and admitting its prior reporting "should not be relied upon." *See* Enron's 11/8/01 Form 8-K, SEC App. Tab 76. Ultimately, Enron's stock collapsed on these and other revelations. Knowing that Enron was a financial house of cards and had been falsifying its financial results

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3 Plaintiffs submit defendants' use of the discovery stay as a sword to proffer allegedly exculpatory "evidence" while at the same time hiding behind the discovery stay offends the PSLRA's intended purpose. The submission of extraneous factual argument and evidentiary material (*e.g.*, conference call transcripts, PowerPoint presentations, etc.) has caused plaintiffs undue prejudice that can be only be remedied by immediately lifting the discovery stay.

4 References to the CC are designated "¶_."

allowed defendants to sell off millions of their Enron shares – large percentages of their ownership interest – and to pocket over $1 billion in illegal insider trading proceeds.

Now, evidencing their inability to deal squarely and directly with the abundant and particularized facts of the CC, defendants dispute the CC's factual assertions and invite the Court to make factual determinations which are improper for consideration at this stage.

III. ON A MOTION TO DISMISS, DEFENDANTS ARE NOT PERMITTED TO ARGUE THE FACTS

A. Plaintiffs' Allegations May Not Be Disputed by Defendants, but Must Be Accepted as True

On motions to dismiss, defendants are not permitted to dispute plaintiffs' factual allegations. Reliance on or adoption of a defendant's fact claims – which the Enron defendants request the Court do here – is reversible error. *See Baker v. Putnal*, 75 F.3d 190 (5th Cir. 1996). Instead, courts must "accept as true all well-pleaded allegations in the complaint" and "construe those allegations in the light most favorable to the plaintiff." *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994). *See Kaiser Aluminum & Chem. Sales, Inc. v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) (same). This is true even if the court doubts plaintiff can prove what is pleaded. *See Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). "What Rule 12(b)(6) does not countenance are dismissals based on a judge's disbelief of a complaint's factual allegations." *Neitzke v. Williams*, 490 U.S. 319, 327 (1989).

Defendants upend the law of this Circuit: on a motion to dismiss, the court may not adopt defendants' claims as fact, but instead must presume the allegations of a plaintiff's complaint are true, drawing every reasonable inference therefrom in favor of plaintiff. *See Baker*, 75 F.3d at 196-97; *Rubinstein*, 20 F.3d at 166; *Kaiser*, 677 F.2d at 1050. Indeed, a court "cannot consider material outside the complaint, such as ***facts presented in briefs***, affidavits or discovery materials." *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1165 (W.D. Wash. 1998). *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1426 (3d Cir. 1997) ("a district court ruling on a motion to dismiss may not consider matters extraneous to the pleadings"); *Saddle Rock Partners v. Hiatt*, Civ. No. 95-2326-GA, 1996 U.S. Dist. LEXIS 20649, at *23 (W.D. Tenn. Mar. 26, 1996) (in securities fraud action, defendants' claim regarding sales is "a factual question beyond the complaint, inappropriate for consideration upon a motion to dismiss"). Where, as here, a Rule 12(b)(6) movant's brief "introduces many facts not alleged in the complaint ... those facts will be ***disregarded***" because a motion to dismiss is "strictly procedural," and this is especially so when a defendant attaches "***nothing***" to create "a record upon which to introduce facts not included in the ... pleadings."[5] *Kinney on behalf of NLRB v. Dominick's Finer Foods, Inc.*, 780 F. Supp. 1178, 1181-82 (N.D. Ill. 1991).

Baker illustrates this principle. In *Baker*, the Fifth Circuit reversed a district court's dismissal of a plaintiff's civil rights claim. The *Baker* plaintiff contended the district court improperly made factual findings, considered more than the pleadings, and failed to accept all well-pleaded facts as true and in a light favorable to plaintiff. 75 F.3d at 196. The Fifth Circuit agreed, noting the trial court

> ***adopted portions of the defendants' claims as fact***.... Thus, the court failed to accept as true [plaintiff's allegations] .... In so doing, the court failed to apply the standards of Rule 12(b)(6). ***Dismissal*** under these circumstances was ***error***.

Id. at 197. As discussed herein, defendants' "joint disclosure" brief attacks plaintiffs' veracity, presents myriad fact questions that cannot be resolved, makes patently absurd arguments, and proffers facts without any evidentiary record in support. Taken together, the following examples demonstrate why the entire brief must be stricken.

1. Defendants Improperly Attack Plaintiffs' Veracity

Defendants are prohibited from injecting their version of the "facts" merely because defendants challenge a plaintiff's truthfulness. "The fact that Defendants ... dispute the veracity of the allegations is inapposite; in reviewing a motion to dismiss, the Court must take all of Plaintiffs' factual allegations as true." *Aston v. City of Cleburne*, Civ. No. 3:99-CV-2255-H, 2000 U.S. Dist. LEXIS 2135, at *14 (N.D. Tex. Feb. 22, 2000). *See Rhodes*, 416 U.S. at 236; *Neitzke*, 490 U.S. at 327.

Defendants repeatedly and flagrantly challenge plaintiffs' veracity. For example, plaintiffs allege investors were not informed of the risks associated with Enron's hedging activities. In

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[5] Defendants repeatedly employ this tactic, making sweeping factual assertions without any evidence to support them (notwithstanding their submission of 13 volumes of material).

response, defendants argue these allegations are "not true." Joint Brf. at 24. Plaintiffs allege Enron lied about the number of customers and transactions at Enron's broadband services, claiming it has 16 million customers who in fact belonged to other ISPs, not Enron. ¶300(k). "This allegation ... suffers from a lack of veracity," according to defendants. Joint Brf. at 141-49. Plaintiffs allege Chewco, LJM1 and LJM2 were used to enter transactions to conceal "very large" losses from Enron's merchant activities, ¶385, but according to defendants, the allegation "is simply wrong." Joint Brf. at 52. On page 60 of their brief, defendants go so far as to claim plaintiffs "misstate" what was "involved in and disclosed about" the Raptors, even though the Board's own Special Investigation Committee ("Powers Committee") concluded, "Enron used the extremely complex Raptor structure finance vehicles to avoid reflecting losses in the value of some merchant investments in its income statement." Powers Report at 97. Defendants make similar arguments throughout their "joint disclosure" brief. No matter how defendants slice it, all of it is improper and must be stricken.

2. The Court Should Reject Consideration of Defendants' Fact Allegations

Defendants invite the Court to make myriad substantive factual determinations in violation of well-settled Fifth Circuit law. *See Baker*, 75 F.3d at 196-97; *Rubinstein*, 20 F.3d at 166; *Kaiser*, 677 F.2d at 1050. For example, plaintiffs allege defendants concealed billions of dollars of debt. In a pattern repeated throughout their brief, defendants claim "through the text and notes," defendants' disclosures were "not vague" and portrayed a "fair picture" of Enron's financial status at the time the disclosures were made. Joint Brf. at 10-11. As the Fifth Circuit has held, the adequacy of disclosure is an ***inherently factual question*** which ***cannot be resolved*** when ruling on a motion to dismiss. *See Lone Star Ladies Inv. Club v. Schlotsky's, Inc.*, 238 F.3d 363, 369 (5th Cir. 2001) ("Whatever the ultimate answer to the adequacy of the disclosures under the 1933 Act, we are not persuaded that that decision ought be made here in ruling on a motion to dismiss for failure to state a claim."). Improper fact arguments permeate the entire "joint disclosure" brief, in violation of Fifth Circuit law:

- Plaintiffs allege Enron "concealed" price triggers in its financial arrangements; defendants dispute the adequacy of their disclosure, claiming the existence of "contingent obligations to issue Enron stock was disclosed in a number of places" (Joint Brf. at 14);

- Plaintiffs allege defendants violated GAAP by failure to consolidate LJM1 and LJM2 into Enron's balance sheet; defendants first argue these special purpose entities should not have been consolidated (*id.* at 15 n.11), then argue "[a] hindsight analysis of alleged mistakes under GAAP does not state a claim under the securities laws" (*id.* at 45);

- Plaintiffs allege two SPEs, "Firefly" and "JV-Company," were used to conceal billions of dollars in debts; defendants argue the "debt" purportedly never left Enron's balance sheet and that a "portion of it was recharacterized from long-term debt to a minority interest obligation on the balance sheet," disputing plaintiffs' allegation (*id.* at 20);

- Plaintiffs allege defendants failed to "'fully disclose nature or extent of [Andrew] Fastow's financial interests'" in the LJM partnerships; defendants dispute the adequacy of their disclosure, claiming they adequately disclosed Fastow's compensation and relationship with the LJM partnerships (*id.* at 42-43);

- Plaintiffs allege Enron used its partnerships to enter into transactions to conceal large losses from Enron's merchant investments; defendants claim this argument "is simply wrong" and dispute the adequacy of their disclosure, pointing to a hopelessly vague sentence that purportedly constitutes "disclosure" (*id.* at 52);

- Plaintiffs allege Enron engaged in a fraudulent transaction involving LJM2 and the Nova Sarzyna power plant; without citation to ***any*** evidence, defendants inject a host of purported "facts" concerning a "restrictive financing covenant," "limited waiver[s]," "covenant default," and other highly improper fact arguments lacking ***any*** support (*id.* at 56); and

- Concerning the Raptors, defendants argue plaintiffs "misstate" what "was involved in" the Raptors; defendants then provide a host of "facts" concerning the purpose for the Raptors – without citation to ***any*** authenticated evidentiary record (*id.* at 60).

That is not all. Some of defendants' arguments are so absurd they border on the comical, underscoring defendants' desperation:

- Defendants argue plaintiffs "probably" intended, but failed, to allege certain facts concerning consolidation; defendants go on to say the "***intended***" allegation "would be wrong" – even though plaintiffs ***never*** alleged it (*id.* at 64);

- Plaintiffs allege the New Power spin off was a sham and its securities worthless. Defendants respond with unsubstantiated facts: "the market for concept stocks decreased dramatically ***one week*** following the New Power IPO" and, although New Power "had real customers[,] ... ***evidently not as many as it needed***" (*id.* at 65-66);[6]

- Concerning Enron's $1.2 billion equity writedown due to the Raptors, when Enron and Andersen discovered an "error" in accounting for the Raptors, they initially

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6 "The bottom line, however, is that these arguments are fact intensive matters usually requiring expert testimony concerning the state of the financial markets and the like. Accordingly, such issues are inappropriate for disposition in the context of a motion to dismiss." *In re DaimlerChrysler AG Sec. Litig.*, No. 00-993-JJF, 2002 U.S. Dist. LEXIS 6458, at *63 (D. Del. Mar. 22, 2002).

determined the $1 billion error was "***not material***" and a restatement was "***not necessary***" (*id.* at 95); and

- Plaintiffs allege the Blockbuster venture was a total fraud and alleges Ken Rice flatly admitted to two potential engineering recruits "'[Enron] can't deliver the Blockbuster deal.'" Defendants argue Rice's admission in no way evidences fraud but merely demonstrates Enron "was recruiting these anonymous engineers to ensure that Enron ***could*** perform the Blockbuster contact" (*id.* at 152) (emphasis in original).

Defendants' improper fact argument is further highlighted by their discussion of mark-to-market ("MTM") accounting. "To wipe clean the conclusory and unsubstantiated taint" of plaintiffs' allegations, defendants improperly opine on their use of MTM accounting. *Id.* at 70-82. In so doing, defendants attempt to controvert the CC's averments of financial fraud by contending the allegations are simply attacks on the "judgment" and "informed estimat[ions]" of Enron's "management." *Id.* Defendants defend and justify with unsubstantiated "facts" their accounting methodology for Enron's energy securities contracts, including the determination of the present value of estimated future cash flows and the projection of future cash inflows and outflows. Defendants further argue they did not violate GAAP in using MTM accounting treatment for EES contracts (notwithstanding the lack of a historical track record). Joint Brf. at 166-74.

Whether defendants' false and misleading financial accounting was the product of their "cooking the books" or was the mistaken application of accounting rules is a ***factual question*** that is ***not*** appropriately raised here, nor can it be fairly and adequately determined without the benefit of discovery. *See In re Triton Energy Ltd. Sec. Litig.*, Civ. No. 5:98-CV-256, 2001 U.S. Dist. LEXIS 5920, at *23 (E.D. Tex. Mar. 30, 2001) ("[w]hether Defendants violated the applicable accounting standards is a question of fact"); *Burlington Coat Factory*, 114 F.3d at 1421 ("it is a factual question whether [defendants'] accounting practices were consistent with GAAP ... we are required to credit plaintiffs' allegations ***rather than defendants' responses***"); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 164-65 (2d Cir. 2000) (misstatements of income represents fact question that cannot be decided on motion to dismiss).

What's more, defendants are prohibited from asserting the truth of any document, even if the document is publicly available including being filed with the SEC. *Lovelace*, 78 F.3d at 1020 n.6

("We will not consider, in deciding a motion to dismiss on the pleadings, the contents of relevant public disclosure documents for the purpose of proving the truth of their contents.").

B. Defendants' Submission of PowerPoint Slides, Transcripts from an Analyst Conference and Conference Call Transcript Must Be Stricken

Beyond their improper fact arguments, defendants compound their error by attaching non-public, unauthenticated documents that are neither referenced in nor relied upon by the CC.[7] These documents include purported transcripts of an analyst conference and a conference call, and PowerPoint slides allegedly shown at an analyst conference on January 20, 2000. *See* App. Tabs 38, 39, and 49.

