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.	§	

OPPOSITION TO ARTHUR ANDERSEN LLP'S MOTION TO DISMISS

854

TABLE OF CONTENTS

Page

Page

TABLE OF AUTHORITIES

CASES **Page**

Page

Page

STATUTES, RULES AND REGULATIONS

I. Introduction

The lure of tens, if not hundreds, of millions of dollars in consulting and auditing fees from Enron led Andersen to abandon its role as the investing public's "watchdog." Although this is not the first time Andersen has committed fraud for lucrative consulting fees – Waste Management comes to mind – participation in the Enron fraud is certainly the most egregious. A labyrinth of clandestine Special Purpose Entities ("SPEs") such as Chewco, LJM and LJM2 enabled Enron to conceal its staggering debts and devastating losses from merchant investments. Andersen structured, and when necessary restructured, the SPEs to mask Enron's true financial condition. Time and again, Andersen not only designed the complex transactions, Andersen issued "clean" audit opinions on Enron's financial statements, representing to investors that Enron's financial statements were presented in accordance with Generally Accepted Accounting Principles ("GAAP") and that Andersen's audits were performed in accordance with Generally Accepted Auditing Standards ("GAAS").

There is no dispute that Andersen made materially false statements. Enron has now restated its certified financial statements for 97-01, slashing $600 million in previously reported profits and $1.2 billion in shareholders equity, and Andersen has declared that its unqualified audit reports on Enron's 97-00 annual financial statements "should not be relied upon." These are admissions that Enron's 97-00 annual reports, along with the registration statements and prospectuses which incorporated them, were materially false and misleading when issued.

In the face of abundant detail of Andersen's knowledge, as well as the admitted destruction of evidence, Andersen argues plaintiffs have failed to sufficiently allege scienter. Andersen urges the Court to view plaintiffs' allegations piecemeal, as if each allegation itself must raise a strong inference. The Fifth Circuit rejects this approach. Nevertheless, the allegations of scienter are so strong that any one suffices. When considered in their totality, the inference of scienter is overwhelming.

The Consolidated Complaint ("CC") identifies specific communications between Andersen partners that reveal the firm knew of the Enron fraud. For example, one month before Andersen certified Enron's 99 financial statements, partner Carl Bass, a member of its Professional Standards

Group ("PSG"), Andersen's oversight authority, in a 2/00 e-mail to defendants Neuhausen and Stewart, described several Enron transactions involving an SPE – "this whole deal looks like there is no substance." Days later, in an e-mail to Stewart, Bass criticized another Enron SPE, again for having no real substance, and disapproved a transaction in which Enron was set to gain from the appreciation of the capital stock it contributed to the SPE in clear violation of GAAP. These objections to Enron's dubious accounting practices led Andersen, at Enron's direction, to remove Bass from the engagement team. According to Enron Chief Accounting Officer Richard Causey, Bass was too "rule-oriented" and "wasn't very flexible at times in some of the accounting matters." *United States v. Arthur Andersen LLP*, No. H-02-121, 5/9/02 Trial Transcript at 1115:8, 11-12. ("Trial Tr.").

Three weeks before Andersen released its clean audit opinion for Enron's 00 financial statements, senior partners from the Andersen Chicago and Houston offices met via conference call to discuss Enron's serious accounting improprieties. A follow-up memorandum from the call reveals that the partners identified and discussed numerous irregularities in Enron's accounting. Nonetheless, Andersen agreed to issue a clean opinion because of Enron's potential to grow into a $100 million-a-year client.

Documents produced recently confirm that Andersen knew Enron was manipulating its financial statements through abuse of SPEs. During the 2/7/99 Enron Audit Committee meeting, engagement team leader David Duncan characterized Enron's SPEs as "push[ing] limits" and having "a high 'others could have a different view' risk profile." Plaintiffs' Appendix, Ex. 18.[1] Partner Neuhausen derided LJM in a 5/28/99 e-mail as being beset with "conflict[s] of interest galore. Why would any director in his right mind ever approve such a scheme?" 5/9/02 Trial Tr. at 1056:5-6. Neuhausen warned that the PSG would be "very uncomfortable" with Enron recording income from selling assets to LJM. *Id.* at 1060:10. Duncan agreed "the whole thing [was] a bad idea." *Id.* at 1062:20-21.

---

[1] All exhibit references are to plaintiffs' Appendix filed herewith.

Ignoring these details of its fraud in the CC, Andersen relies on its stock argument made in every case that it would never risk its "international reputation" to commit fraud on behalf of one client. Given the long line of fraudulent schemes that Andersen has been involved in – Colonial Realty, ACC/Lincoln, Sunbeam, Waste Management and the Arizona Baptist Foundation – plus Andersen's campaign to destroy more than 30 trunks of Enron-related documents, the firm's indictment for obstructing justice and the guilty plea of lead engagement partner David Duncan, it is incredible that Andersen would argue about its "international reputation" being "at risk."

Andersen has filed a canned motion to dismiss that ignores the well-pleaded allegations in the CC. Andersen's motion comes nowhere close to warranting dismissal of any portion of the CC. The motion should be denied.

II. Factual Overview

Andersen certified that Enron's financial statements for 97-00 comported with GAAP and its audits of Enron's financial statements complied with GAAS. ¶899.[2] With respect to Enron's 00 financial report on Form 10-K, Andersen declared:

> We conducted our audits in accordance with auditing standards generally accepted in the United States....
>
> In our opinion, the financial statements [of the Company] present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations, cash flows and changes in shareholders' equity for each of the three years in the period ending December 31, 2000, in conformity with accounting principles generally accepted in the United States.

¶903. Andersen issued nearly identical audit reports for 97 (issued 2/23/98), 98 (issued 3/5/99) and 99 (issued 3/13/00). Andersen's reports were false and misleading due to its failure to conduct its audits in compliance with GAAS and because Enron's financial statements were not prepared in conformity with GAAP, as alleged in detail in ¶¶418-611, so that issuing the reports was in violation of GAAS and SEC rules. Andersen knew its reports would be relied upon by present and potential investors in Enron securities. With Andersen's consent, the audited financial statements were included in the registration statements, prospectuses, and annual shareholders' reports Enron filed

[2] All "¶__" references are to plaintiffs' CC filed 4/8/02. Additionally, all emphasis is added and all citations and footnotes are omitted unless otherwise indicated.

during the Class Period. ¶905. Andersen also reviewed and approved Enron's interim financial reports and press releases, which contained false financial statements. ¶897. As discussed below, Andersen knew the details of Enron's fraudulent transactions and was a participant in the scheme to defraud investors.

A. Year-End 97 Crisis

The alleged fraudulent scheme and course of business involving Enron finds its origin in mid-97 when Enron suffered huge losses on British natural gas and MTBE transactions, which called into question its trading and risk management skills. Analysts downgraded Enron's stock and lowered their forecasts of Enron's future earnings growth. Enron's stock lost one-third of its value and Enron's executives' performance-based bonuses were slashed. Enron was determined to halt its stock's decline and push it back to higher levels. Enron knew this could only be accomplished by reporting stronger-than-expected financial results, thus enabling it to credibly forecast stronger future earnings growth. Unfortunately, Enron's actual business operations were not capable of generating such results. ¶8.

To make matters worse, in late 12/97, Enron learned that an entity it had established with an outside investor – Joint Energy Development Incorporated ("JEDI") – and had done transactions with to generate 40% of the profits Enron reported during 97 – had to be restructured, as the outside investor was going to withdraw from JEDI. This created a crisis. Because the outside investor in JEDI had been independent of Enron, JEDI had ***not*** been consolidated into Enron's financial statements, *i.e.*, Enron did deals with JEDI as an independent party, recognized profits and did not carry JEDI's debt on its books. Thus, unless JEDI could be quickly restructured with a new, independent investor, ***Enron would have to wipe out all of the profitable transactions it had done with JEDI in 97 – put JEDI's $700 million debt on Enron's balance sheet – and lose the ability to generate profits from similar such deals with JEDI's successor going forward***. ¶9.