The transcripts and the PowerPoint slides are outside the CC's four corners. A document is outside the complaint and not a proper subject of judicial notice if its contents are not alleged in the complaint or if its authenticity is questioned. *See Carter v. Stanton*, 405 U.S. 669, 671 (1972) ("matters outside the pleadings were presented and not excluded by the court. The court was therefore required by Rule 12(b) of the Federal Rules of Civil Procedure to treat the motion to dismiss as one for summary judgment"); *Jackson*, 789 F.2d at 309-10 ("A motion to dismiss ... is to be evaluated only on the pleadings. It is not interchangeable with a motion for summary judgment, for the latter may impose a burden on the non-moving party to supplement its pleadings with affidavits, depositions, or other evidence to demonstrate that a genuine dispute exists over material facts."); *Cooper v. Pickett*, 137 F.3d 616, 622-23 (9th Cir. 1998) (although "plaintiffs make allegations about ... conference calls, but do not expressly mention or refer to the transcripts, or even identify their existence," and "plaintiffs disputed the authenticity and accuracy of the transcripts ... and objected to their use .... The transcripts therefore cannot be considered in ruling on the motion to dismiss."). As the Court has noted, "usually a court limits its review under a Rule 12(b)(6) motion to the facts stated in the complaint and any documents either attached to the complaint or incorporated into it, or it converts the motion to one for summary judgment under Rule 56, with notice to the parties and an opportunity to be heard." *In re Sec. Litig. BMC Software, Inc.*, 183

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[7] Plaintiffs do not object to defendants' submission of publicly available SEC filings in their massive, multivolume appendix.

F. Supp. 2d 860, 881 (S.D. Tex. 2001). The Court's analysis squares with *Lovelace*, where the Fifth Circuit held that while a district court may consider "the contents of relevant public disclosure documents," this holding does ***not*** apply to "'other forms of disclosure such as press releases or announcements at shareholder meetings.'" 78 F.3d at 1018 & n.1. *See Leslie v. Lloyd's of London*, Civ. No. H-90-1907, 1991 U.S. Dist. LEXIS 21614, at *13 (S.D. Tex. May 11, 1991) ("In its inquiry, the court is limited to the content of the complaint.").

The conference call transcript and analyst conference transcript must be stricken. Though the CC references conference calls, it does not reference any ***transcripts*** of those calls.[8] *See Cooper*, 137 F.3d at 622-23. As the Court has held, "[i]n particular, because the conference call transcripts are not referenced in the complaint, they should not be considered." *BMC*, 183 F. Supp. 2d at 883 n.32. A similar result was reached in *In re Scholastic Sec. Litig.*, No. 97 Civ. 2447 (JFK), 1998 U.S. Dist. LEXIS 13910, at *4-*5 (S.D.N.Y. Aug. 31, 1998), where the plaintiffs referenced a conference call from which a submitted transcript was allegedly made. The *Scholastic* court refused to consider the actual transcript on a motion to dismiss because the complaint made no reference to a ***transcript*** of the call and did not identify the existence of the transcript. *Id.* Moreover, as was the case in *Cooper*, plaintiffs make allegations concerning conference calls, but "do[es] not expressly mention or refer to the transcripts, or even identify their existence." *Cooper*, 137 F.3d at 623. In fact, as in *Cooper*, the transcripts defendants included in their appendix came into being only through the defendants' actions. Further, defendants' purported transcript of the analyst conference is even more egregious because plaintiffs do ***not*** refer to defendants' statements at such an event.

Thus, the transcripts and the PowerPoint slides are ***not*** appropriately before the Court. As numerous decisions explain, courts must use care "policing the line between those documents included as part of the pleadings and those that constitute evidence [which], while presumably admissible and relevant at trial, nonetheless are ***not*** properly considered on a motion to dismiss." *Hirata Corp. v. J.B. Oxford & Co.*, 193 F.R.D. 589, 593 (S.D. Ind. 2000); *see Lovelace*, 78 F.3d at 1017-18.

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[8] Excepting two instances at the end of the Class Period, Enron failed to give ***any*** safe-harbor warnings on its conference calls. *See* §VB *infra*.

Moreover, defendants fail to show under Fed. R. Evid. 201 that the challenged documents, or their "factual" contents, are proper subjects for judicial notice. Rule 201(b) allows a court to take judicial notice of "fact[s] ... not subject to reasonable dispute in that [the fact] is either (1) generally known ... or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Further, these exhibits constitute inadmissible hearsay if accepted for their truth. As the Court in *Shiry v. Moore*, No. C 94-1485 SBA, 1995 U.S. Dist. LEXIS 22054, at *17 (N.D. Cal. Mar. 9, 1995), explained:

> The rule is not designed to expand the use of judicial notice, but rather continues "the tradition ... of caution in requiring that the matter be beyond reasonable controversy."

Id. (quoting Fed. R. Evid. 201(b), Advisory Committee Notes).

Cursory examination of the challenged exhibits demonstrates the standards for taking judicial notice have not been met. Defendants cannot credibly claim the PowerPoint slides or the transcripts (which plaintiffs have never had access to) are the type of material that is generally known or capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned. For these reasons, plaintiffs object to the identified exhibits and requests the Court strike them and disregard all references to them for all purposes.

IV. DEFENDANTS HAVE WAIVED THE AUTOMATIC DISCOVERY STAY

Defendants' submission of evidence should be deemed a voluntary waiver of the automatic discovery stay imposed by the PSLRA so that plaintiffs may take appropriate discovery. In situations such as this, the PSLRA expressly provides that the automatic stay may be lifted to permit plaintiffs to conduct discovery to "prevent undue prejudice." *See* 15 U.S.C. §78u-4(b)(3)(B). As the court in *Estate of Sorrells v. City of Dallas*, 192 F.R.D. 203, 209-10 (N.D. Tex. 2000), explained in an analogous circumstance, where defendants sought to rely upon facts while shielding itself from discovery using a claim of qualified immunity, the remedy for such conduct is permitting a plaintiff to engage in otherwise prohibited discovery:

> The absurdity of this scenario should be plain.... [Defendants] now hide behind the shield of qualified immunity to deny access to evidence solely within their control while using that same evidence against plaintiffs. ***Limiting discovery in these circumstances is inherently unfair.***

Id. at 209. *See Smith v. Luther*, Civ. No. 4:96cv69-D-B, 1996 U.S. Dist. LEXIS 21476, at *5 (N.D. Miss. Aug. 14, 1996) ("[i]n this court's view, it is inappropriate for [the] defendants to gain shelter from discovery under the qualified immunity shield while simultaneously attacking plaintiff with documentary evidence from which he cannot defend himself because of the discovery stay'").

The law regarding the waiver of an attorney-client privilege is instructive here. The Fifth Circuit holds:

> The attorney-client privilege "was intended as a shield, not a sword" ... the attorney-client privilege is waived when a litigant "place[s] information protected by it in issue through some affirmative act for his own benefit, and to allow the privilege to protect against disclosure of such information would be manifestly unfair to the opposing party."

Conkling v. Turner, 883 F.2d 431, 434 (5th Cir. 1989). *See Golden Valley Microwave Foods, Inc. v. Weaver Popcorn Co.*, 132 F.R.D. 204, 208 (N.D. Ind. 1990) (self-serving disclosure results in full disclosure); *Teachers Ins. & Annuity Ass'n v. Shamrock Broad. Co.*, 521 F. Supp. 638, 641 (S.D.N.Y. 1981) (waiver will be found for withheld information to "make the disclosure complete and not misleadingly one-sided"). Even the *Sorrells* court found the discussion of waiver of attorney-client privilege instructive. 192 F.R.D. at 209 n.6 ("courts have found waiver in other circumstances when a party uses a privilege or immunity as both a sword and a shield").

Here, justice and fairness dictate the automatic stay be lifted so that plaintiffs may take the appropriate discovery needed to present a balanced account. The PSLRA expressly provides the automatic stay may be lifted under such circumstances to permit plaintiffs to conduct discovery. *See* 15 U.S.C. §78u-4(b)(3)(B) (stay may be lifted to "prevent undue prejudice").

V. DEFENDANTS' MISSTATEMENTS

In addition to making factual arguments, defendants' "joint disclosure" brief also makes numerous misstatements. A comparison of the "joint disclosure" brief, Enron's disclosures, the CC, and Enron's subsequent admissions, causes one to wonder whether the "joint disclosure" brief is not ***even more misleading*** than Enron's financial disclosures issued during the Class Period.

A. Enron's Statements During the Class Period Were Materially False and Misleading

1. Defendants make the remarkable assertion, "Enron's disclosures were adequate, complete and disclosed the facts Plaintiffs contend were concealed or misrepresented." Joint Brf. at 2. And "there were ***no material misrepresentations or omissions*** by Enron (or by ***any*** defendant) concerning Enron securities." Joint Brf. at 224 (emphasis in original). Yet even the Powers Report, to which defendants refer, states the following:

> Nevertheless, the footnote disclosures ***failed to achieve a fundamental objective: they did not communicate the essence of the transactions in a sufficiently clear fashion*** to enable a reader of the financial statements to understand what was going on. Even after months of investigation, and with access to Enron's information, ***we remain uncertain as to what transactions some of the disclosures refer***. The footnotes also glossed over issues concerning the potential risks and returns of the transactions, their business purpose, accounting policies they implicated, and contingencies involved. In short, the volume of details that Enron provided in the financial statement footnotes did not compensate for the obtuseness of the overall disclosure.

Powers Report at 197. This hardly squares with defendants' assertion "the 'billions' in debt that Plaintiffs claim was 'hidden' was disclosed in the notes to the financial statements, providing the investors with ***a full and fair presentation of Enron's financial exposure***." Joint Brf. at 12.

Do defendants really believe the Powers Committee was not competent to read a financial statement? Enron's 11/8/01 Form 10-K states the Powers Committee consisted of newly-elected director William Powers, Dean of the University of Texas School of Law, and outside directors Frank Savage, Paul Ferraz Pereira, and Herbert S. Winokur, Jr. The Powers Committee also retained the law firm of Wilmer, Cutler & Pickering as its counsel, including William R. McLucas, former head of the SEC's Enforcement Division. Wilmer, Cutler retained Deloitte & Touche to provide accounting advice to the law firm – hardly novices to the federal securities laws and accounting rules and regulations.[9]

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[9] Defendants make the ridiculous argument plaintiffs have enjoyed enormous "pretrial discovery" due to the availability of this report, congressional testimony and documents and press coverage of Enron's demise. Joint Brf. at 3 n.1. Defendants know plaintiffs have ***not*** had the opportunity to conduct formal discovery of Enron and its officers and employees or any other defendant, and in fact defendants have vigorously fought any lifting of the PSLRA discovery stay.

2. The CC describes in detail the falsifications of Enron's financial statements, including the amounts by which its financial statements were misstated in 97-00 and the beginning of 01:

ENRON ACCOUNT RESTATEMENTS				
	1997	***1998***	***1999***	***2000***
Recurring Net Income Amount of Overstatement	$ 96,000,000	$113,000,000	$250,000,000	$ 132,000,000
Debt Amount of Understatement	$711,000,000	$561,000,000	$685,000,000	$ 628,000,000
Shareholder's Equity Amount of Overstatement	$313,000,000	$448,000,000	$833,000,000	$1,208,000,000

¶61. Yet defendants claim the CC fails to "explain which part of each financial statement is allegedly overstated or understated, and why." Joint Brf. at 8. To the contrary, the CC identifies the amount of the misstatements Enron has ***admitted*** to by year and category. *See* ¶¶61, 384 (tables) & ¶419 (charts). Defendants claim they have made a "full reading and painstaking parsing" of the CC. Joint Brf. at 104. But they ignore the clearly pleaded misstatement information which is in multiple locations in the CC.

Moreover, Enron's 11/8/01 Form 8-K revealed the need to restate its financial statements for 97-00, and the first two quarters of 01. This is an ***admission*** the prior financial statements were materially false, based on facts Enron's management had when the financial statements were originally issued. *See* SEC App. Tab 76. "GAAP only allows a restatement of prior financial statements based upon information 'that existed at the time the financial statements were prepared.' ... Thus, under GAAP, restated financial statements ***must*** constitute an admission of past errors." *See* Brief of SEC as *Amicus Curiae in Camden Asset Management, L.P. v. Arthur Andersen LLP – In re Sunbeam Sec. Litig.*, No. 98-8258-Civ.-Middlebrooks (Jan. 31, 2002) (attached as Ex. 35 to plaintiffs' appendix). It is undisputed Enron issued false financial statements and, in its 11/8/01 Form 8-K, Enron admitted its financial statements for 97-00 should ***not*** be relied upon. SEC App. Tab 76, at 2.

3. Defendants claim "Enron followed GAAP in the preparation of its financial statements, using the expertise of the nation's top experts in that field." Joint Brf. at 6. This factual

assertion is inappropriate, unsupported, and wrong. Enron has restated its results for the past four years precisely because it failed to follow GAAP when the results were prepared. ¶518. Concerning Enron's reliance on experts, at least one of them, Thomas Bauer of Arthur Andersen, testified before Congress on 2/7/02 that Enron misled him as to at least one transaction:

> It recently has become clear that in 1997, when the Chewco transaction was conceived, Enron withheld information from me and misled me on the accounting issues related to Chewco. I knew nothing of this at the time. I was told that I had been provided with all relevant documentation in Enron's possession. Had the information that was withheld been timely provided to me in 1997 when I requested it, the accounting advice and opinion of Andersen would have been different.