However, Enron ***could not find a legitimate buyer for the outside investor's interest*** in JEDI. So Enron and Barclays Bank quickly formed a new entity – Chewco – which Enron and an Enron executive (Michael J. Kopper ("Kopper")) controlled, to buy the outside investor's interest in JEDI. Chewco ***did not have an outside equity investor which was an independent third party***. So, Barclays loaned $240 million to Chewco, requiring a guarantee from Enron. Barclays also loaned the money to two straw parties (Little River and Big River) to provide for their purported "equity" investment in Chewco. Because Barclays knew that the purported equity investors in Chewco were, in fact, Enron "strawmen," Barclays required Chewco to support the purported "equity loans" it made to the two "strawmen" via a $6.6 million reserve paid to Barclays! ¶10. Andersen received documentation detailing the $6.6 million reserve. ¶946(b). The reserve cut Chewco's purported 3% contribution of independent "equity" in half. ¶439. As a result, Chewco – and consequently JEDI – should have been consolidated in Enron's 97-00 audited financial reports, and ***all of Enron's 97 profits from transactions with JEDI should have been eliminated***. ¶¶10, 442.

By the non-arm's-length Chewco transaction at year-end 97, Enron avoided a disaster for Enron by keeping the previously recorded JEDI profits in place, inflating Enron's 97 reported profits and keeping millions of dollars of debt off its books. Chewco was now also positioned to serve as a controlled entity which Enron could use to do non-arm's-length transactions with, creating at least $350 million in phony profits for Enron and allowing Enron to conceal millions of dollars of debt. Between 98 and 01, Enron and Andersen would create other controlled partnerships and entities and use them to generate hundreds of millions of dollars of phony profits while concealing billions of dollars of Enron debt. ¶11.

B. The 97-00 Successes – Enron's Stock Soars

As Enron reported ***better-than-expected year-end 97 financial results***, its stock moved higher. During 98 through mid-01, Enron appeared to evolve into an enormously profitable high-growth enterprise, reaching annual revenues of $100 billion by 00, with annual profits of $1.2 billion, presenting a very strong balance sheet that entitled it to an ***investment grade credit rating***. By 01, Enron had become the 7th largest U.S. corporation and was consistently reporting ***higher-than-forecasted earnings each quarter*** and forecasting ***continued strong growth***. ¶¶12-13. Enron extolled the success, and earning power of its Wholesale Energy trading business ("WEOS"), its retail Energy Services business ("EES") and its Broadband Content Delivery and Access Trading, *i.e.*, intermediation, business ("EBS"). ¶14.

Throughout 98 and 99, as Andersen certified Enron's purported reported record profits, Enron in releases, reports and conversations with investors and analysts and Enron's banks – in analyst reports – stated (¶14(a)):

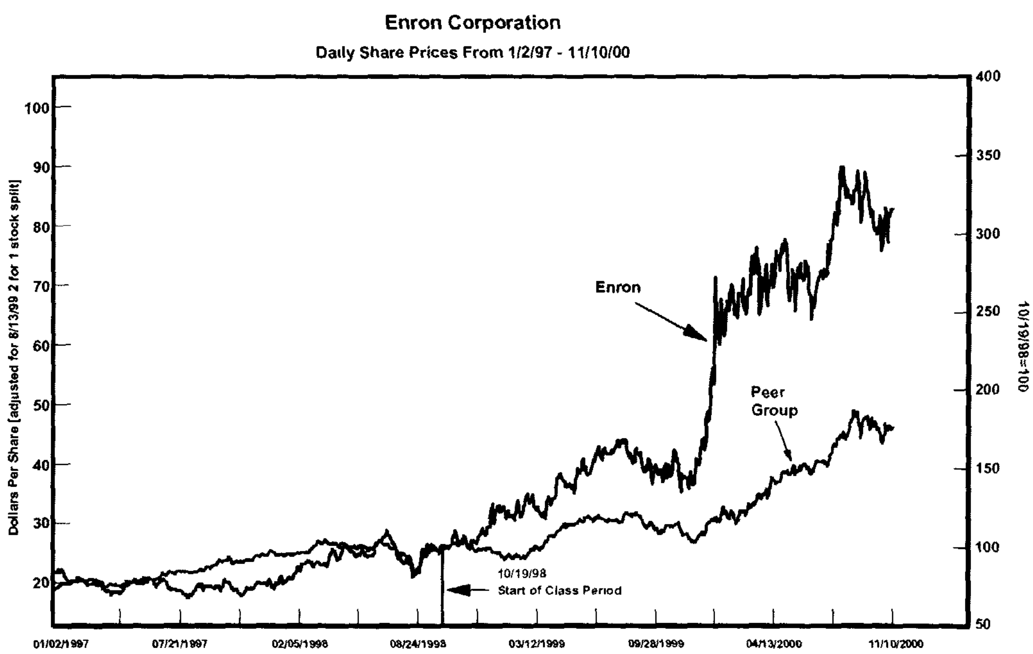
- Enron's strong results were due to the success of all of its business lines.
- Enron had a leading position in each of its businesses. Enron had an extremely strong franchise position.
- Wessex Water would be accretive to Enron's business now and a $20 billion business in five years. Azurix Corp. was becoming a major global water company.
- International projects would drive major earnings growth for Enron. The Dabhol, India power project would contribute to earnings in 99 and beyond.
- WEOS's business remained strong.
- EES was exceeding expectations for contracts and profitability. EES was adding billions in new contracts and would be profitable by 4thQ 00.
- Enron was optimistic about its broadband business. EBS was firing on track.
- Enron's tremendous competitive advantages enabled it to achieve strong EPS growth.
- Enron was very well managed and knew how to manage and mitigate risk. Enron had effectively used off-balance sheet non-recourse financing. Enron had a strong balance sheet. Enron was a master of risk management.
- No other company offered such impressive sustainable growth.
- Enron was hitting on all eight cylinders. Enron's outlook was excellent. Enron was very optimistic.
- Enron was a global powerhouse, with EPS growth to exceed 17%. Enron would maintain strong earnings growth for years.

During 00, as Andersen certified Enron's purported record annual profits, Enron and its banks stated (¶14(b)):

- Enron's strong financial results were due to strong results in all operations.
- Enron had very strong momentum. Its new trends were sustainable and would accelerate.
- Enron's business was booming. All its operations were gaining momentum.
- Investors were about to see breakout performance of EES and rapid growth and development of EBS.
- EES's new contracts and profitability were accelerating. EES had the potential to double Enron's size in a few years.

- EBS broadband trading was accelerating. The market was larger than expected, and would reach $100 billion in a few years with 3%-4% margins.
- Enron/Blockbuster video-on-demand ("VOD") deal a "Killer Opp." Unparalleled quality of service. Contract worth over $1 billion. VOD to rollout nationally in 01. All components in place. VOD had solid technology and platform.
- Enron's WEOS merchant investments were protected through hedging.
- Enron had monumental earnings potential over the next five years. Enron was well managed and a pioneer in global energy. Enron was never in better shape. Enron was very optimistic about the continued strong outlook for the Company.
- Growth and strong earnings were why investors should buy Enron stock.

As a result of Enron's strong earnings, the positive statements about its business and the forecasts of continuing strong earnings growth, Enron's stock was a very strong performer and its debt securities also traded at high prices. ¶15. Enron's apparent success and forecasts of strong profit growth gave Enron and its bankers ready access to the capital markets by which they raised billions of dollars by selling newly issued Enron securities to public investors, using the proceeds to repay Enron's bank debt. ¶16. Enron's stock soared to its all-time high of $90-3/4 in 8/00 and then continued to trade at or near these levels for months, as shown below (¶15):



However, the apparent success of Enron was an illusion – a false picture created by manipulative devices and contrivances – a fraudulent scheme and course of business by defendants that operated as a fraud and deceit on the purchasers of Enron's publicly traded securities. The fraudulent scheme was accomplished by, *inter alia*, Andersen and several banks, which pocketed hundreds of millions of dollars a year from Enron – which by 97-98 had become the ***golden goose of Wall Street***. ¶17.