Hearing of the Oversight Investigations Subcommittee of the House Energy & Commerce Committee, Testimony of Thomas Bauer, 2/7/02.

4. Enron's ability to continue as a going concern was dependent on maintaining an investment grade credit rating, and concealing debt was crucial since the amount of debt was factored into Enron's credit ratings. ¶19. Disputing the amount of debt concealed by Enron, defendants claim Enron's disclosures informed investors of the amount of its consolidated and unconsolidated debt. Joint Brf. at 10. To support their assertion, defendants claim some $66 billion in debt was disclosed. *Id.* But in Enron's 2000 Annual Report, the analysis is phony.

First, the amount Enron considered as debt was only $10.229 billion in 00, according to the Form 8-K filed on 11/8/01, ***not*** $66 billion. SEC App. Tab 76, at 4. Defendants' table categorizes nearly every item on the liabilities section of the 00 Balance Sheet as "Debt." *See* Joint Brf. at 10-11. But defendants must know Enron did not consider "Accounts payable" ($9.7B), "Liabilities from price risk management activities" ($19.9B), "Customer deposits" ($4.3B), "Deferred income taxes" ($1.6B), and "Other" ($4.9B) as "Debt." The 00 Annual Report, on which defendants rely, shows what Enron considered debt: "Debt as a percentage of total capitalization increased to 40.9% at December 31, 2000." Total capitalization was $25 billion, thus what Enron considered debt was only $10.2 billion – $25 billion x 40.9% = $10.2 billion. Moreover, this equals the only two items on Enron's balance sheet labeled "debt." Those two items are "Short-term debt" ($1.679 B) and "Long-Term Debt" ($8.550 B). Thus, what Enron represented as debt – $10.2 million – in its 00 Annual Report was just a ***fraction*** of the $66 billion defendants now claim was disclosed to investors. Debt, not other liabilities, was what Enron used to calculate its Debt to Equity ratios. *See* ¶¶420-421, 424.

Second, defendants include in their analysis the $1.9 billion (face value) in zero coupon notes that were not issued until 2/01. This inclusion is ***highly misleading*** in two ways: (a) defendants include the post-year-end note offering in the debt category, but compare it to the $65 billion in assets at year end, excluding the cash Enron received when the offering closed; and (b) defendants use the face amount of the notes rather than the amount due. According to the footnote they cite in the Annual Report (at 41 n.7), the amount of notes issued was only $1.25 billion, not the $1.9 billion face amount, which will be the amount ***at maturity*** in 2021.

Third, defendants include three different minority interests totaling $1.75 billion as debt. Joint Brf. at 10-11. But they fail to explain why any investor reading the Annual Report at note 8, to which defendants refer, would understand this to be an Enron debt. Nowhere does the note indicate Enron is liable for the amount of minority interests, rather it indicates "Enron has the ***option*** to acquire the minority holders' interest" in the entities. *See* SEC App. Tab 15, at 81.

Fourth, defendants include $2.428 billion attributable to Whitewing and $1.2 billion attributable to Azurix as debt that was disclosed to Enron investors in note 10 of the Annual Report. But the note says no such thing. It is reproduced below to illustrate the truth about the disclosure – in contrast to defendants' claim Enron's financial statements gave a "fair presentation of Enron's financial exposure." Joint Brf. at 12.

> ***Enron has authorized 16,500,000 shares of preferred stock, no par value. At December 31, 2000, Enron had outstanding 1,240,933 shares of Cumulative Second Preferred Convertible Stock (the Convertible Preferred Stock), no par value. The Convertible Preferred Stock pays dividends at an amount equal to the higher of $10.50 per share or the equivalent dividend that would be paid if shares of the Convertible Preferred Stock were converted to common stock. Each share of the Convertible Preferred Stock is convertible at any time at the option of the holder thereof into 27.304 shares of Enron's common stock, subject to certain adjustments. The Convertible Preferred Stock is currently subject to redemption at Enron's option at a price of $100 per share plus accrued dividends. During 2000, 1999 and 1998, 55,251 shares, 23,664 shares and 17,797 shares, respectively, of the Convertible Preferred Stock were converted into common stock.***
>
> In 1999, all outstanding shares of Series A Preferred Stock held by Whitewing were exchanged for 250,000 shares of Enron Mandatorily Convertible Junior Preferred Stock, Series B (Series B Preferred Stock). Also in 1999, Enron entered into a Share Settlement Agreement under which Enron could be obligated,

under certain circumstances, to deliver additional shares of common stock or Series B Preferred Stock to Whitewing for the amount that the market price of the converted Enron common shares is less than $28 per share. In 2000, Enron increased the strike price in the Share Settlement Agreement to $48.55 per share in exchange for an additional capital contribution in Whitewing by third-party investors. The number of shares of Series B Preferred Stock authorized equals the number of shares necessary to satisfy Enron's obligation under the Share Settlement Agreement. Absent certain defaults or other specified events, Enron has the option to acquire the third-party investors' interests. If Enron does not acquire the third-party investors' interests before January 2003, or earlier upon certain specified events, Whitewing may liquidate its assets and dissolve. At December 31, 2000, Enron had outstanding 250,000 shares of Series B Preferred Stock with a liquidation value of $1.0 billion. The Series B Preferred Stock pays semi-annual cash dividends at an annual rate of 6.50%. Each share of Series B Preferred Stock is mandatorily convertible into 200 shares of Enron common stock on January 15, 2003 or earlier upon the occurrence of certain events.

> ***In connection with the 1998 financial restructuring (yielding proceeds of approximately $1.2 billion) of Enron's investment in Azurix, Enron committed to cause the sale of Enron convertible preferred stock, if certain debt obligations of the related entity which acquired an interest in Azurix, are defaulted upon, or in certain events, including, among other things, Enron's credit ratings fall below specified levels. If the sale of the convertible preferred stock is not sufficient to retire such obligations, Enron would be liable for the shortfall. Such obligations will mature in December 2001. The number of common shares issuable upon conversion is based on future common stock prices.***

SEC. App. Tab 16, at 45. Nowhere in these paragraphs is an understandable, let alone transparent, statement about the exposure in the amounts argued by defendants in their Joint Brief as clearly set out for the reasonable investor.

Fifth, similar to the Whitewing and Azurix liabilities, the $3.722 billion in equity instruments is supposedly disclosed in note 11. But note 11 simply does ***not*** say what defendants claim:

> Derivative Instruments. At December 31, 2000, Enron had derivative instruments (excluding amounts disclosed in Note 10) on 54.8 million shares of Enron common stock, of which approximately 12 million shares are with JEDI and 22.5 million shares are with related parties (see Note 16), at an average price of $67.92 per share on which Enron was a fixed price payor. Shares potentially deliverable to counterparties under the contracts are assumed to be outstanding in calculating diluted earnings per share unless they are antidilutive. At December 31, 2000, there were outstanding non-employee options to purchase 6.4 million shares of Enron common stock at an exercise price of $19.59 per share.

SEC App. Tab 16, at 46. Defendants claim investors knew Enron had debt of $3.722 billion based on this note, but it does not state any such thing.

Defendants also cite note 15 for another $4 billion in supposedly disclosed debt, but give no explanation in the note or otherwise as to how the amount is derived, which belies their next claim that these disclosures "were not vague, and they portrayed a fair picture of the financial exposure of Enron as it was known at the time the statements were created." Joint Brf. at 11. Defendants also falsely assert, "Plaintiffs never identify or quantify the allegedly hidden debt" (*id.*), but both categories are found throughout the CC:

(i) ¶447: Chewco – $628 million (in 2000) – this debt it not in any of the debt disclosure cited by defendants;

(ii) ¶559: Mahonia – $2.2 billion – this debt is not in any of the debt disclosures cited by defendants;

(iii) ¶¶565-568: Prepaid swaps with CitiGroup and CS First Boston – this debt is not in any of the debt disclosures cited by defendants;

(iv) ¶¶569-571: Connecticut Resources Transaction – $220 million – this debt is not in any of the debt disclosures cited by defendants;

(v) ¶659: Sequoia, Choctaw, Cherokee and Cheyenne SPE/Partnerships – $1.5 billion – this debt is not in any of the debt disclosures cited by defendants.

5. In arguing Enron's debt was disclosed, defendants claim the debt relating to the several SPE's was disclosed. Joint Brf. at 12-13. But they fail to identify any disclosure of the ***first*** SPE alleged to have been concealed – Chewco. Defendants include purported disclosures about Azurix, Whitewing and Atlantic Water Trust, but nothing about Chewco. Joint Brf. at 13-20. Of course, defendants do not argue Chewco was disclosed. They can not. It was not. ¶510. The Chewco SPE alone concealed as much as $711 million in debt from Enron's financial statements. ¶447. Defendants also make the factual assertion Enron did not have a controlling interest in Whitewing, Marlin, or Atlantic Water Trust. Joint Brf. at 15. In truth, these entities were used by Enron to generate off-book transactions. ¶497. In reality, Enron controlled these entities and transactions, as alleged. Thus, defendants' factual argument is contradicted by Company documents and the CC and a substantive determination is inappropriate at this stage.

6. Defendants claim the Firefly and JV-Company SPEs were properly excluded. Joint Brf. at 20. This is a factual assertion inappropriate at this stage and, in any event, defendants' response fails to answer the allegations the entities were used to conceal debt. ¶496.

7. These defendants claim "GAAP prevented LJM1 and LJM2 from being consolidated onto the balance sheet because Enron had no financial interest or voting control in either of them." Joint Brf. at 15. But this is the ***opposite of what Enron admitted to*** in its 11/8/01 Form 8-K and ignores the role of CFO Andrew Fastow in those entities. In particular, the Form 8-K at part 2(B) states: "Enron's decision that the LJM1 subsidiary should be consolidated in 1999 and 2000 is based on Enron's current assessment that the subsidiary did not qualify for nonconsolidation treatment because of inadequate capitalization." ¶¶448-449. And the CC clearly pleads CFO Fastow was the managing member of the general partners of both LJM1 and LJM2, and pleads these entities used Enron facilities and management – Fastow and CAO Causey – to evaluate them to allocate costs between Enron and LJM2. ¶¶449, 451, 460.

8. Enron also manipulated its results by treating asset transfers to related entities as sales rather than as loans, including energy-related projects and dark-fiber broadband swaps. Osprey and Marlin were structured transactions, which helped Enron keep debt off its books, and they had price triggers that created obligations on Enron's part once its stock price dropped to a certain level. Consequently, these transactions were a significant reason Enron failed. Osprey was an investor in Whitewing, with which Enron did numerous sales transactions to generate income. Whitewing alone had 75 subsidiaries, which were used by Enron to generate income and conceal debt. ¶497. Defendants claim the CC misapplies accounting principles as to Osprey, Marlin, and Whitewing and defendants claim transactions with these entities were adequately disclosed. Joint Brf. at 15-19. In response, the CC alleges Enron used these entities to transfer impaired assets to avoid recording impairment charges. Moreover, Enron did not surrender control over these assets, which precluded recognition as a sale. ¶¶498-501. Defendants also make numerous misstatements about the CC's allegations and Enron's involvement in the alleged fraud:

(a) They claim the reference to FASB Statement of Financial Accounting Standard ("SFAS") No. 125 is a misapplication since it only applies to financial, not physical, assets.

This ignores the fact "financial assets" under SFAS No. 125 includes "evidence of an ownership interest in an entity." SFAS No. 125, ¶432. The CC identifies several types of assets Enron transferred to Osprey, Marlin, and Whitewing to conceal losses, including interests in power plants, pulp and paper plants, gas pipelines, electricity transmission, distribution lines, and dark fiber. ¶499.

(b) Defendants claim "Plaintiffs acknowledge Enron obtained legal opinions on the control and the bankruptcy remote issues," of SFAS No. 125 issues, citing to ¶101. Joint Brf. at 18. In truth, ¶101 says no such thing, but merely discusses CitiGroup's involvement generally, including helping to structure derivatives and hedging financial transactions, but nothing specific to the transactions in the manner defendants assert. Moreover, their defense that management relied on outside professionals is unavailing. The CC clearly alleges it was well known within Enron's management – of which each of these defendants was a part – these assets had decreased in value by the second half of 00. ¶500. Moreover, the 00 Annual Report, referenced by defendants (SEC App. Tab 16, at 31) states: "The following financial statements of Enron Corp. and subsidiaries (collectively, Enron) were prepared by management, which is responsible for their integrity and objectivity."

(c) Defendants recite two disclosures about asset transfers to Whitewing from Enron's 00 Annual Report. Joint Brf. at 18-19. They conveniently gloss over the fact some assets were impaired and ignore the fact the assets were transferred to avoid recording impairment charges. No hint of this practice was disclosed.

9. As to the allegations the Firefly and JV-Company SPE's were created to move debt off Enron's balance sheet, defendants claim both were "qualifying SPEs under EITF No. 90-15." Joint Brf. at 20. The CC alleges both were created for the purpose of changing the perception of Enron's financials, and accomplished their goal by concealing debt. ¶496.

10. Defendants point to Enron's disclosures about its hedging activities as an indication that "[i]nvestors were thus made aware of how Enron accounted for its hedges." Joint Brf. at 21-24, 68 (concerning the Raptors, defendants claim "[t]hat these structures subsequently experienced credit difficulties was nothing more than a fully disclosed counterparty credit risk that came to fruition"). Yet ***none*** of the disclosures quoted by defendants address the allegations they challenge. For

instance, ¶¶34, 155(e), 214(e) and 300(e) discuss the use of Enron's stock as a hedge for an investment. The Powers Report noted such a hedge "was not, and could not have been a true economic hedge." Powers Report at 82; ¶456. The risks of hedging, generally, may have been disclosed, but Enron's use of ***phony hedges*** was not. Defendants repeatedly grouse the CC does not include certain disclosures from Enron's SEC filings. But these disclosures did ***not*** include the facts alleged to have been concealed, which begs the questions: why do defendants believe it necessary to include a disclosure in a complaint which does ***not*** disclose a practice that plaintiffs claim is not disclosed?