Inside Enron there was a fixation on Enron's stock and doing whatever was necessary to generate the financial results necessary to push the stock ever higher. Throughout Enron's corporate headquarters in Houston were TV monitors that constantly displayed the price of Enron stock. Inside Enron there was a saying that managers were to always be "***ABC***ing," meaning to "***a***lways ***b***e ***c***losing" deals to generate revenues and profits, even if the economics of the deal were suspect – a practice facilitated by a compensation system inside Enron for corporate managers and executives that directly rewarded them financially for ***closing*** transactions and placing a high (*i.e.*, inflated) value on them, regardless of the true economic substance of the deal, so long as the deal generated an apparent profit when "marked to market." ¶50.

Inside Enron, the pressures applied to corporate managers by the top executives to do anything necessary to enable Enron to make its numbers was widespread, as was the knowledge that Enron's revenues and earnings were being falsified at the direction of top executives who rewarded the lower level managers who engaged in such conduct with bonuses in larger amounts to those who were willing to facilitate what had become a Company-wide fraudulent pattern of behavior. Former insiders have been quoted as saying "***[y]ou don't object to anything***" and "***[t]he whole culture at the vice-president level and above just became a yes-man culture***."

> But that culture had a negative side beyond the inbred arrogance. ***Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's*** energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied ***on internal estimates. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts – even though it had no impact on the actual cash that was generated.***

Fortune, 12/24/01 (¶51).

> ***"If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings," says one young Enron control person.***

"Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"

* * *

The flaw only grew more pronounced as Enron struggled to meet the wildly optimistic expectations for growth it had set for itself. "You've got someone at the top saying the stock price is the most important thing, which is driven by earnings," says one insider. "Whoever could provide earnings quickly would be promoted."

The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, she says, the harder they would have to push the next year. "It's like being a heroin junkie," she said. "How do you go cold turkey?"

Business Week, 2/25/02 (¶51). In fact, in mid-8/01, an Enron executive (who was a former Andersen accountant) wrote Lay, telling him the Company was "***nothing but an elaborate accounting hoax***," and, in referring to the SPE transactions, that nothing "***will protect Enron if these transactions are ever disclosed in the bright light of day***" – warning that many employees believed "***[W]e're such a crooked company.***" ¶51.

By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits, while concealing billions of dollars of debt that should have been on its balance sheet – inflating its shareholder equity by billions of dollars. Enron had turned into the largest Ponzi scheme in history – constantly raising fresh money by selling its securities or those of related entities, while appearing to achieve successful growth and profits. But, because Enron's reported profits were being generated by phony, non-arm's-length transactions and improper accounting tricks – including the abuse of "mark-to-market" accounting[3] to accelerate the recognition

[3] Enron engaged in several accounting tricks and manipulations to falsify its financial results during the Class Period. Chief among these was the abuse of "***mark-to-market accounting***" whereby Enron computed the purported profit it would ultimately obtain on a multi-year contract, discount that to present value and recognize the entire "mark-to-market" profit in the current period. Unless Enron's expected profit on the transaction was truly hedged, Enron was required in each following quarter to recompute or readjust the profit computation to adjust for changing economic values. "Mark-to-market" accounting was appropriate only where Enron had a long-term track record which gave it the ability to accurately estimate and forecast future values (as was true with certain aspects of Enron's wholesale energy business). However, Enron misused and abused mark-to-market accounting ***throughout its entire business to grossly inflate its reported revenues and profits***. In Enron's wholesale energy business this was done by assigning unrealistic values to

of hundreds of millions of dollars of profits to ***current periods*** from transactions in which Enron was only entitled to receive ***cash over many future years*** – Enron was cash starved. Yet to continue to report ***growing*** profits, Enron was forced to not only continue to engage in such transactions and accounting abuses, ***but to accelerate the number and size of such transactions it engaged in***. This created a vicious cycle further exacerbating Enron's need to obtain cash from these transactions. To make matters worse, Enron had capitalized certain controlled entities it was doing phony deals with (and which Enron's bankers and their executives were helping to fund), with shares of Enron stock and ***had agreed to issue millions of additional shares of its stock to these entities if Enron's stock price declined below certain "trigger prices,"*** *i.e.*, \$83, \$81, \$79, \$68, \$60, \$57, \$52, \$48, \$34 and \$19 per share ***and to become liable for the debt of those entities if Enron lost its investment grade credit rating***. Because of the "triggers" and the way Enron capitalized these entities, it was absolutely vital to Enron and Andersen and the other participants in the fraudulent scheme and course of business that Enron's stock continue to trade at high levels and that Enron maintain its "investment grade" credit rating, otherwise the scheme would unravel. ¶¶18, 20.

Enron became completely dependent on maintaining its investment grade credit rating and a high stock price so that Enron could continue to have access to the capital markets to borrow billions in commercial paper and to enable it to periodically raise hundreds of millions of dollars of new longer term capital it needed to repay its commercial paper debt and the short-term loans it was receiving from its banks to sustain its business operations and so the stock issuance "triggers" would not be hit which would force Enron into a death spiral. ¶20.

---

wholesale energy transactions which inflated current period income. In Enron's EES business where Enron had no long-term track record to justify the use of mark-to-market accounting, Enron nevertheless consistently utilized mark-to-market accounting to record huge current period profits on long-term, highly speculative retail energy risk-management contracts which, in fact, Enron had no basis to project a profit on and in fact knew would likely result in losses. Finally, in Enron's EBS business – also a new business where Enron had absolutely no track record which would justify the use of mark-to-market accounting – Enron utilized mark-to-market accounting to generate hundreds of millions of dollars of phony current period profits in several transactions. Enron not only abused mark-to-market accounting to initially value multi-year transactions to generate inflated current period profits, it also, when reviewing those computations on a quarterly basis as it was required to do, consistently ***increased*** the estimated value of the transaction even though subsequent data revealed ***a reduction of the estimated value of the transaction, a practice known within Enron as "moving the curve."*** ¶36.

C. The Partnerships and SPEs

To falsify Enron's reported financial condition and results, Enron and Andersen engaged in a series of purported "partnership" and "related party" transactions with the entities known as SPEs. GAAP requires majority-owned entities to be consolidated into the financial statements of the majority owner unless control rests with another. ¶431. Enron, Andersen, its partners and other defendants devised a scheme to account for entities Enron controlled, including Chewco, LJM, and LJM2, so the Company could avoid consolidating these entities and thereby conceal its massive debt and losses. These defendants abused an accounting provision that allows, under discreet circumstances, for the nonconsolidation of certain subsidiaries. Andersen knowingly misapplied guidance from FASB Emerging Issues Task Force ("EITF") Abstract No. 90-15, which on its face pertains only to leasing transactions. According to EITF 90-15, a majority owner can avoid consolidating its subsidiaries if the initial equity investment of an unrelated third party totals at least 3% (or more depending on the circumstances). ¶433. For Enron and Andersen, this 3% minimum became a benchmark for determining whether to consolidate any SPE. Notwithstanding that EITF 90-15 does not even apply to the sort of SPEs Enron was forming, Andersen knew many of Enron's SPEs lacked an initial independent equity investment of at least 3%. Andersen, moreover, knew Enron effectively controlled the SPEs and, under GAAP, was therefore required to consolidate them. ¶¶431-433, 910.

In 99, Enron and Andersen created two LJM partnerships (LJM and LJM2) which Enron secretly controlled. Enron then engaged in numerous transactions – which were, in fact, manipulative contrivances – with the LJM partnerships and associated SPEs, which inflated Enron's reported profits by more than a billion dollars – at the same time enriching Enron's CFO (Fastow) and his friends and all of Enron's banks or bankers named as defendants, who had been secretly allowed to invest in the LJM2 partnership as a reward for their participation in the scheme – by hundreds of millions of dollars. The reason for establishing these partnerships was that they would permit Enron to accomplish transactions it could not otherwise accomplish with an independent entity, by providing Enron with a buyer of assets that Enron wanted to sell. ¶23. Thus, one of the primary vehicles used to falsify Enron's financial results during 99-01 was LJM2, which Enron used to create numerous SPEs (including the infamous "Raptors") which engaged in non-arm's-length fraudulent transactions to artificially inflate Enron's profits while concealing billions of dollars of its debt on terms so unfair to Enron that the deals provided huge returns to the LJM2 investors. ¶24.