11. Defendants claim the risks involved in the related-party hedging transactions were disclosed, citing as support certain notes included in the 99 and 00 Form 10-Ks. Joint Brf. at 24-26. In fact, the disclosures did not include the facts alleged to have been concealed and the disclosures included false statements.

(a) Defendants' analysis glosses over at least two important facts: the hedges were not real, and related-party transactions were ***not*** on terms that could be expected in an arm's-length transaction. Moreover, the purpose of a "hedge" is to offset investment risk. *See Dictionary of Finance and Investment Terms, Barrons*, 254 (5th ed.). The 00 Form 10-K states Enron entered into the transactions "to hedge certain merchant investments." SEC App. Tab 15, at 95. The CC clearly alleges the hedges were ***not*** real. For example, the LJM2 partners were to receive their entire investment back before any hedging could occur. Hence, supposedly "independent" parties had no capital at risk and Enron was left to hedge with itself. ¶478.

(b) Defendants claim plaintiffs never explain how a reasonable investor could have been misled about the credit risk of the Raptor vehicles, for example, when Enron expressly cautioned its investors that the results of these specific hedges, like the results of its hedges, generally, were dependent upon the creditworthiness of its related parties. Joint Brf. at 24-26 and at 60. In fact, the CC does exactly that. The CC alleges CFO Fastow's involvement with and compensation in LJM was concealed. ¶511. The related-party notes in the 99 and 00 Form 10-Ks included a phrase that colored, if not obscured, any investor's understanding of these transactions: "Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties." SEC App. Tab 15, at 95; *see also* SEC App. Tab 10, at 101 ("Management believes that the terms of the transactions with related parties are representative of terms that would be negotiated with unrelated third parties."). This statement was false and concealed the fact these transactions were not entered into for Enron's benefit and were grossly unfair to Enron. ¶516.

(c) Enron failed to disclose the risk of it having to issue more shares was imminent. Enron bore the risk of its so-called hedges, such that they were an increased risk to ***Enron***, and not a decreased risk as expected in an ordinary hedge. ¶619. This risk was not disclosed by what defendants are ***now*** able to glean from the SEC filings. Defendants claim investors were told of the significant risks associated with Enron's decision (a) to hedge investments, (b) with a related party, (c) whose creditworthiness, (d) hinged on the value of Enron's stock. Joint Brf. at 26. This ignores what Enron actually disclosed – and what it omitted – about its related-party transactions. The disclosure did ***not*** inform investors the Raptors were a massive credit support for Enron's hedging transactions and the disclosure failed to inform investors there was no independent capital "at risk" by independent parties by the time the hedging transactions began. ¶¶478, 620. Moreover,

> [t]he footnotes also glossed over issued concerning the potential risks and returns of the transactions, their business purpose, accounting policies they implicated, and contingencies involved. In short, the volume of details that Enron provided in the financial statement footnotes did not compensate for the obtuseness of the overall disclosure.

Powers Report at 197.

(d) Enron employees realized how misleading its disclosures were. Executive Sherron Watkins wrote to Chairman Lay in August 01:

> I realize that we have had a lot of smart people looking at this .... ***None of that will protect Enron if these transactions are ever disclosed in the bright light of day***.
>
> * * *
>
> My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. ***Looking at the stock we swapped, I also don't believe any other company would***

have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron.

¶850.

(e) The purported disclosures were themselves false and misleading: (i) Enron lacked a factual basis to assert how the transactions compared to those with unrelated third parties; (ii) the disclosures omitted key details of transactions; and (iii) the disclosures and information about how they were drafted "reflect a strong predisposition on the part of at least some in the Company to minimize the disclosures about the related-party transactions." Powers Report at 201.

B. Defendants' False Statements Are Not Immunized by the Safe-Harbor Provision of the PSLRA

1. Defendants' reliance on the PSLRA's safe harbor for forward-looking statements is unavailing. Joint Brf. at 26-27(a).

(a) They have not cited, nor can they, any disclosure during the Class Period by which Enron informed the public its hedges were not true hedges, and that it was essentially hedging with itself. ¶495.

(b) They claim Enron informed investors its hedges could be affected by counterparty credit risk. But these disclosures did not inform investors these hedges were not with a creditworthy, independent, outside party, and there was no transfer of economic risk of a decline in the underlying investments because Enron still bore virtually all the economic risk. ¶462.

(c) Except in only two instances at the end of the Class Period, Enron ***failed to give any safe-harbor warning*** on its conference calls. ¶985. Defendants claim this is "nonsense," but ***cannot*** dispute it. They offer not one example of a safe-harbor warning ***on a conference call*** despite the many held during the Class Period, including those alleged at ¶¶145, 157, 179, 197, 224, 247, 263, 282, 309, 317, 329 & 344.

2. Defendants attempt to hide behind the PSLRA's safe-harbor provision as to management's statements in numerous SEC filings that it ***believed*** the related-party transactions were reasonable compared to those with unrelated parties. Joint Brf. at 38-39. In fact, because management's statements were not forward-looking in nature, the safe-harbor did not apply to them, plus management knew their statements were false.

(a) Pursuant to §21E of the PSLRA, the safe harbor applies ***only*** to forward-looking statements: those containing a projection of revenues and income; management's plans and objectives for future operations; future economic performance; or statements containing a projection or estimate. What defendants actually said – historic, past-tense or contemporaneous, present-tense – was about the terms of transactions it had already entered into with the LJM partnerships compared to similar transactions. *See, e.g.*, ¶515. The disclosures as to the fairness of the LJM partnerships were actually backward-looking statements. There was nothing forward-looking about them within the meaning of the PSLRA.

(b) Defendants had no factual basis to make the statements that they believed the terms for the LJM partnerships were reasonable compared to those with unrelated third parties, and management made no effort to substantiate this assertion. "Indeed, based on the terms of the deals, it seems likely that many of them could ***only*** have been entered into with related parties." Powers Report at 199 (emphasis in original).

(c) Management knew these transactions were not reasonable compared to similar deals with unrelated third parties. This is demonstrated by how the deals were structured to benefit certain insiders and favored bankers, and not to provide a legitimate hedge to Enron. ¶516. As Sherron Watkins wrote, "I don't think any other unrelated company would have entered into these transactions at these prices." ¶850. Moreover, Ms. Watkins identified several members of management who complained about these deals:

> (i) Jeff McMahon was highly vexed over the inherent conflicts of LJM. ***He complained mightily to Jeff Skilling*** .... 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets ....
>
> (ii) ***Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.***
>
> (iii) I have heard one manager level employee ... say "***I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." ... Many similar comments are made when you ask about these deals.***

¶850. Thus, contrary to defendants' assertions, key Enron officers knew these transactions were unfair at the time, which is buttressed by defendants' stock sales. For each defendant, based on their insider trading patterns, it was more probable than not the trading was based on inside information, including that the Company could implode "in a wave of accounting scandals." ¶¶415, 850.

3. Remarkably, defendants assert their related-party disclosures "told prospective investors everything Plaintiffs contend was concealed from them." Joint Brf. at 30. This statement is wrong and it ignores three facts: (1) the Class Period begins in 1998; (2) Enron had no related-party disclosure in either its 97 or 98 Form 10-Ks; and (3) the 99 and 00 disclosures were false and misleading.

(a) Enron did not even include a note for related-parties in its 97 and 98 Form 10-Ks. *See* SEC App. Tabs 1 and 6; ¶510. And the Chewco transaction, through which Enron concealed as much as $711 million in debt, was not disclosed in the Form 10-Ks for those years. ¶¶447, 510.

(b) The disclosures in the 99 and 00 Form 10-Ks were false, asserting the transactions were on reasonable terms when reasonable compared with what could have been achieved with an unrelated third party – an assertion the Powers Report rejected (*see* §V.A. 11(d)(e) *supra*), and asserting the transactions were actually hedges, which they were ***not***. *Id.*

4. Defendants brush aside the fact Enron restated four years of financial statements, restoring hundreds of millions of dollars in debt that had previously not been reported. They argue Enron's decision to restate certain transactions does not, in itself, establish that any defendant violated the securities laws. Joint Brf. at 30. But defendants mischaracterize what Enron did through its restatement – it concluded that entities should have been, but were not, consolidated. SEC App. Tab 76, at 3. The failure to consolidate caused Enron's income to be overstated by $591 million. ¶61. Moreover, the restatement was just the beginning of what Enron misstated. ¶¶422-423. Enron did not simply update or amend language in a new filing, as happened in *Lovelace*, 78 F.3d at 1020 n.4. Rather, Enron reduced previously-reported shareholders' equity by hundreds of millions of dollars over four and a half years. SEC App. Tab 76, at 4.

5. Defendants assert Enron's related-party disclosures were adequate. Joint Brf. at 31-39. In truth, defendants failed to communicate the essence of the transactions in sufficient fashion to enable investors to be reasonably informed and were, in fact, false and misleading.[10]

(a) The disclosures falsely represented LJM transaction terms were reasonable when compared to those with unrelated third parties and, in the 99 and 00 Form 10-Ks, failed to identify CFO Fastow's role and the $30 million he received through his LJM participation. ¶67. These transactions, many of which occurred near quarter and year ends, permeated Enron's business. These highly structured and complex transactions were widespread, required the personal attention of several top executives, and were often discussed, such that Enron's officers either knew of or recklessly disregarded the falsification of Enron's public reports. ¶395.

(b) Company insiders, including officers, knew Enron did not deserve its investment grade credit rating due to the concealment of off-balance-sheet partnerships and SPEs. ¶300(p). Defendants do not and cannot claim this was disclosed.

(c) Defendants also argue Enron disclosed what was material about LJM, pointing to the 00 and 01 Proxy Statements, deciding for the Court what is material. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) ("[M]ateriality may be characterized as a mixed question of law and fact .... The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw ... and these assessments are peculiarly ones for the ***trier of fact***."). These Proxy Statements connect Fastow with LJM, but they also represent:

> These transactions occurred in the ordinary course of Enron's business and were negotiated on an arm's length basis with senior officers of Enron other than Mr. Fastow. Management believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties.

SEC App. Tab 22, at 30. These statements were misleading because the terms were ***unreasonable*** to Enron. In fact, the LJM2 Private Placement Memorandum spoke about Fastow's access to Enron information about potential investments, suggesting that LJM2 would get better deals due to the CFO's involvement, which is ***not*** the same for unrelated parties. ¶461. The unbelievable returns to

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10 In any event, this cannot be decided on a motion to dismiss. *See Lone Star Ladies*, 238 F.3d at 369.

investors in the LJM transactions – as high as 2,500% – is testament to the fact the terms were extremely favorable to LJM and, by necessity, ***unfavorable to Enron***. ¶¶25, 813.

(d) When Enron did disclose a transaction with LJM, it omitted important facts. For example, Enron paid related entities to settle put options on Enron stock. ¶483. And one thing not clear from the related-party disclosure in the 00 Form 10-K was Enron had been entering into transactions predicated on its stock price declining. *Compare* Joint Brf. at 32 *with* Powers Report at 199-200.

(e) Fastow's huge windfall was not, as defendants argue, a fact subsequently made known to management, but was actually anticipated before he received it. Joint Brf. at 44. LJM2 investors were told of huge returns earlier investors had received, and new investors could expect returns of 2,500%. ¶25. Moreover, because several Enron employees received huge returns, the spectacular returns people were receiving were well known within the Company. ¶459.

C. Enron Concealed Debt Associated with Non-Qualifying SPEs and Partnerships

1. Defendants mischaracterize the allegations about billions of dollars in debt that should have been reported on Enron's balance sheet. Defendants simply are wrong when they claim this debt was disclosed. Joint Brf. at 45. Each of the CC's paragraphs they reference – ¶¶3, 98-99, 418(a), 506, 652, and 803 – refer to debt that ***should have been*** on Enron's ***balance sheet***, but was ***not***. Enron has subsequently admitted certain entities, including Chewco, JEDI and LJM, should have been on the balance sheet. Thus, defendants are misstating both the allegations and their disclosures when they argue Enron's disclosures contradict these claims. Note 9, "Unconsolidated Equity Affiliates," from the 99 and 00 Form 10-Ks cited by defendants, did ***not*** disclose how much debt each of these entities had or what Enron's portion of the debt was. The Note disclosed only combined balance sheets from the several entities. What the notes disclosed is Enron had investments in Azurix, Bridgeline Holdings, Citrus Corp., Dabhol, JEDI, JEDI II, SK-Enron, Transportadora de Gas del Sur S.A., Whitewing and others; that these entities had unconsolidated assets of $33 billion; and had long term debt of $9.7 billion in 00. *See* SEC App. Tab 15, at 82-83 and Tab 10, at 87. No indication was given that this was Enron's debt or how many billions related

to which entities. Clearly, Enron hid this debt from its balance sheet, which the CC alleges and *Enron admitted*.

D. The Enron Collapse Was Not Merely About "Alleged Mistakes" Under GAAP

1. Enron's collapse, from one of the most valuable companies in the country to the largest bankruptcy in history, inflicted billions of dollars in losses on investors. ¶66.