Because the LJM2 partnership was going to be so lucrative to investors in that entity ***and provide exceptional returns as the Enron Ponzi scheme continued***, Enron and the banks decided that in funding LJM2, they would ***allow certain favored high-level officers of the banks to invest in LJM2***. The LJM2 partnership offering memorandum by which Enron brought investors into the partnership – ***which was not a public document*** – contained an invitation to benefit from the self-dealing transactions that LJM2 would engage in. It stressed the "***unusually attractive investment opportunity***" resulting from LJM2's connection to Enron. It emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow, and other Enron insiders.[4] It explained that "***[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities***" and that it "***expects to benefit from having the opportunity to invest [some $150 million] in Enron-generated investment opportunities that would not be available otherwise to outside investors***." It specifically noted that Fastow's "***access to Enron's information pertaining to potential investments will contribute to superior returns.***" ***In addition, investors were told that investors in a similar Fastow-controlled partnership (JEDI) that had done deals with Enron like the ones LJM2 would do had tripled their investment in just two years and that overall returns of 2,500% to LJM2 investors were actually anticipated.*** ¶25. Enron and Andersen knew that because LJM2 was going to engage in transactions ***with Enron where Enron insiders would be on both sides of the transactions, the LJM2 partnership would be extremely lucrative – a deal that was virtually guaranteed to provide huge returns to LJM2's investors as the Enron Ponzi scheme went forward***. ¶24. In short, the non-public offering memorandum was an invitation to join in the benefits of non-arm's-length self-dealing transactions with Enron, *i.e.*, the looting of Enron. ***Enron's bankers and the top executives of those banks were permitted to invest in LJM2***

[4] In fact, Fastow's dual role by which he could self-deal on behalf of the LJM2 partnership with Enron's assets was so important ***that investors in LJM2 were assured that they did not have to make any additional capital contributions if Fastow's dual role ended***. ¶24.

as a reward to them for their ongoing participation in the scheme – a sure thing for them. ¶¶24-25.[5]

It was indispensable to the scheme that LJM2 be funded at year-end 99 to serve as a vehicle to consummate several transactions with Enron before year-end 99 to create huge profits for Enron in the 4thQ 99 so that Enron could meet and exceed its forecasted 99 earnings. However, as had been the case with Chewco at year-end 97, there was tremendous time pressure and Enron (which was raising the private equity capital for LJM2) could not complete the formation of LJM2 and raise sufficient money from the equity investors in LJM2 in time to fully form or fund LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in 12/99, in an extraordinary step, Andersen and other defendants, knowing that LJM2 was going to be an extremely lucrative investment anyway, created documentation that enabled the banks to advance virtually 100% of the monies needed to initially fund LJM2. ¶26. The reason the banks and their top executives put up the money to pre-fund LJM2 was that they knew that enabling Enron to do the 99 year-end deals with the LJM2 and its SPEs was indispensable to Enron avoiding reporting a very bad 4thQ 99 – which would have caused its stock to plunge. ¶28.

From 6/99 through 6/01, Enron entered into numerous non-arm's-length fraudulent transactions with the LJM partnerships. Enron sold assets to LJM that it wanted to get off its books on terms that no independent third party would ever have agreed to. ***The transactions between the LJM partnerships and Enron or its affiliates occurred close to the end of financial reporting periods to artificially boost reported results to meet forecasts Enron and other participants in the scheme had been making.*** For instance, near the end of the 3rd and 4thQ 99, Enron sold interests in seven assets to LJM and LJM2 in transactions that Andersen structured, reviewed, and allowed. The transactions permitted Enron to conceal its true debt levels by removing the assets from Enron's

[5] While Enron's publicly filed reports disclosed the existence of the LJM partnerships, these disclosures did not reveal the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not fully disclose the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and to disguise their substance and import. The disclosures also represented that the related-party transactions were reasonable compared to transactions with third parties when, in fact, they were not. ¶67.

balance sheet and, at the same time, record large gains. However, (i) as it had agreed in advance it would do, Enron bought back five of the seven assets after the close of the financial reporting period; (ii) the LJM partnerships made large profits on every transaction, even when the asset they had purchased actually declined in market value; and (iii) those transactions generated "earnings" for Enron of $229 million in the second half of 99 out of total earnings for that period of $549 million. In three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against any loss. Thus, the LJM partnerships functioned only as vehicles to accommodate defendants in the manipulation, falsification and artificial inflation of Enron's reported financial results, while enriching the LJM investors who were benefitting from the looting of Enron. ¶32. [6]

Andersen and its partners knew Enron's transactions with the LJM partnerships served no economic purpose other than concealing debt and losses and enriching Fastow and other Enron executives. ¶¶948, 950. CFO Fastow and other Enron executives controlled LJM and LJM2 and reaped tens of millions of dollars in management fees and purported appreciation of their investments in the partnerships. ¶¶944, 948, 949(a), (d), 950. LJM2's private offering memorandum – which Andersen partners read – revealed that Enron retained significant economic and operating interests in the investments and trumpeted the superior returns to be expected as a result of its general partners obtaining inside information from Enron. ¶¶948, 950. The private offering memorandum also disclosed that Enron was carrying at least $17 billion in assets, 33% of the Company's total, off its balance sheet. ¶¶948, 949(b). Moreover, no later than 12/99, PSG partner Carl Bass, a member of an Andersen national team of auditing experts and overseers, was objecting vociferously to Enron's treatment of the LJM SPEs. ¶913. One month before Andersen certified Enron's 99 financial statements, Bass, in an e-mail to defendants Stewart and Neuhausen,

6 The returns to the LJM2 investors were huge – up to 2,500% on one deal and 51% overall ***in the first year*** of the partnership. ***Skilling has recently told investigators such gargantuan returns were possible only because LJM2, with Fastow at the wheel, was defrauding Enron in the billions of dollars of deals it was doing with Enron so Enron could create false profits and hide billions of dollars in debt***. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02.

characterized several SPE transactions as "look[ing] like there is no substance" to them. ¶929. Yet Andersen continued to issue clean audit reports on Enron's financial statements.

One "hedging" transaction with LJM in 6/99 involved Rhythms NetConnections ("Rhythms") stock owned by Enron, to "hedge" Enron's huge gains in Rhythms stock and enable Enron to create a huge profit. Enron transferred its own stock to the SPE in exchange for a note. But if the SPE were required to pay Enron on the "hedge," the Enron stock would be the source of payment. Enron's purported hedge of its Rhythms position was never a true economic hedge, because LJM's ability to meet its obligations depended on the strong performance of Enron stock. ¶¶33, 456. GAAP precluded Enron from recognizing income due to increases in the value of its capital stock, yet Andersen approved these transactions. Other "hedging" transactions occurred in 00 and 01 and involved SPEs known as the "Raptor" vehicles. These were also structures, funded principally with Enron's own stock, that were intended to "hedge" against declines in the value of certain of Enron's merchant investments. These transactions were not economic hedges. They actually were manipulative devices devised to circumvent accounting rules. The economic reality was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron. Enron and Andersen used these contrivances and manipulative devices to inflate Enron's reported financial results. In 99, Enron recognized income of over $100 million from the Rhythms' "hedging" transaction. ***In the last two quarters of 00, Enron recognized pre-tax earnings of $530 million on several transactions with the Raptor entities*** out of reported pre-tax earnings of $650 million. These ***"earnings" from the Raptors' manipulative contrivances accounted for more than 80% of the total***! ¶33.

Hedging Enron's investments with the value of Enron's stock created an enormous and unusual motive for the participants in the scheme to keep Enron stock trading at inflated levels. This was because if the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This happened in late 00 and early 01. In 12/00, Enron's gain (and the Raptors' corresponding net loss) on these transactions was over $500 million. Enron could recognize these gains – offsetting corresponding losses on the investments in its merchant portfolio – ***only if the Raptors had the capacity to make good on their debt to Enron***. If they did not, Enron would be required to record a "credit reserve," a loss that would defeat the very purpose of the Raptors, which was to shield Enron from reflecting the decline in value of its merchant investments. ¶34.

As year-end 00 approached, two of Enron's LJM2-financed Raptor SPEs were in danger of coming unwound as they lacked sufficient credit capacity to support their obligations. If something were not done to prevent the unwinding of these SPEs, Enron would have to take a multi-million dollar charge against earnings which would expose the prior falsification of Enron's financial results and result in Enron's stock plunging, more and more of the stock issuance "triggers" in the LJM2 SPEs would be hit, and a vicious fatal down-cycle would kick in. Therefore, with the participation of Andersen, Enron restructured and capitalized the LJM2-financed Raptor SPEs at year-end 00 by transferring to them rights ***to receive even more shares*** of Enron stock, creating ever-increasing pressure on Enron and the other participants in the scheme to support Enron's stock price. This artifice enabled Enron to avoid recording a huge credit reserve for the year ending 12/31/00. ¶35.

Andersen and its partners knew the Raptor transactions were manipulative devices when they certified Enron's financial statements as complying with GAAP. Even a cursory review of the Raptor transactions revealed they violated several fundamental accounting precepts. ¶¶951-952. Basic accounting principles forbid companies from recognizing the appreciation of their own stock as income. ¶952(a). The substance of the Raptors transactions effectively allowed Enron to report net income and gains on its income statement that were backed almost entirely by Enron stock, and contracts to receive Enron stock, which the Raptors held. *Id.* In essence, these transactions conjured income from thin air. *Id.* Andersen also allowed Enron to avoid recording individual impairment charges for Raptor investments that suffered substantial, permanent declines in value. ¶952(c). Defendants Cash, Duncan, Lowther, Odom and Stewart blessed Enron's accounting for the Raptors, though PSG partner Bass warned them that Enron's accounting for the SPEs was deceptive. ¶¶929, 952(c). Ultimately, Enron reduced its shareholders' equity by $1 billion to reverse the improper accounting for the Raptor transactions. ¶494.

D. Enron Energy Services ("EES")

The falsification of Enron's financial results was not limited to non-arm's-length fraudulent illicit partnership and SPE transactions. While Enron's wholesale energy business was the largest single contributor to its profits, Enron and its banks were also telling investors that an area of tremendous growth for Enron was its retail energy services business – EES – whereby Enron purportedly undertook to manage the energy needs of corporate consumers for multi-year periods in return for fees to be paid over a number of years. Enron and its banks presented this business as achieving tremendous success by constantly signing new multi-million or even billion-dollar contracts which allowed EES to exceed internal forecasts and that this division had turned profitable in the 4thQ 99 and was achieving substantial gains in its profitability thereafter. ¶37.

However, EES was actually losing hundreds of millions of dollars. This was because in order to induce large enterprises to sign long-term energy management contracts and "jumpstart" this business so it could appear to obtain huge contract volumes, Enron was entering into EES management contracts which it knew would likely result in huge losses. However, by the abuse of mark-to-market accounting, Enron grossly overvalued the ultimate value of these contracts and created greatly inflated current period profits from transactions which generated little, if any, current period cash, and which would likely actually result in long-term cash out plans and losses. As a letter written in 8/01 to Enron's Board by an EES manager stated just after Skilling "resigned"(¶38):

> One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron .... (*i.e.*, ***EES's management's ... hiding losses/SEC violations***).
>
> * * *
>
> ... [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked.
>
> * * *
>
> ... [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion.... [T]hey decided ... to hide the $500MM in losses that EES was experiencing.... ***EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously***.

E. Enron Broadband ("EBS")

Another purported growth area of Enron's business was its broadband services business – EBS – which consisted of constructing an 18,000-mile fiber optic network which Enron was constructing and engaging in trading access to Enron's and others' fiber optic cable capability, *i.e.*, "Broadband Intermediation." Enron and its banks presented ***both parts*** of Enron's broadband business as poised to achieve and later as actually achieving huge success, reporting that its fiber optic network was being or had been successfully constructed, was state of the art and provided unparalleled quality of service, and that its broadband trading business was succeeding and achieving much higher trading volume and revenues than expected – *i.e.*, "***exponential growth***." ¶39.

A prime example of the purported success of Enron's broadband content business was its video-on-demand ("VOD") joint venture with Blockbuster Entertainment, announced in 7/00. Enron presented this 20-year agreement as having a ***billion dollar value***, that it was a ***first-of-its-kind product*** whereby consumers would obtain VOD content from Blockbuster in their home as if they were watching the movie on their own VCR (start, stop, rewind) and that this incredible advance in technology was made possible due to the ***high quality of Enron's fiber optic network***. Abusing mark-to-market accounting and an LJM2 SPE, Enron recognized an astonishing $110+ million profit on this deal in the 4thQ 99 and 1stQ 00, even though the project was failing in its test markets because Enron did not have the technology to deliver the product as represented – and which could never have gone forward because Blockbuster did not have the legal right to deliver movies in a digital format, the only format which could be utilized for VOD. ¶40.[7]

F. New Power

Another example of how Enron and Andersen misrepresented Enron's reported results is the New Power IPO in 10/00, by which Enron improperly recognized a $370 million profit in the 4thQ 00. Enron controlled New Power and owned millions of shares of New Power stock. If Enron and its banks could take New Power public and create a trading market in its stock, then Enron could recognize a profit on the gain in value on its shares by "hedging" that gain via yet another non-arm's-length transaction via LJM2. In the 4thQ 00, Enron desperately needed to create profits to perpetuate

---

[7] Just eight months after announcing this contract with great fanfare and just weeks after representing that testing of the system in four cities had ***succeeded*** and that the service was being launched nationwide, Enron was forced to abandon the venture. But Enron did not reverse the huge profits it had secretly recorded on this transaction, for to do so would have not only exposed its ongoing abuse and misuse of mark-to-market accounting, but also would have crushed Enron's stock at a time when Enron and the other participants in the scheme were desperately attempting to halt Enron's then falling stock price so that it would not fall below certain trigger prices. ¶41.

the Ponzi scheme. Enron and its bankers did the New Power IPO – 27.6 million shares at $21 per share in 10/00. Then, in a deal secretly structured before the IPO, Enron created a phony profit using an LJM2 SPE called Hawaii 125-0. CIBC and other of Enron's banks made a "loan" of $125 million to Hawaii 125-0, ***but secretly received a "total return swap" guarantee to protect them against any loss from Enron***. Enron transferred millions of New Power warrants to Hawaii 125-0 to "secure" the banks' loan and thus created a huge $370 million "profit" on the purported gain on the New Power warrants. Hawaii 125-0 simultaneously supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, one week later, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. New Power stock immediately fell sharply, as the chart below shows:

This collapse converted Enron's huge gain on its New Power equity holdings into a huge loss early in 01 – a loss of about $250 million – which was concealed. ¶42.

G. Hidden/Disguised Loans

Another tactic utilized by Enron to falsify Enron's financial condition and hide debt involved manipulative transactions with JP Morgan, CitiGroup and CS First Boston. JP Morgan used an entity it controlled known as "Mahonia," located in the Channel Islands off England. J.P. Morgan and Enron utilized a scheme which JP Morgan had utilized before with a commodities trader from Sumitomo, by which large bank loans are disguised as commodity trades. In fact, offsetting trades were arranged with the ultimate cost differential being in favor of the bank, representing the interest rate on the disguised loan. By utilizing this manipulative device, JP Morgan and Enron falsified Enron's financial condition, concealing some $4 billion in debt. ¶44.[8]

CitiGroup and CS First Boston engaged in similar subterfuges to disguise large loans to Enron. CitiGroup lent Enron $2.4 billion via "pre-paid" swaps – the so-called "Delta" transactions – conducted through CitiGroup's Cayman Island subsidiary. These swap transactions perfectly replicated loans and were, in fact, loans – but Enron never reported them as such on its balance sheet. CS First Boston also engaged in making disguised loans to Enron. CS First Boston gave Enron $150 million to be repaid over two years, with Enron's payments to vary with the price of oil. The transaction was made to appear to be a "swap," but was, in fact, a loan – a reality admitted by the bank: "***It was like a floating-rate loan***," said Pen Pendleton, a CS First Boston spokesman. "***We booked the transaction as a loan***." However, Enron did not show the loans on its balance sheet. ¶45.