> In the late 1990s, by my count, Enron lost about $2 billion on telecom capacity, $2 billion in water investments, $2 billion in a Brazilian utility and $1 billion on a controversial electricity plant in India. Enron's debt was soaring. If these harsh truths became obvious to outsiders, Enron's stock price would get clobbered – and a rising stock price was the company's be-all and end-all. Worse, what few people knew was that Enron had engaged in billions of dollars of off-balance-sheet deals that would come back to haunt the company if its stock price fell.

Newsweek, 1/21/02 (¶69). Yet defendants deem this "[a] hindsight analysis of alleged mistakes under GAAP," their conduct merely was "judgment calls," and complain the accounting rules were "so confusing." Joint Brf. at 45-50. But the rules are clear for these issues and the reasons for Enron's collapse were widely known within the Company.

(a) Enron was required to consolidate entities it controlled. There is a presumption under GAAP that consolidated financial statements are more meaningful to investors, such that consolidation is required where a company controls another entity. For an SPE to not be consolidated, it must have standing apart from the entity and the entity cannot maintain control. ¶¶430-432. Under GAAP, an entity independent of Enron had to control the SPE – for example, have at least 3% equity interest in the SPE, which was a ***minimal*** standard that would not apply if other factors indicated Enron still had control – and bear the risks and rewards of ownership for it not to be consolidated. ¶433.

(b) An analysis of the Chewco transaction is illustrative. "If Enron controlled Chewco, the accounting rules for SPEs required that Chewco be consolidated into Enron's consolidated financial statements." Powers Report at 47. Chewco was financed largely by a loan guaranteed by Enron. An Enron executive, Michael Kopper, was a controlling party and the supposedly independent 3% equity was by way of an "equity loan" from Barclays. ¶¶437, 439. But not even this requisite 3% "equity" was provided since Barclays ultimately demanded a reserve.

Even the transaction's structure indicated Enron maintained effective control over the entity and Enron has admitted Chewco did not meet the criteria for non-consolidation. SEC App. Tab 76.

(c) The allegations about the LJM transactions plead facts showing Enron controlled these entities, including Fastow's involvement, the use of Enron employees, and the fact Enron retained the risk of loss from transferred assets. ¶¶449-450, 462.

(d) Enron management was widely aware of these problems. The Sherron Watkins letter shows a detailed knowledge of the problems: "the business world will consider the past successes as nothing but an elaborate accounting hoax." ¶59. And the Powers Committee interviewed many people who reported the issues surrounding Chewco, including the reserve account, "were known and openly discussed." Powers Report at 52.

(e) Enron's culture instilled in its managers the maxim that making quarterly numbers was more important than the underlying economics of a deal. As a result, the pressure to make those numbers was widespread and constant. Bonuses were paid to those who facilitated such conduct, while many employees believed Enron was a "crooked company." ¶¶50-51.

(f) Defendants also claim the CC fails to identify when consolidation should have occurred or why. Joint Brf. at 46. But the CC does ***exactly*** that: Chewco should have been consolidated beginning 97, JEDI starting in 97, and LJM & LJM2 in 99 and 00. ¶¶440, 450.

2. Defendants misquote a paragraph in the CC, omitting the identity of three partnerships alleged to be used by management to manipulate financial results. Using this mischaracterization, defendants then claim plaintiffs' allegations suffer from insufficient particularity – defendants claim they have no notice of their alleged fraud. Joint Brf. at 50-53. They quote ¶385 from the CC, ***but omit the words Chewco, LJM1 and LJM2*** and then boldly conclude, "Plaintiffs cannot assert a claim for securities fraud without identifying the transactions they are talking about or why they were allegedly fraudulent." Joint Brf. at 51. The identification of these three partnerships – Chewco, LJM1 and LJM2 – is key because the very transactions defendants claim were not detailed are ***specifically identified***: ¶¶442-447 as to Chewco, and ¶¶453-456, 466-475 as to LJM. Moreover, the LJM2 transactions – the Raptors – that had the most impact on Enron's

financial results are detailed in ¶¶477-495. These allegations describe the transactions and the periods in which they were improperly reported.

Defendants also attempt to convert allegations of intentional manipulation of what Enron reported to the public (¶385) into an allegation of mismanagement. Plaintiffs allege Enron could not have done the deals with Chewco, LJM and LJM2 with independent third parties rather than Enron-controlled entities. In fact, the CC alleges Enron did these transactions with ***related*** parties since an independent third party would have refused to participate because there was no economic substance to them. As the Sherron Watkins letter indicated, "I don't think any other unrelated company would have entered into these transactions at these prices." ¶850.

Defendants also assert the inflation of Enron's earnings by almost $1 billion is not identified as to the transaction. Again, they ***ignore*** the CC. "Enron also improperly recorded an additional $1 billion in income from LJM2 which it did not restate." ¶450. This is consistent with the Powers Committee findings. Transactions with the Raptors during 00-01 allowed Enron to avoid reporting on its income statement almost $1 billion in losses from its merchant investments. Powers Report at 99.

3. Enron also used LJM to engage in several other manipulative transactions, most of these at the end of 4Q99, including Cuiaba, ENA CLO, Nowa Sarzyna, MEGS, Yosemite, and Backbone. Defendants claim the CC's allegations are insufficient to allege the recognition of income from these transactions or to allege the omission of disclosure notes was improper. Joint Brf. at 53-59. To the contrary, the CC identifies the impropriety of the accounting for each of these transactions, when it occurred, and the amount improperly reported. No more is required.

(a) **Cuiaba**. The CC clearly states Enron sold its interest in this power plant to LJM even though LJM had no real economic interest in the plant, LJM's capital was not at risk, the risks and rewards of ownership had not passed to LJM, and Enron used this transaction to report a gain to which it was not entitled. ¶¶467-468. The fact the individual defendants' participation in this transaction is not identified at this part of the CC does not indicate they were not involved. Enron employees were widely aware of improper transactions that did not have economic substance. *See* ¶¶50-51, 850.

(b) **ENA CLO** [Enron North America's Collateral 3rd Loan Obligation]. Enron pooled a group of loans that were split into separate "trances," and sold in a securitization to Whitewing, an associated entity, because Enron was unable to sell them to anyone else. It was not a bona fide sale as Enron not only guaranteed the buyers would not lose any money but also ensured they would be made whole on the transaction. For this reason the transaction had no economic substance to Enron and was done solely to inflate sales of loans and avoid taking a writedown. ¶¶469-470.

(c) **Nowa Sarzyna and MEGS**. In these year-end 99 deals, Enron sold its interests to LJM2 to record the income in 99 or to avoid recording a loss that was required under GAAP. In both instances, Enron repurchased the interests shortly after years-end, essentially limiting the transaction's impact. Moreover, defendants' explanation of the Nowa Sarzyna transaction – Enron's repurchase of the asset shortly after year-end was to avoid a covenant default – is ***unsupported*** and inappropriate. It also ignores Enron's intention LJM would be a temporary holder of the asset and the Company would have to find a place for the asset soon after year-end. Clearly, Enron was trying to get the asset off its books for year-end financials only. ¶¶471-472.

(d) **Yosemite**. This highly manipulative transaction, not even completed when it was recorded, was postdated to be recorded in 99 so Enron could avoid "unconsolidated-affiliates" footnote disclosure in its 99 financial statements. Moreover, LJM2 did not, in fact, buy the trust certificates. Instead the Enron-controlled entity was used as a conduit for Condor to make the acquisition within one week of the purchase. ¶¶473-474. Contrary to what defendants claim, more than a complex transaction, plaintiffs have alleged a sham transaction that allowed Enron to avoid reporting its interest in Yosemite in the year-end 1999 financial statements.

(e) **Backbone**. This was another transaction with Fastow's LJM2 allowing Enron to record income from an asset that was not worth anywhere near the $54 million Enron recognized from it. The fact the negotiations for this transaction made Fastow angry – he knew EBS was selling

LJM2 dark fiber that was not useable – indicates his interest in protecting LJM2 investors more than Enron and shows this related-party transaction should not have been recorded as a sale. ¶475.

4. Defendants claim none of these transactions on their own were material to Enron's financial statements. This ignores the CC's allegations: due to the constant, widespread pressure to make quarterly and year-end numbers, employees were encouraged to do deals that did not have economic substance, but would inflate to Company's results. *See* ¶¶50-51. Defendants cannot credibly argue Enron's financial statements were not materially misstated, particularly the LJM transactions, which overstated Enron's earnings by $1 billion. Defendants' comparison of the potential impairment to the total capitalization of the Company to argue the deals were not material is inappropriate. Materiality should be measured by its effect on income and the aggregate of misstatements should be compared to see if they are material to the financial statements of the company. *See* SEC Staff Accounting Bulletin No. 99.

5. **The Raptors**. The LJM deals which had the most impact on Enron's financial statements were the Raptors – four vehicles created through LJM2 that allowed Enron to recognize hundreds of millions of dollars in gains and avoid recognizing losses on its investments. ¶¶477-488. Because Enron controlled these LJM partnerships, they should have been consolidated with the Company. ¶449. But Enron used these entities to avoid recognizing losses, including those on Avici Systems stock and New Power Company, and to enter into stock contracts with Enron. ¶¶480, 485. In each instance, because LJM investors were assured to receive back their investments such that they had no capital at risk when the transactions were entered into, transactions with these entities were improperly reported as if they had been with independent parties. ¶478.

(a) Defendants patina these manipulations as "mistakes" or errors. But these entities were structured to prevent Enron from having to report losses it had incurred, as was required by GAAP.

(b) Interestingly, defendants claim the hedging derived from the Raptor structures was mentioned in the related-party disclosures and the 00 Form 10-K. Joint Brf. at 60. In fact, the Raptors are ***not mentioned at all*** in these SEC filings.

(c) Defendants claim the CC does not plead Enron knew the Raptor hedges would fail at anytime before they did. This ignores the numerous places the hedges are alleged not to be real and would not work. ¶¶33-34, 62, 300(p), 456, 462-463, 478, 481, 485, 619, 622, 731, 816, 838, 891.

(d) Defendants assert Enron disclosed its hedges were risk-based and dependent on market conditions. Joint Brf. at 76. This does not answer the central issue: whether Enron made adequate disclosures (yet another fact question inappropriate for resolution at this stage). In fact, these were ***not*** true hedges – something Enron did not disclose.

6. Defendants claim LJM2's original 3% investment in each of the three SPEs, Raptor I (Talon), Raptor II (Timberwolf) and Raptor IV (Bobcat), remained at risk the entire time of the transaction. Joint Brf. at 64. This purely factual argument is made without ***any*** support and is contradicted by the CC, which alleges "LJM2 was guaranteed a specified initial return of $41 million, or a 30% annualized rate of return from Talon, whichever was greater, from income earned by Talon before hedging could begin with Enron." ¶478. *See* Powers Report at 102. Moreover, defendants' argument that the $41 million distribution was income and not equity, leaving the original 3% at risk, is ***false***. The CC alleges the $41 million in "income" was a sham, based on a put – essentially a bet by Enron its own stock price would decline substantially – that Enron sold at a grossly inflated price solely to provide the necessary cash to transfer to LJM2. ¶479. Enron also engaged in a costless collar as to the Raptors to avoid recognizing a loss. Defendants distort this language, arguing it is only natural in business to attempt to avoid losses. Joint Brf. at 64. But this ignores the CC's allegations that Enron engaged in these transactions to avoid ***reporting losses*** rather than to avoid ***incurring*** them in the first place.

E. Enron's Recognition of a Stock Price Gain on the New Power IPO Was Improper

1. Remarkably, defendants claim the New Power IPO stock-price gain would have been recognized regardless of the creation of the Raptors, and plaintiffs just misunderstand basic accounting. Defendants further argue these gains were disclosed in the 00 Annual Report and required to be recognized under GAAP. Joint Brf. at 65. Each of these statements is wrong.

(a) Enron would not have been able to lock in its stock-price gain at the IPO absent the Raptors transaction. New Power stock had declined soon after the IPO such that if Enron had not locked in its gain, it would have been offset by the end of the 4thQ 00 by a subsequent decline and no gain would have been recognized in the financial statements. *See* ¶¶486-488. Defendants' claim also contradicts testimony given on 2/7/02 by board member Herbert Winokur to the Committee on Energy and Commerce:

> I cannot and will not defend this transaction. It seems obvious to me that one cannot hedge an investment in New Power with warrants on the same New Power stock. It is equally obvious to me that the terms of this transaction, which seem to me to fail to properly value the New Power stock being contributed, were grossly unfair to Enron.

Hearing of the Oversight Investigations Subcommittee of the House Energy & Commerce Committee, Testimony of Herbert Winokur, 2/7/02.

(b) Defendants claim the gain from the New Power IPO was disclosed in note 3 to the 00 Annual Report under securitizations. That Note does indeed address gains from sales representing securitizations, but it makes ***no*** mention of New Power or the Raptors. On the contrary, the Note states that it relates to sales to Whitewing associates, and the amount of $370 million (the New Power gain) is ***not*** found in the note.

(c) There is a disclosure about the New Power IPO in the management discussion and analysis section. *See* SEC App. Tab 15, at 42-43. But it discloses a gain of only $121 million related to the IPO and fails to disclose any other relationship with LJM2 or Raptors concerning the hedge it used to recognize income from its IPO.