By so doing, JP Morgan, CitiGroup and CS First Boston were able to ***secretly*** prop up Enron's deteriorating finances without disclosing that in fact, Enron ***had borrowed between $4-$6 billion from those banks***. Also astonishing about the Mahonia and Delta transactions is the way JP Morgan and CitiGroup were "***paid off***" to engage in this manipulative subterfuge. Based on Enron's

---

[8] Knowing Enron's true financial condition was precarious, JP Morgan attempted to insure against default on those disguised loans by buying performance bonds from several insurance companies. However, the insurers have refused to pay, alleging that in fact, the commodity trades were fraudulent and a subterfuge to conceal the real nature of the transactions, *i.e.*, done for the purpose of disguising loans. ***A federal district court judge has ruled that there is significant evidence to support the insurers' claims of fraud and deception and that these transactions were, in fact, disguised loans***. ¶44.

purported investment grade credit rating, Enron could have borrowed money from banks at 3.75%-4.25%. However, in the phony Mahonia and Delta transactions, ***Enron paid JP Morgan and CitiGroup between 6.5%-7.0% for the disguised loans – a huge difference from the cost of a legitimate bank loan – which made these disguised loans hugely profitable for JP Morgan and CitiGroup*** – in effect paying them off for participating in these bogus transactions. ¶46.

H. Enron's Access to the Capital Markets

Enron required constant access to huge amounts of capital. For Enron to continue to appear to succeed it had to keep its investment grade credit rating and keep its stock price high. Enron's investment grade credit rating and high stock price could ***only*** be maintained by (i) limiting the amount of debt shown on Enron's balance sheet; (ii) reporting strong current period earnings; ***and*** (iii) forecasting strong future revenue and earnings growth. Yet Enron was able to achieve these ends only by pursuing an increasing number of phony transactions, many of which were accomplished by increasing the number and size of transaction entities which were supposedly independent of Enron but which, in fact, Enron controlled through a series of secret understandings and illicit financing arrangements, including the LJM2 partnerships. As a result of reporting strong earnings, the apparent success of its business and its future earnings growth forecasts, Enron had unlimited access to the capital markets, borrowing billions of dollars in the commercial paper markets and by selling billions of dollars of Enron securities to the public. Enron and its bankers, working with Andersen, raised over $6 billion in new debt and equity capital from public investors through numerous securities offerings, thus raising the capital necessary to allow Enron to repay or pay down its short-term debt and continue to operate. These Enron offerings are shown below (¶48):

ENRON SECURITIES UNDERWRITINGS	
Date of Offering	**Security Sold**
11/96	8 million shares Enron Capital Trust I 8.3% Trust Originated Preferred Securities at $25 per share
7/97	$100,000,000 6-5/8% Enron Notes
8/97	$150,000,000 6.5% Notes due 8/1/2002

Date of Offering	Security Sold
11/97	$200,000,000 Remarketed Reset Notes due 11/15/2037
1/97	6 million shares Enron Capital Trust II 8-1/8% Trust Originated Preferred Securities at $25 per share
11/97	$250,000,000 6.625% Notes due 11/15/2005
11/97	$300,000,000 6.45% Notes due 2001
5/98	35 million shares of common stock at $25 per share
7/98	$250,000,000 6.40% Notes due 7/15/2006 $250,000,000 6.95% Notes due 7/15/2028
9/98	$250,000,000 Floating-rate Notes due 3/30/2000
11/98	$250,000,000 6.95% Notes due 7/15/2028
2/99	27.6 million shares of common stock at $31.34
5/19/99	$500,000,000 7.375% Notes due 5/15/2019
8/10/99	$222,500,000 7% Exchangeable Notes due 7/31/2002
5/00	$500,000,000 Notes due 5/23/2005 and 6/15/2003
2/01 (private placement) 7/01 (resales)	$1,907,698,000 Zero Coupon Convertible Senior Notes due 2021, original issue date 2/7/2001

None of these offerings would have been possible without Andersen's consent to include its false and misleading audit opinion in the Registration Statements.

I. Late 00/Early 01 Prop-Up

In late 00/early 01, Enron's financial results began to come under scrutiny from a few accounting sleuths and short-sellers, who began to question the quality of Enron's reported financial results. While Enron, its top insiders and its bankers assured investors of the correctness of Enron's accounting and the high quality of Enron's reported earnings, the success and strength of its business and its solid prospects for continued strong profit growth, in part because of this increasing controversy, Enron's stock began to decline. As this price decline accelerated, it put pressure on Enron's top executives to do something – anything – to halt the decline in the price of the stock as they knew that if that price decline continued and the stock fell to lower levels, more and more of the Enron stock "triggers" contained in agreements for LJM2 SPE deals would be triggered, ***which would require Enron to issue over 100 million shares of its common stock to those partnerships, causing a huge reduction in Enron's shareholders' equity***. ¶52.

In late 3/01, inside Enron it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect a shortfall in credit capacity of the LJM2-financed Raptor SPEs, which would have been catastrophic and exposed the scheme. Rather than take that loss and face these consequences, Enron "restructured" the LJM2-financed Raptor vehicles by transferring ***more than $800 million of contracts to receive Enron's own stock to them just before quarter-end, which permitted the participants in the scheme to conceal substantial losses in Enron's merchant investments, keep billions of dollars of debt off Enron's balance sheet and allowed the Enron Ponzi scheme to continue***. ¶53.

During early 01, Enron continued to report record results and it and its bankers continued to make very positive statements (¶54):

- Enron's strong results reflected breakout performance in all business units. Enron was a strong unified business.
- WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages.
- EBS intermediation was great. Broadband glut and lowered prices ***would help Enron***.
- VOD was successfully tested and launched. Proven technology created enormous opportunities.
- All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was very optimistic. Enron was confident growth was sustainable for years to come.

J. The Impending Collapse

By the Summer of 01, Enron realized that it would not be able to continue to sustain the illusion of strong profitable growth and that it would have to take large write-offs in the second half of 01 that, in turn, could result in a downgrade of Enron's critical investment grade credit rating – an event that defendants knew would mean that debt on the books of the SPEs Enron did business with (and partnerships controlled by them), which debt Enron had assured investors was "***non-recourse***" to Enron would, in fact, become Enron's obligation. ¶55.

On 8/14/01, Enron announced that Skilling – who had become Enron's CEO just months earlier – was resigning, for "***personal reasons***." While this resignation fanned the controversy over the true nature of Enron's finances and the condition of Enron's business, Enron and its banks lied to investors, telling them that Skilling's resignation was only for personal reasons and did not raise "***any accounting or business issues of any kind***" and that Enron's financial condition "***had never been stronger***" and its "***future had never been brighter***." They said there was "***nothing to disclose,***" Enron's "***numbers look good,***" there were "***no problems***" or "***accounting issues***." According to them, the Enron "***machine was in top shape and continues to roll on – Enron's the best of the best***." ¶57.

K. The End

By 8/01, inside Enron management employees were complaining to Enron's Board that the fraud at Enron was so widespread it was out of control. In 8/01, two employees complained to the Board (¶59):

1. One employee wrote:

> Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.
>
> * * *
>
> We have recognized over $550 million of fair value gains on stock via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.
>
> ***I am incredibly nervous that we will implode in a wave of accounting scandals.... [T]he business world will consider the past successes as nothing but an elaborate accounting hoax....***

[W]e booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

* * *

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.....***

* * *

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

* * *

3. ***There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly....***

    a. 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 ....

    b. ***Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.***

    c. 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....***

B. A second employee wrote:

One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrong doings of the various management teams at Enron. However ... I'm sure the board has only scratched the surface of the impending problems that plague Enron at the moment. (*i.e.*, EES's ... hiding losses/SEC violations ... lack of product, etc.).

* * *

[I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked. (JC Penney being a $60MM loss alone, then Safeway, Albertson's, GAP, etc.). Some customers threatened to sue if EES didn't close the deal with a loss (Simon Properties – $8MM loss day one).... Overnight the product offerings evaporated.... Starwood is also mad since EES has not invested the $45MM in equipment under the agreement.... Now you will loose [sic] at least $45MM on the deal.... You should also check on the Safeway contract, Albertson's, IBM and the California contracts that are being negotiated.... It will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion....

This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, "Disclosures about Segments of an Enterprise and related information," EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about....

There are numerous operational problems with all the accounts.

* * *

... Some would say the house of cards are falling....

You are potentially facing Shareholder lawsuits, Employee lawsuits ... Heat from the Analysts and newspapers. The market has lost all confidence, and its obvious why.

You, the board have a big task at hand. You have to decide the moral, or ethical things to do, to right the wrongs of your various management teams.

* * *

... But all of the problems I have mentioned, they are very much common knowledge to hundreds of EES employees, past and present.

On 10/16/01, Enron shocked the markets with revelations of $1.0 billion in charges and a reduction of shareholders' equity by $1.2 billion. Within days, *The Wall Street Journal* began an exposé of the LJM SPEs, the SEC announced an investigation of Enron, and Fastow, "resigned." In 11/01, Enron was ***forced to admit that Chewco had never satisfied the SPE accounting rules and – because JEDI's non-consolidation depended on Chewco's status – neither did JEDI, and Enron consolidated Chewco and JEDI retroactive to 97. This retroactive consolidation resulted in a massive reduction in Enron's reported net income and massive increase in its reported debt***. Enron then revealed that it was restating its 97, 98, 99 and 00 financial results to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity as detailed below (¶61):

ENRON ACCOUNTING 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
Shareholders' Equity Amount of Overstatement	$ 313,000,000	$ 448,000,000	$ 833,000,000	$ 1,208,000,000

These partnerships – Chewco, LJM and LJM2 – ***were used by Enron and its banks to enter into transactions that Enron could not, or would not, do with unrelated commercial entities***. The significant transactions were designed ***to create phony profits or to improperly offset losses***. These transactions allowed Enron to conceal from the market ***very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged – that is, that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was simply an entity in which only Enron had a substantial economic stake. The Raptors transactions with LJM2 alone resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ 01 that were almost $1 billion higher than should have been reported***! ¶62.[9]

Notwithstanding the write-offs and restatement revelations of 10/01-11/01, Enron, JP Morgan and CitiGroup believed that they could limit their legal exposure for participation in the scheme if they could sell Enron to another company. So, in 11/01, as the Enron scheme began to unravel, Enron tried desperately to arrange a salvation merger with Dynegy to avoid the insolvency of Enron and the inevitable investigations and revelations that would follow such insolvency. ¶64. However, the due diligence efforts of Dynegy uncovered that the true financial condition of Enron was far worse than had been disclosed publicly and that Enron had been engaged in a wide-ranging

---

[9] As huge as the 11/01 restatements of Enron's 97-00 financial statements were, they just scratched the surface of the true extent of the prior falsification of Enron's financial statements, failing to eliminate additional hundreds of millions of dollars of phony profits as Enron, Andersen and the banks were still trying to keep Enron afloat and trying to conceal how extensive the fraud had really been. ¶63.

falsification of its financial statements over the several prior years. Thus, Dynegy refused to acquire Enron. By 11/28/01, Enron's publicly traded debt had been downgraded to "junk" status. On 12/2/01, Enron filed for bankruptcy – ***the largest bankruptcy in history***. Enron stock and publicly traded debt securities have become virtually worthless, inflicting billions of dollars of damage on purchasers of those securities. ¶66.

As *Newsweek* has written:

> 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).

> ***The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years***. Those fictional figures, showing nicely rising profits, enable Enron to become the nation's seventh largest company, with $100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, and we have to make accountants mortally afraid of certifying them. Anything else is window dressing.

Newsweek, 1/28/02 (¶69).

III. Andersen's Scienter

A. Andersen's Desire for Fees Drove the Firm to Commit Fraud

Greed motivated Andersen to engage in the Enron Ponzi scheme. Enron was Andersen's second largest client, and the firm's relationship with Enron proved to be extremely lucrative. ¶906. In 00 alone, Andersen reaped $52 million in fees from Enron, $25 million for auditing and another $27 million for consulting. *Id.* Duncan earned as much as $2 million per year for his Enron work, and Andersen partners held regular "Client Service Team" meetings to discuss ways to sell more services to the Company. ¶¶906-907.

Andersen betrayed its professional duty to remain skeptical, independent and objective when auditing Enron's books in order to reap more fees from Enron. ¶910. Andersen knew of management's dire interest in sustaining a robust trading price for Enron stock. ¶923. The success of numerous hedges Enron transacted with its SPEs depended on the strength of its stock. *Id.* Moreover, substantial amounts of management's income derived from insider-trading proceeds, and Enron executives received millions of dollars in bonuses for hitting stock-price targets. *Id.* From these and other facts, Andersen knew Enron posed a substantial risk of committing financial fraud, as Andersen was forced to admit recently in testimony before Congress. ¶¶906, 910, 914, 921-926. Indeed, David Duncan testified during Andersen's obstruction of justice trial that he knew Enron was a high risk client. 5/14/02 Trial Tr. at 1734:9-11. *See also* ¶926. But Andersen chose to turn a blind eye to these obvious red flags and continued to issue clean audit opinions. ¶931.

The key to increasing its fees was ensuring Enron maintained its investment grade rating as it expanded. ¶¶910, 923. Andersen, with the participation of other defendants, structured hundreds of complex partnerships so Enron could conceal its vast debt and enormous merchant losses. ¶922. Andersen was intimately involved in the accounting for the Chewco and LJM transactions and billed Enron $5.7 million for approximately ***28,000 hours of work*** on these deals. ¶942. For Andersen it was a simple cost-benefit analysis. Senior partners from the Houston and Chicago offices determined that the potential to double the Enron fee level to an unprecedented $100 million per year justified retaining Enron as a client, though its fraudulent transactions posed serious risks for the firm. ¶912. Andersen abandoned its role as a skeptic – the investing public's "watchdog" – and committed fraud. ¶¶898, 910-913.

As a result of lavishing Andersen with tens of millions in fees each year, Enron demanded – and received – complete obedience from the firm. Senior Andersen partners removed partner Carl Bass from his oversight role on the Enron audits because he opposed Enron's improper accounting practices and Andersen's approval of them. ¶913. Bass was a senior member of Andersen's PSG oversight group and voiced strong opposition to Enron's accounting for at least two years. *Id.* In 12/99, Bass wrote an e-mail to defendants Neuhausen and Stewart expressing his opposition to Enron's accounting for a particular SPE and urged Andersen to reject Enron's accounting for the entity. ¶928. In 2/00, Bass wrote Neuhausen and Stewart to rebuke Enron's treatment of several transactions from another SPE. ¶929. Bass concluded, "this whole deal looks like there is no substance." *Id.* Just three days later, Bass advised Stewart that an Enron SPE lacked real substance and he was alarmed to discover that Enron intended, in clear violation of GAAP, to recognize revenues from the appreciation of Company stock contributed to the SPE. ¶¶454, 929. Defendants Bauer, Cash and Duncan were privy to Bass' conclusions. ¶929.

Enron executives were outraged with Bass. ¶913. Defendant Richard Causey, with Duncan's help, pressured senior Andersen management in Chicago to remove Bass from the Enron account. *Id.* Causey went so far as to complain about Bass during a meeting with defendant Joseph Berardino, CEO of Andersen Worldwide at the time. *Id.* Causey found Bass dangerous because he was too "rule-oriented" and "wasn't very flexible at times in some of the accounting matters." 5/9/02 Trial Tr. at 1115:8, 11-12. Three weeks later, senior Andersen management removed Bass from his oversight position, just days after he objected to Enron's accounting for Raptor transactions and Blockbuster, which together represented at least $150 million in improperly recognized income or avoided losses at the end of 00. ¶¶913, 932. Bass testified in Andersen's criminal trial that his removal was upsetting because the client was basically telling Andersen who would and would not consult on the engagement. 5/9/02 Trial Tr. at 1056.

B. Andersen's Willingness to Commit Securities Fraud on Behalf of Lucrative Clients

Enron was not the first time Andersen certified fraudulent financial statements to protect the huge fees it earned. Andersen played a significant role in Waste Management's ability to perpetrate one of the largest accounting frauds in history. The fraud emanated from the Houston office's audits of Waste Management, which restated its 92-96 annual financial statements. Waste Management admitted to overstating profits by as much as $1.7 billion, then the largest restatement of earnings in history. As with Enron, Andersen recognized early that Waste Management undertook "aggressive" accounting practices, identified Waste Management as a "high-risk client," and observed significant profit inflation by it. But during this period, Andersen's consulting fees from Waste Management had grown to dwarf its audit fees, making it Andersen's most valuable client. Unwilling to risk losing its lucrative consulting fees, Andersen certified Waste Management's annual financial statements for three years though the company refused to correct accounting improprieties the firm identified. According to the SEC, the decision to certify Waste Management's financial reports was backed at the highest levels of Andersen's management, including Andersen's Practice Director, Managing Partner and Audit Division Head. ¶919(a).