(d) Defendants claim the disclosure in the 3/31/01 Form 10-Q about related-party transactions somehow cures Enron's egregious violation of GAAP in which it increased an asset for notes received for its common stock in violation of GAAP. "Under SEC regulations, for example, a material deviation from GAAP on the face of financial statements will be presumed to be misleading despite footnotes or other disclosures to the statements." *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1307 n.5 (C.D. Cal. 1996). This practice violated a basic accounting principle: equity is ***not*** recorded until cash is received for it. ¶951. Moreover, this accounting treatment was reversed in the restatement to reduce the equity and the notes receivables that Enron had previously recorded improperly. SEC App. Tab 76. This is an admission the prior accounting was incorrect. ¶518.

(e) That the fragile structure of the Raptors transactions were known within the Company is evidenced by the 8/01 Sherron Watkins letter to Ken Lay. ¶59.

F. Enron Used Mahonia, Delta and Connecticut Resources to Conceal Debt

1. Defendants ignore the fact U.S. District Judge Rakoff in New York has already found with respect to the Mahonia transaction: "taken together, then, these arrangements now appear to be nothing but a disguised loan." ¶563. Defendants nonetheless assert these transactions were distinguishable from a loan. Joint Brf. at 68-69. Despite specific allegations of billions of dollars in loans that were not recorded as such by Enron, ¶¶559, 565, 570-571, defendants argue these activities were disclosed on the balance sheet and in the notes in the financial statement. In truth, ***none*** of defendants' references identify any of these sham transactions because Enron never intended to deliver the subject commodities under the purported forward-sales contracts. ¶560. As the *New York Times* reported, "[i]n all, Enron took advantage of accounting rules to avoid reporting as much as $3.9 billion in loans on its balance sheet." ¶564.

2. Defendants claim the effect of these transactions was disclosed. Joint Brf. at 69. But the notes in the financial statements to which defendants point – notes 1 and 3 in the 00 Annual Report – do ***not*** identify these transactions. *See* SEC App. Tab 15, at 67-70 and 71-76. Moreover, this ignores the allegation these transactions were mischaracterized as forward-sales contracts by Enron and not as the loans they really were. Defendants' citation to notes 1 and 3 only ***confirms*** Enron's mischaracterization of the transactions.

G. Enron Abused MTM Accounting to Inflate its Reported Earnings

1. Defendants claim the allegations about MTM accounting are deceptive due to the failure to mention the "legitimacy of MTM accounting." Joint Brf. at 72, 166-71. If anyone is being "disingenuous" or "deceptive," it is defendants because every paragraph reference they cite – ¶¶18, 36, 38, 40-41, 70(a), 70(e) (which does not exist), 121(g), 155(e), 155(f), 214(e), 340, 422, (defendants must mean 423), 426, 520, 525, 533-39, 540, 542-544, 727, 890, and 959 (Joint Brf. at

69) – mentions the ***misuse*** of MTM accounting, and does not attack the accounting method *per se*, but rather Enron's ***abuse*** of it. There is a stark difference between attacking an accounting method and attacking an entity's misuse and abuse of it to inflate revenues. Contrary to defendants' assertions, the CC pleads numerous facts explaining how Enron misused this accounting method to do just that. Defendants, having purposefully mischaracterized the allegations, then undertake a detailed analysis to provide what they claim MTM accounting is and the interpretation of GAAP standards for it. These standards ***support*** the allegations Enron misused this accounting method to inflate its earnings.

(a) In ¶534, which defendants cite but apparently did not read, the CC states MTM accounting can be used to recognize income in the current quarter. But MTM accounting is ***only*** allowable where the revenue streams are predictable and can be based on historical records of similar transactions. Further, ¶534 refers to EITF No. 98-10, which discusses MTM accounting and its use. Thus, defendants' claim that the CC fails to even "mention the legitimacy of MTM accounting" is clearly at odds with the paragraphs cited by defendants.

(b) Under MTM accounting, gains and losses should be reflected to account for market fluctuations. Joint Brf. at 71-72. The CC alleges Enron engaged in "moving the curve," *i.e.*, altering assumptions used to record income under MTM accounting so that more income could be recorded or that losses in future quarters could be avoided. *See* ¶537. Thus, whereas MTM accounting requires companies to make reasonable assumptions as to market value, Enron was making what it knew were unreasonable assumptions so that earnings would appear more favorable.

(c) In one instance, Enron used MTM accounting to record income from a deal with Eli Lilly even though Enron knew it would lose money: Enron paid Eli Lilly $50 million up front to get the deal, agreed to spend an additional $94 million to upgrade Lilly's facilities, and another $24 million to train Lilly's employees. ¶541. Such abuse of MTM accounting to inflate earnings in no way indicates plaintiffs disagree with the proposition MTM accounting can be an acceptable method in appropriate circumstances.

(d) EITF No. 98-10, which defendants cite and is also cited in the CC, indicates MTM accounting should be used for trading activities. One condition to determine if an activity is a trading activity is whether the majority of counterparties to the energy contracts are not retail customers and the majority of competitors are traders. EITF No. 98-10(a), part b. But Enron used MTM accounting for broadband deals – deals that generally were contracts for services that had not yet been provided – rather than income from commodity products. Moreover, Enron could not estimate future revenue streams to be derived from these contracts. Enron's customers typically were end users, *e.g.*, the deal with Breimen University in Germany. ¶¶546-547.

(e) The CC details Enron's ***abuse*** of MTM accounting for demand-side-management ("DSM") contracts that did not make sense long-term from a profitability point-of-view. Through the abuse of MTM accounting, Enron could report significant income in the current quarter when the contracts were signed. Because many of these contracts would be ***money losing***, additional contracts would have to be signed in future quarters to make up the difference. This was known internally at Enron as "continually feeding the monster," and included deals with JC Penney, IBM and CitiGroup. Enron was always selling at a negative just so it could report earnings using MTM accounting up front. ¶¶300(g)(i)-(iv).

2. Enron never disclosed it was ***abusing*** MTM accounting by employing it for broadband transactions for which it had no basis, and Enron never disclosed it was manipulating the estimates to record income it had not earned. Defendants argue Enron made repeated disclosures about the use of MTM accounting and goes on for several pages highlighting various disclosures that ***touch on*** MTM accounting. Joint Brf. at 72-78. But defendants fail to point to any paragraph in the CC where plaintiffs merely allege Enron was concealing it used MTM accounting. The one paragraph in the CC defendants cite – ¶36 (Joint Brf. at 72) – does not indicate Enron concealed the use of MTM, but rather states Enron ***abused*** it. None of defendants' disclosures (Joint Brf. at 72-78) reveal Enron was abusing MTM accounting to inflate earnings by "moving the curve" or reveal Enron was using MTM for broadband transactions for which it had no history of trading from which it could make reasonable estimates. ¶¶537-539, 547. Defendants' reliance on *Lemmer v. Nu-kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 U.S. Dist. LEXIS 13978 (N.D. Tex. Sept. 6, 2001), is misplaced: plaintiffs' claims are not unsupported conclusions that could have been parsed from

documents containing cautionary and explanatory language. In fact, the disclosures defendants point to include ***none*** of the allegations of the abuse of MTM accounting alleged in the CC.

(a) Enron's statements during the Class Period were false and misleading because the earnings Enron reported were based in part upon an abusive use of MTM accounting. Defendants claim the falsity of Enron's press releases, SEC filings and other public statements has not been properly alleged for lack of particularity as to why the statements were false. Defendants ignore the fact Enron's use of MTM accounting inflated its earnings, which were represented in numerous false statements. The CC includes a detailed analysis of Enron's misaccounting based on misuse of MTM for transactions that were actually losses, thus making Enron's statements about its excellent quarterly results in 00 false since these results were based, in part, on Enron's fraudulent accounting, particularly its abuse of MTM accounting. ¶¶262-263, 300(g) and 533-548.

(b) The involvement of numerous employees in MTM accounting is also shown in Ms. Watkins' letter, which indicated there were problems with MTM positions and indicated Enron had been aggressive in its accounting. ¶¶59, 930. Even Andersen's partners termed MTM accounting as "intelligent gambling." ¶¶930, 938.

(c) Enron personnel were under tremendous pressure to do deals even if they were money-losing because the deals could be recognized up front under Enron's abusive MTM accounting. Inside Enron, the saying was that managers were always "*ABC*ing," meaning "*a*lways *b*e *c*losing" deals even if the economics of the deal did not make sense. ¶50. The culture inside Enron was such that "everybody fudges earnings" and employees either became "yes men" or failed to advance in the Company. These defendants advanced and each was given large numbers of options and sold a large amount of stock. ¶84. In the face of these allegations of deliberate manipulation of earnings under MTM accounting, defendants make the bold factual assertion, "Enron's accounting treatment was entirely proper under GAAP." Joint Brf. at 87. And in the CC, as shown here, it was not.

3. Defendants assert "Plaintiffs' inability to specify and plead the particular facts and circumstances relevant to the broad-based allegations concerning MTM accounting, is thus fatal to their claim." Joint Brf. at 81-82. But the CC alleges specific transactions, why or how Enron abused

MTM accounting, and does not – contrary to defendants' false accusation – allege MTM accounting can never be appropriate under GAAP.

4. Defendants quibble with the CC's descriptive MTM accounting rules, claiming historical trading records are not determinative of MTM accounting. Joint Brf. at 171-73, 182. This ignores a key principle of MTM accounting: the ability to estimate contract's fair value (¶537):

> If a quoted market price is not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar energy contracts and the results of valuation techniques to the extent available in the circumstances. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses.

App. Tab 57, at 8 (EITF n.2).

Defendants take the inconsistent position as to Azurix that "SFAS No. 121 is not even the proper GAAP rule to apply," but then claim Enron was justified in not writing down its investment in Azurix until 3rdQ 01 when Azurix recorded an impairment charge under ***SFAS No. 121***. *Compare* Joint Brief at 85 *with* Joint Brf. at 86. Defendants claim the proper test for Enron to apply for the investment was whether the "investment had experienced 'other than temporary' decline." Joint Brf. at 85. Yet, this is the very test which is identified in the CC. ¶585 (GAAP requires "a loss be recorded for impairment when the impairment is other than temporary."). Defendants then make the bald factual assertion, "Enron did that test when required for Azurix." Joint Brf. at 85. Defendants give no basis for when the test was required or when it was done and what the results were. They give absolutely no support for a conclusion which contradicts the allegations in the CC. The CC lays out specific problems that indicated impairment issues well before 3rdQ 01, namely infrastructure problems in Argentina, negligence claims against Azurix in Argentina, forced price cuts for Wessex Water, the departure of Azurix's CEO, and extensive layoffs of employees. ¶¶590-92. Yet no reserve was recorded prior to that time in 3rdQ 00 when Azurix announced its own write-off. If this is what defendants mean by their statement that Enron did the test when required, they clearly ask the Court to disregard factual allegations in the CC which allege reasons an impairment charge should have been measured and recorded prior to the 3rdQ 01.

5. Concerning the audit adjustments Enron failed to make in 97, which essentially doubled the reported net income for the Company that year, defendants assert, "[m]ateriality cannot be reduced to a numerical calculation." Joint Brf. at 89. Then defendants proceed to do just that. Defendants claim Andersen's calculation was not unreasonable and the adjustment based on normalized income was not material. In fact, the decision to restate Enron's financial statements ***for this reason*** indicates the amount was material, which represented 48% of net income and 10% of recurring net income. ¶517.

6. The restatement of financial statements indicates the issued financial statements were misstated based on information available at the time they were originally reported. *See* APB Opinion No. 20. Defendants' restatement analysis ignores the many other specific allegations concerning their involvement in the accounting decisions that were made and the widespread knowledge Enron's accounting was aggressive and distorted. It is important to remember the restatement affected only part of Enron's improper accounting alleged in detail. ¶¶422-423, 519.

7. The restatement of the Chewco transaction is indicative of Enron's practice of creating structures that could help it avoid reporting debt on its books and be able to report income from transactions from those entities. Defendants' arguments about how Chewco was structured ignores the background for the Chewco transactions. Enron attempted to create Chewco, but certain ways of forming it failed to meet its goals of creating an entity that it would not have to consolidate, including transferring Kopper's interest to his partner and creating an "equity loan" from Barclays which, in fact, was nothing but a loan. ¶¶436-439. The "technical" accounting issue with respect to the reserve was just one part of the problem, namely Enron controlled the entity that it failed to consolidate in its financial statements. Moreover, defendants' assertion Chewco required restatement because of "management's discovery of new information," Joint Brf. at 91, is not supported by the record. One of Enron's senior auditors, Tom Bauer, testified Enron misled him about the reserve agreement:

> Enron accounting employees called me to discuss concerns that had recently arisen about Chewco. On November 2nd, 2001, Andersen received a set of Chewco documents gathered by the special committee of Enron's board of directors. When I reviewed these materials, I was appalled to discover a document I had never seen before, a two-page side agreement between JEDI and Chewco amending their 1997

> loan agreement.... As I mentioned previously, Enron gave me the loan agreement during the 1997 audit, but they did not reveal the existence of the contemporaneous side agreement. The side agreement materially altered the accounting treatment of Chewco.... The undisclosed side agreement meant that Chewco's and JEDI's financial statements should have been consolidated with Enron's since 1997. I do not know why this critical side agreement was withheld from me in 1997.

Hearing of the Oversight Investigations Subcommittee of the House Energy & Commerce Committee, Testimony of Thomas Bauer, 2/7/02.

8. The improper accounting for LJM1 is relegated to "a simple oversight." Joint Brf. at 92. But the CC alleges many other issues surrounding LJM1, including Skilling's involvement in the attempt to avoid reporting a loss on the transaction while Enron's employees received huge returns in the deal. ¶¶457-459.

9. Interestingly, defendants argue the $1.2-billion adjustment to equity related to the Raptors structures "precludes a strong inference of fraud" just a few pages after citing the *Microstrategy* case, in which the court concluded GAAP violations are probative of fraudulent intent if the rules violated are simple ones. *Compare* Joint Brf. at 92 *with* 94. Lynn Turner, former Chief Accountant at the SEC, was extremely surprised Enron and Andersen misaccounted for the Raptors equity transaction because it is such a "basic" accounting rule – equity is ***not*** to be recorded until cash is received. ¶951.

H. Enron Began its Broadband Efforts Well Before January 00

1. Defendants assert the allegations about EIN's severe problems in 99 ignore the fact EBS was not launched under 1/00. Joint Brf. at 141. Defendants then point the Court to a purported transcript of a 1/20/00 analyst conference presentation by Skilling. *See* App. Tab 49. Defendants apparently trusted the Court and plaintiffs would not read it because the ***first paragraph*** states "Enron Communications" is being "renamed" EBS, not that EBS was being "launched." For several pages, defendants base or buttress their arguments on the assumption that EBS was not launched until 00. They are simply wrong.[11] And they claim that EIN or EBS did not exist in 99, but the 99 Form 10-K states:

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[11] Defendants' footnote points out an apparent typo in the CC: Rice has been CEO of EBS since June ***1999***. SEC App. Tab 10, at 28 (1999 Form 10-K). *See* Joint Brf. at 141 n.181

> Enron Broadband Services is currently developing the Enron Intelligent Network ("EIN"), a high capacity, global fiber optic network with a distributed server architecture, to provide services to the broadband market....
>
> The EIN consists of a high capacity fiber optic network based on ownership or contractual access to approximately 14,000 miles of fiber optics throughout the United States, with a distributed server architecture.... At December 31, 1999, the EIN included over 200 large capacity servers in 30 locations throughout the United States.

SEC App. Tab 10, at 16-17. If EBS did not exist in 99, how could it have been developing EIN through that year? As additional evidence of the existence of EBS before 00, defendants' own exhibits include a PowerPoint presentation showing the EBS headcount increasing from 89 in 98 to 490 in 99. App. Tab 39, at AC_00_Communications-2.

Relying on a purported transcript of the 1/20/00 presentation, defendants also claim Enron assigned "a full zero" for the value of communications business acquired from Portland General. But this is not relevant to the development of EIN. Whatever value Enron attributed to the Portland General Communications business would not affect whether Enron was developing the EBS business.

I. Enron Made False Statements About Enron's Business Units

Defendants divide their next arguments into an analysis of Enron's business units, including the wholesale energy trading business ("WEOS"), the energy services business ("EES"), and broadband content delivery and access trading ("EBS").

1. Wholesale Energy Trading Business

Defendants argue the CC's WEOS allegations are too "vague and conclusory" to satisfy the PSLRA's pleading requirements in that they are "devoid of any factual support." Joint Brf. at 99. To support this assertion, defendants quote what they call a "Rote Allegation I" from ¶121(e), footnoting that it is reiterated in ¶¶155, 214, 300 and 339. Joint Brf. at 99. What they do not write is the factual support they claim is missing from ¶121(e) is, in fact, set out in other paragraphs – including the ones they cite.

For instance, ¶214(e) (i) and (ii) discuss the way Enron manipulated assumptions to calculate its WEOS earnings, including the use of numerous assumptions such as foreign-exchange rates, revenue growth, inflation rates, cost escalation, economic growth and demand, which were manipulated to inflate revenues. One example: Enron would pick the ***lowest*** consumer-price-index figure from all available world markets and then the ***highest*** possible revenue stream escalator figures, which in contrast would boost the project's profit by many millions of dollars. ¶214(e)(i). Another example: in 4thQ 99 Enron global markets in London had revenues far below projection. As a result traders were told to increase their sales by $2 million for each of the prior quarters by increasing the curve on future sales contracts – "moving the curve" was ***endemic*** inside Enron. ¶214(e)(ii). Defendants are wrong when they state the allegations fail to indicate which quarter Enron adjusted a value and by what amount. Joint Brf. at 100-01. These details are provided in ¶214(e). A similar but different manipulation of this type is specified in ¶300(e)(ii) about Enron's liquid-propane-gas group creating phony earnings at year-end 00.

Defendants assert after a "full reading and painstaking parsing of the Complaints," the allegations concerning defendants' false statements about WEOS and the reasons those statements were false were difficult to decipher – they "have no clue" how to translate plaintiffs' claims. Joint Brf. at 104. The allegations concerning the falsity of these statements are not vague. For example, ¶247 states Skilling, Koenig and Fastow in a 7/24/00 conference call made statements, including:

- This quarter's results clearly demonstrated Enron's leading market positions in wholesale energy.
- Enron's wholesale business was large, extremely well-established and global. Its earnings growth had been very consistent and was sustainable.
- At the wholesale level, Enron had just had a tremendous quarter. Enron felt very good about it, very positive and was optimistic about the outlook for the future. Enron's market position had never been better.

Then ¶300(e)(i) and (ii) delineate the reasons why these statements and others repeating them were false: Enron's WEOS business results were manipulated and falsified to boost profitability, including phony hedging transactions, the abuse of MTM accounting, and by moving valuations upward at quarter's end to boost wholesale-operations profits for that period, plus details describing the curve manipulation, which is alleged to have occurred in every quarter in all of Enron's WEOS operations.

Defendants cite several of what they classify as forward-looking statements and then falsely assert each "were accompanied by meaningful cautionary language that the Complaints simply ignore." Joint Brf. at 110. Defendants' first two cites are from the 10/13/99 and 1/18/00 conference calls. ¶¶119, 197. Contrary to their assertion, ***there was no safe-harbor disclosure on these calls.*** ¶985. As to the quotes in ¶293, which are from the 00 Annual Report to Shareholders issued in early 3/01, defendants claim it contained a risk disclosure. Joint Brf. at 110-11. But defendants cite not from the 2000 Annual Report, but from the Form 10-K. The Annual Report, quoted in ¶293, does ***not*** have the disclosure referenced by defendants – the Annual Report and the Form 10-K are ***different documents.*** Thus, defendants' claim that each of the three quotes was accompanied by meaningful cautionary language is wrong – they did ***not*** contain the disclosures defendants claim.

And defendants' reliance on the PSLRA safe-harbor is likewise misplaced due to the falsity of the statements regarding WEOS's its past results. These are not ***forward-looking*** statements, but were historical or present-tense, and thus are not protected. The detailed allegations about Enron's practice of abusing the MTM including accounting, ¶300(e), sufficiently alleges these ***past-tense*** statements were false when made.

2. Enron's Broadband Business

Defendants make numerous factual arguments about EBS. Joint Brf. at 119-54. Many of them lack support and are false:

(a) Discussing the video-on-demand Blockbuster venture, defendants claim, "Enron performed a successful test of its technology with a limited number of titles in December, 2000." Joint Brf. at 123. In fact, the test was not successful – and it was a ***sham***. The only solution for Enron's inability to deliver what it promised was to load 40 movies onto a server and then subscribers would have to wait for it to be downloaded, which required a set-top box. This nonsense system simply was not like anything Blockbuster and Enron had promised and told the market it would provide. ¶524. While Enron was announcing the deal was a success in 12/00, behind the scenes Enron executives were directing the video-on-demand team to completely revise the business plan. *See* ¶339(o). This was no surprise, since from the beginning internal Enron employees had known "we didn't have the technology to do it" and "the Blockbuster deal was a fraud." EBS executive Rice went so far as to inform engineers Enron could not "deliver the Blockbuster deal." ¶339(o).

(b) Defendants assert the "market recognized that Enron was entering uncharted cyberspace in these ventures." Joint Brf. at 121. This is diminished greatly, if not contradicted by, Enron's 7/19/00 statement when it announced the 20-year Blockbuster deal: "The agreement brings together for the first time a global, end-to-end solution that can effectively deliver a wide variety of secure, on-demand entertainment." ¶240. And Chairman Lay explained the deal: by this "killer [application] for the entertainment industry," "we're going to change the whole entertainment experience for the average American over the next few years." ¶¶240-241. Defendants' assertion is further belied by the fact after the purportedly fantastic Blockbuster deal was announced, and Enron stressed its enormous potential and the quality of its broadband content-delivery system, as well as better-than-expected 2Q00 results, Enron's stock price soared to its all time high of $90-3/4 in 8/00. ¶261. Moreover, defendants' exhibits, which plaintiffs do not accept as an accurate portrayal of what occurred, show that Skilling told analysts in 1/00 the Broadband business alone was worth "$37 per Enron share." App. Tab 49, at 30. Although the market would not yet give it such a valuation, that is what ***defendants*** say Skilling estimated the value to be.

(c) Defendants claim, "Enron did not foresee that the broadband market would melt down or that Blockbuster would be unable to fulfill its commitment to secure movies for video on demand." Joint Brf. at 126. They offer ***no*** support for this assertion. In contrast, the CC alleges otherwise in great detail. ***First***, Enron did not have the technical ability to transmit movies or other content with sufficient quality or speed to permit the video-on-demand content-delivery system to succeed. Enron knew internally it did not "have the technology to do it, and we didn't have the expertise." ¶300(o). ***Second***, several employees working on the Blockbuster deal were told time and time again after they objected to the lack of economic substance to "just drink more Enron Kool-Aid." *Id.* ***Third***, from the beginning Blockbuster did not have the rights for electronic content distribution for movies. Enron did not have one movie to offer, let alone one in DSL quality. *Id.* Defendants knew early on the deal was not economically feasible – internal studies showed that Enron would have to spend $1,200-$1,600 per subscriber for equipment to get the video-on-demand to work. ¶523. EBS managers had no way of projecting costs for this service and had simply come up with the figure – $1.20 per subscriber – out of thin air. ¶522. Defendants knew early on this was an extremely problematic deal and Enron would not be able to fulfill its commitments.

(d) Defendants point to an apparent statement in 7/01 by Enron's CEO that there was "'a meltdown out there'" in the broadband area. Joint Brf. at 125 (emphasis omitted). But they gloss over the fact ***four months earlier*** Skilling told EBS executives in Portland that the broadband business faced a "complete melt down," and that same month, 3/01, Skilling told investors in New Orleans that Enron's broadband operation was going full speed, "pedal to the metal." ¶311. A statement in 7/01 does not immunize defendants from liability for knowingly false statements in 3/01.[12]

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[12] The business had been problematic long before 7/01 or even 3/01. On 5/17/02, the *New York Times* reported:

> Big energy trading companies engaged in scores of transactions aimed at creating the appearance of activity as they tried to build a market for trading high-speed communications capacity, according to records and interviews with former employees and executives at the companies.
>
> The companies – led by Aquila, El Paso Energy Partners, Enron and Reliant Resources – made the trades in late 2000 and 2001, as the Internet bubble peaked and they sought to sell Wall Street on the idea that a fast-growing communications market was emerging. The energy traders were also trying to persuade telecommunications companies to do business with them.
>
> * * *
>
> Another former Enron employee said, "This is about: 'Lets get trading volume going.' They wanted to create a market faster than they created as gas and power."
>
> * * *
>
> Former Enron and Reliant officials who insisted on anonymity, said that the trading was so lethargic at times that traders felt pressed to do round-trip trades, or sometimes even to trade at a loss.
>
> Still, Enron and analysts valued the broadband division last year at about $25 a share, or about $20 billion. Amid the Internet mania, such figures spurred other energy companies to jump into broadband, though none was as aggressive as Enron in its wooing of investors. At a presentation to investment analysts early last year, Enron said that its transaction volume had jumped from 3 broadband trades in the first quarter of 2000 to 581 trades in the first quarter of 2001.

David Barboza, "Energy Trades Echoed in Broadband Market," *New York Times*, 5/17/02. Additional details continue to emerge about Enron's phony practices concerning broadband.

(e) Defendants claim the market was aware broadband was not succeeding due to losses reported through 00 and 01. Joint Brf. at 137-39. They fail to point out, of course, broadband also had a gross margin of $318 million in 00. SEC App. Tab. 15, at 43. And the CC alleges Enron's broadband results were misstated due to the Blockbuster deal, which is described in detail. ¶¶521-526.

(f) Defendants assert the successful "EIN was not dependent upon InterAgent." Joint Brf. at 140. This directly contradicts an allegation in the CC. ¶214(h). For support, defendants point to a 2/9/00 J.P. Morgan report – an extremely weak source considering J.P. Morgan is a co-defendant – that states: "Today, technology exists that allows the client's fiber to attach to Lucent's Bandwidth Manager Box™ inside a telecommunications hotel." App. Tab 27, at 5. This does ***not*** say EIN was not dependent upon InterAgent. At a minimum, this is not the time to resolve factual disputes.

(g) Defendants discount specific allegations about a transaction in which Enron received a $100,000 order from RealNetworks in exchange for a $7 million purchase order issued ***to*** Real Networks with the unsupported factual assertion this was typical of "the remarkably-common business practice of doing business with those who did business with it." Joint Brf. at 143. Whether this is true is an issue for the jury, not a motion to dismiss.

(h) Defendants assert the specific allegations about a 1/00 PowerPoint presentation to analysts are demonstrably false because their slide from the meeting does not use the word "current" in discussing the amount of actual fiber lines in the United States *See* Joint Brf. at 144. Yet, their redacted version of comments made at that meeting quotes Skilling:

> [O]ur fiber network – is expanding. To be quite honest, we've got just about all we need right now. We are extending it to some places to get some additional capabilities, but we've got essentially the fiber backbone that we need to do what we need to do.

App. Tab 49, at 4. Again, these are factual issues inappropriate for resolution here.

(i) Defendants also seek to rebut the specific allegation about the $300 million dark-fiber swap with LJM, which inflated 3Q00 results, with the factual assertion the transaction was "not a swap." Joint Brf. at 145. Their only support is the 00 Form 10-K discussing a "sale" of dark fiber to a related party. SEC App. Tab 15, at 96. Defendants ignore the swap allegation was contained in a paragraph about "concealed facts," again challenging the CC's factual assertions, which is improper. Consequently, their argument supports the claim Enron concealed the fact the transaction was indeed swap.

(j) The CC alleges EBS did not have a single customer in 99. ¶300(h). Defendants do not dispute this. They claim the CC ignores EBS was not launched until 00. Even according to defendants' apparently redacted version of the 1/00 analyst meeting, Ken Rice claimed: "If you look at some of our customers ... Lucent, Sun, IstreamTV, ... CountryCool.com ... Latin Soccer, NextVenue, Adams Films ...." App. Tab 49, at 25. Plainly, Rice was claiming EBS had customers.

(k) In arguing the particular allegations about EBS's technical inability to deliver under the Blockbuster agreement, ¶300(o), defendants claim the CC fails to allege any insuperable technical problems that would have prevented Enron from moving forward if Blockbuster had been able to provide content. Joint Brf. at 153. They ignore what Enron announced. "The agreement brings together for the first time a global, ***end-to-end solution*** that can effectively deliver a wide variety of secure, on-demand entertainment." ¶240. Moreover, by the end of 00, all Enron could do to transmit movies was load 40 movies onto a server and wait for them to be downloaded. ¶524. Even if Blockbuster had provided content, a failing Enron knew about it early on and even went to Hollywood to cut its own deal, Enron would ***not*** have been able to provide the promised services. As *The Wall Street Journal* reported on 1/17/02:

> At its peak, in March 2001, the venture with Blockbuster provided only about 1,000 test customers with movies in four U.S. cities. Many of those customers didn't even pay. "It was nothing but a pilot project," says Blockbuster's Ms. Raskopf. "***I don't know how anyone could have been booking revenues***."

Rebecca Smith, "Show Business: A Blockbuster Deal Shows how Enron Overplayed its Hand," *The Wall Street J.*, 1/17/02.

(l) An additional factual argument by defendants – again without support – was "Enron did not use mark-to-market accounting" on Braveheart at all. Joint Brf. at 153. The CC clearly alleges Enron improperly accounted for Braveheart not only through the use of MTM, but also because Braveheart was not independent, EBS had not earned the revenue, EBS could not provide the promised services, and the revenue was not collectible. ¶522.

J. Enron Energy Services

1. Defendants cling to the concept GAAP encompasses the application of business judgment as a shield. Joint Brf. at 172. But the application of a variety of acceptable accounting procedures do ***not*** justify Enron's deliberate manipulation of its reported results through the misuse of MTM accounting. The CC is replete with examples of Enron's MTM accounting ***abuse*** even though the contracts had been sold at a loss – so great was the pressure to make deals. EES contracts with JC Penney and Owens Illinois were both losing contracts on which Enron recognized income. ¶300(g)(iii). Enron recorded income under a contract with Eli Lilly even though it had to pay Eli Lilly $50 million just to get the contract and then $94 million to upgrade Lilly's facilities. ¶300(g)(iv). Enron employees were told to adjust the economic assumptions for contracts, "moving the curve," so that losses would not have to be recorded. ¶537. Thus, the CC pleads specific instances of Enron's manipulation of recorded and reported income by ***abusing*** MTM accounting.

2. Enron manipulated its results by booking $44 million in income from a contract with Eli Lilly wherein Enron had been required to pay and invest $168 million to get the deal, but Enron did not disclose this. ¶¶540-543. Defendants argue Enron's "obligation to Lilly was in no way hidden from the public, because Enron made it public." Joint Brf. at 176. But their characterization of the press release through which Enron supposedly made this information public does ***not*** say what defendants claim it said:

> Through this agreement, Enron will manage the supply of electricity and natural gas for Lilly facilities in Indiana, as well as perform operations and maintenance on energy assets and related energy infrastructure upgrades that will increase energy efficiency at Lilly facilities.

App. Tab 13, at 1. Enron's $168 million obligation to Lilly for this contract simply is not disclosed.

K. Enron Was Required to, But Did Not, Record Impairment Charges for Dabhol

1. In discussing the Dabhol project, defendants make the unsupported factual assertion "that Enron ***would*** be paid" the high rates it envisioned – "the [Indian] government ***guaranteed*** payment." Joint Brf. at 188. Recent media reports suggest the local government was strong-armed

into accepting the deal while its ability to pay was doubtful. *See* "60 Minutes Explores Enron deals in India," *Houston Chronicle*, 4/12/02.

2. Dabhol was extremely problematic due to the economics of the deal. The valuation was grossly inflated and political issues in India, which halted construction, indicated recovering its initial funding was doubtful. ¶¶598-602. Defendants try to turn these allegations into mismanagement and whether Enron should have abandoned the deal. Joint Brf. at 190. The CC says nothing about either of those irrelevant issues, but instead focus on Enron's reporting and accounting practices and whether the asset should have been written down.

L. Capitalization of Worthless Assets Are Not Permitted by GAAP

1. Defendants' assertion that capitalization of start-up expenses was permitted by GAAP is, at a minimum, inaccurate. Joint Brf. at 203. Plaintiffs describe costs in ¶581 that are ***not*** start-up costs, as defined in SOP 98-5, which states costs such as "ongoing customer acquisition are not start-up activities." Specifically, the improperly capitalized costs plaintiffs describe include developer, financing and promotional fees incurred on ***failed project proposals.***

2. Defendants claim plaintiffs cite no GAAP principles that were violated. But GAAP has never allowed companies to carry ***worthless assets***, such as unsuccessful project proposals, on their balance sheets. Furthermore, plaintiffs cite 1978 and 1980 GAAP pronouncements: financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources. ¶610(c) (FASB Statement of Concepts No. 1, ¶40). These principles were violated as discussed herein and in the CC.

M. The Complaint Pleads Facts to Show Individual Defendants Knew Enron Was Publishing Allegedly False and Material Information

1. Defendants claim plaintiffs "plead no facts to show that any ***individual Defendant*** knew that Enron was publishing allegedly false and material information." Joint Brf. at 204. But defendants knew Enron was falsifying its financial condition, especially its international operations, through a technique known inside the Company as "***snowballing***." *See, e.g.*, ¶581. Specifically, the CC states: (1) former executives explained quarter after quarter, year after year, Enron International

"***got pressure from corporate about meeting earnings***," which prohibited write-offs; (2) an international accounting officer repeatedly told CAO Causey that a writedown ***had to be taken*** because so many proposals were no longer even arguably viable; and (3) Causey, at ***Skilling's direction***, routinely responded, "corporate didn't have room" to take a write-off because doing so would bring Enron's earnings below expectations. ¶581.

N. First Quarter 99 Disclosure Mischaracterized Unsuccessful Bid Expenses as Start-up Activities

Enron recorded an after-tax $131 million charge purportedly to reflect the initial adoption of SOP 98-5. ¶¶581-582. But it misled investors because the charge was not related to the new accounting pronouncement but to write-off costs associated with unsuccessful project-proposal expenses. Defendants mischaracterize the write-off of unsuccessful bid expenses as a result of a change in GAAP. Joint Brf. at 209. As discussed above, the carrying of impaired or worthless assets on a company's balance sheet has never been allowed by GAAP. Moreover, SOP 98-5 only relates to "activities related to opening a new facility, introducing a new product or service, conducting business in a new territory" and explicitly precludes "ongoing customer acquisition[s]" as start-up activities.

O. Timing of Write-offs

1. Defendants rely on *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990), as it pertains to the timing of the write-offs. Joint Brf. at 205. But determining when a bad loan and costs related to unsuccessful bids should be written-off requires two distinct analyses. For example, evaluating a loan or a receivable requires a company to analyze future cash flow, future business prospects, current management, plus other macroeconomic issues. By contrast, costs related to a bid are ***instantaneously*** worthless once a company receives notice of its unsuccessful bid, and should be written off at that time.

2. Defendants defend Lay's 7/98 interview with *Bloomberg News* about Wessex – which they claim they are unable to locate and claim it cannot create liability under the PSLRA – as "classic non-actionable corporate optimism." Joint Brf. at 219-20. But their reliance on *BMC* for this point is unavailing. Lay's statement, a copy of which is attached as Ex. 12 to plaintiffs' Appendix, was a

recitation of what he told *Bloomberg News*, not a statement by *Bloomberg* about the Company. Given what defendants knew about the true economics of the Wessex water deal, Lay's statement the water business would contribute as much to Enron's bottom line as the electricity and gas businesses within five years is actionable because it was ***false***. ¶¶115, 121(h).

P. The Market Was Not Aware of Enron's Hidden Debt

1. One of defendants' most outrageous factual assertions is, "[t]he market knew the extent of Enron's off-balance sheet financing. It was well aware of Enron's exposure to credit risks as a result of its derivative trading." Joint Brf. at 237 Whether they wrote this with a straight face is doubtful, especially when the Court considers the following:

(a) Enron filed the largest bankruptcy in U.S. history within months of being the seventh-largest company in the United States, accounting for 25% of all U.S. energy trades. ¶¶13, 66.

(b) Enron's off-balance-sheet transactions and accounting machinations provided the impetus for it to obtain an investment grade credit rating, which enabled Enron to sell ***$1.9 billion*** in zero coupon convertible notes in early 01 and to exchange them in 7/01. ¶¶288, 336.

(c) Even when outsiders questioned Enron's business, the Company and its investment bankers vociferously denied any problems or significant risks. In 2/01, when *Fortune* questioned the unsupported earnings, CFO Fastow claimed Enron's financial information was a secret:

> As for the details about how it makes money, Enron says that's proprietary information, sort of like Coca-Cola's secret formula. Fastow, who points out that Enron has 1,217 trading "books" for different commodities, says, "***We don't want anyone to know what's on those books***. We don't want to tell anyone where we're making money."

¶289.

(d) Enron's phony forward-sales contracts allowed it to mischaracterize what were really loans as liabilities from price-risk management, which misled investors. ¶706.

2. To support the assertion the market was aware of Enron's exposure to credit risk, defendants refer to certain analyst reports they claim "establish this 'truth on the market.'" Joint Brf. at 237. ***First***, in this Court, "the fact-intensive truth-on-the-market defense is rarely appropriate for

dismissal of a § 10(b) complaint for failure to plead materiality." *BMC*, 183 F. Supp. 2d at 905-06. Even at summary judgment, granting dismissal based on the truth-on-the-market doctrine is appropriate only if defendants show that "'no rational jury could find' that the market was misled." *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 1996). ***Second***, the reports cited by defendants minimized risks:

(a) BT Alex. Brown, 1/13/99: while this report identifies off-balance- sheet financing, it does so by grouping it with non-recourse financing. Joint Brf. at 237; App. Tab 16, at 7. The report concludes: "We do not believe that the value of risk for Enron is large enough to preclude investing in the common stock." App. Tab 16, at 9.

(b) Deutsche Banc Alex. Brown, 9/15/00: while this report indicates Enron might be exposed to more market risk than the average energy company, it states, "'Enron manages market risk on a portfolio basis, subject to parameters established by its board of directors, and an independent risk control group ensures compliance with stated risk management policies." Joint Brf. at 238; App. Tab 30, at 18.

(c) The remaining analyst-report references are later in the Class Period, July, August and October 01. The July report refers to the "'confusing notes in ENE's reported financials.'" Joint Brf. at 238. In sum, the CC shows why the underpinning for these reports were false.

(d) Defendants' snippets from various press articles are equally misleading. If anything, they indicate market observers did ***not*** know what Enron's total exposure was. Defendants fail to include the comment in the 6/99 *CFO Magazine* article: "No wonder Fastow goes to great lengths to convince credit analysts that such ***nonrecourse*** debt shouldn't be consolidated, regardless of FASB's position." App. Tab 9, at 4. And the 10/99 *CFO Magazine* does not disclose the risks Enron faced, as defendants suggest, but rather concedes them. And the last paragraph is filled with irony, which the CC makes transparent:

> Despite the traditional rules of financing, Fastow ***reduced the balance-sheet debt, maintained the credit rating***, and reduced the cost of capital while simultaneously growing the balance sheet. In just the last two years, Enron has nearly doubled its total assets, from $16 billion to $30 billion – without shareholder dilution and without a drop in the company's credit rating. Fastow "has successfully

financed billions of dollars in a manner that has held credit quality," says S&P's Barone. "And that is not an easy thing to do. It is a testament to Andy's focus on cash flow and his ability to think outside the box."

App. Tab. 2, at 4. In sum, rather than showing the market was aware of the risks, defendants' articles illustrate the lengths Enron went to conceal them and how successful Enron appeared at the time.

VI. CONCLUSION

Plaintiffs request the Court strike defendants' entire "fact" or "contention" brief. Plaintiffs further request defendants' non-public documents be stricken from the record and all argument or references to these documents be disregarded. In addition, plaintiffs request the Court not make any factual determination as defendants seek here, but disregard all factual argument in the "joint disclosure" brief.

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