Due to Andersen's egregious behavior in auditing Waste Management, the SEC slapped Andersen with a permanent anti-fraud injunction, the first in 20 years, and the largest civil penalty ($7 million) for an accounting firm in SEC history. The SEC also required Andersen to sign a consent decree promising to refrain from committing accounting fraud in the future. Defendant Goolsby signed the consent agreement on Andersen's behalf. Defendants Goolsby and Swanson oversaw both the Waste Management and Enron engagements. ¶919(a).

C. Andersen's Attempted Coverup of Enron's Fraud

During Summer and Fall 01, several developments led Andersen and its partners to conclude that civil litigation and an SEC investigation concerning its role in the collapse of Enron were imminent. ¶¶61, 917, 964. On 8/20/01, Sherron Watkins, an Enron Vice President and former Andersen accountant, warned Andersen audit partner James Hecker, a former colleague, about numerous accounting irregularities at Enron. ¶¶933, 964. The next day, Hecker convened an emergency meeting with defendants Cash, Duncan, Odom, Swanson and others to discuss Watkins' concerns about "the propriety of accounting for certain related-party transactions" with the LJM partnerships. ¶933. By mid-September, senior audit specialists in Chicago, including defendant Stewart, concluded that Andersen partners approved much of Enron's fraudulent accounting. ¶964. As with the Waste Management fraud, Andersen's own memoranda and e-mail revealed headquarters' intimate involvement in the massive fraud. *Id.* Andersen also knew its participation in the Enron fraud violated a standing consent decree it signed with the SEC as a result of its manipulation of Waste Management's financial statements. ¶919(a).

As soon as the Enron fraud began to unravel, Andersen partners, including audit partners, in-house lawyers, and "risk-management experts" in Chicago, began debating about how best to alter memoranda and work papers to minimize potential exposure. ¶964. Defendant Nancy Temple, an Andersen attorney, reminded the Enron audit team to "comply" with the firm's document retention policy. *Id.* Andersen partners understood such "reminders" to be commands to destroy all damaging documents. *Id.* As Patricia Grutzmacher testified during the Andersen criminal trial, defendant

Bauer in a 10/23/01 meeting stated "that if he ever talked to us about getting rid of documents, it would always be along the lines of being in compliance with the firm's document-retention policy." 5/21/02 Trial Tr. at 3243:4-6. In accordance with Temple's directions, senior auditors in Chicago began deleting e-mail related to Enron, including messages regarding Carl Bass' objections to Enron's accounting. ¶965. Nancy Temple even insisted that partners delete e-mail they had retained to support their Enron work. *Id.*

After conferring with defendants Friedlieb, Dreyfus and others, Temple wrote the Enron audit team to suggest changes to memoranda that she, Stewart and other top Andersen officials were drafting to "add back" Carl Bass previously-omitted criticisms in order to create the impression that Andersen exercised appropriate diligence. To conceal her participation in the fabrication of documents, Nancy Temple ordered the audit partners to delete her name from the fictitious memoranda; they were supposed to represent work conclusions of Duncan and other Enron auditors. Temple also instructed them to delete their conclusions that Enron's soon to be released financial statements were misleading. Forty minutes later, Temple wrote to defendant Odom, director for the Gulf Coast Market Circle, instructing the Enron engagement team to "comply" with Andersen's documentation and retention policy. Odom forwarded the e-mail to Duncan. ¶966. Odom had previously told Andersen accountants, "If documents are destroyed and litigation is filed the next day, that's great. We've followed our own policy, and whatever there was that might have been of interest to somebody is gone and irretrievable." ¶965.

On 10/22/01, Enron management notified David Duncan and another auditor that a subpoena *duces tecum* from the SEC was imminent. The next day, Bauer and Duncan, lead partners on the Enron engagements, convened a meeting to stress the exigency of bringing the Enron files into "compliance." Notes from the meeting reveal that the SEC inquiry precipitated the document purge. Defendant Willard, a partner on the Enron engagement, also convened a staff meeting to ensure "compliance" with Andersen's document retention policy. Berardino knew of the destruction of Enron-related documents. ¶966.

Between 10/23 and 11/9/01, massive amounts of Enron-related documents were shredded. *Id.* Bauer has admitted to destroying Enron-related documents during this time period. Just 36 hours after Andersen Chicago and Nancy Temple directed the destruction of documents, Andersen's Houston shred room was flooded with more than 20 trunks of Enron-related documents, necessitating a special visit by Andersen's outside shredding company, Shred-It. Shredding occurred elsewhere too. On 10/23, Houston partners called the head of the London office, and soon the command to destroy was given. The same message was sent by voice mail to an auditor in Andersen's Portland, Oregon office, who confirmed the destruction of his Enron documents the next day. The shredding stopped only when Andersen was actually served, on 11/9, with the SEC subpoena it had been expecting for some time. ¶966.

According to the Justice Department, Andersen destroyed "tons" of documents related to its Enron audits and consulting engagements. On 3/14/02, a federal grand jury indicted Andersen on charges of obstructing justice for inducing its partners and employees to withhold records from regulatory proceedings and to alter, destroy and shred documents with the intent to impede the federal government's probe into Enron's collapse. ¶962. Nancy Temple and Tom Bauer have invoked their Fifth Amendment rights to questions about the document destruction. ¶68; 5/20/02 Trial Tr. at 2815:7-15. Duncan, Andersen's lead auditor on the Enron account, has pled guilty to obstruction of justice for destroying documents prejudicial to Andersen. Duncan testified at trial that he ordered documents destroyed to prevent plaintiffs' attorneys from obtaining them. 5/14/02 Trial Tr. at 1791.

IV. Standard of Review for Andersen's Motion to Dismiss

The Court must accept the facts alleged in the CC as true and construe the allegations in the light most favorable to plaintiffs. *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 406 (5th Cir. 2001). It may not adopt "its own interpretation" of events pled in the CC, nor may it give credence to "alternative" explanations, even ones the Court believes are "more plausible." *Oran v. Stafford*, 226 F.3d 275, 286 n.5 (3d Cir. 2000). Dismissal is improper "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

V. Plaintiffs Have Adequately Alleged Andersen's Violation of §10(b) and Rule 10b-5

A. Plaintiffs Have Pled Andersen's Fraud with Particularity

The PSLRA requires defrauded investors to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. §78u-4(b)(1). In *Zonagen*, 267 F.3d at 412, the Fifth Circuit declared that these requirements are the same as those the Circuit has traditionally applied in assessing securities fraud claims under Rule 9(b), which oblige plaintiffs "'to specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.'" *Accord In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 901 (S.D. Tex. 2001). The PSLRA also requires plaintiffs who plead on information and belief to "state with particularity all facts on which that belief is formed." 15 U.S.C. §78u-4(b)(1). But in the Fifth Circuit, plaintiffs are not compelled to "'allege "all" facts that may be "related" to their claims,' since 'such a requirement is impossible at the pleading stage, because, in nearly every securities fraud case, only the defendants know "all" the facts related to the alleged fraud.'" *ABC Arbitrage v. Tchuruk*, No. 01-40645, 2002 U.S. App. LEXIS 9112, at *44 (5th Cir. May 13, 2002) (quoting *In re NetSolve, Inc.*, 185 F. Supp. 2d 684, 696 n.10 (W.D. Tex. 2001)). Even with the heightened pleading standards of the PSLRA, the Fifth Circuit does "'not require the pleading of detailed evidentiary matter in securities litigation.'" *Id.* at *49.

Plaintiffs have complied with the PSLRA and Rule 9(b) by identifying Andersen's statements and the circumstances under which they were made, by providing specific, contemporaneous facts to explain why they were false and misleading, and by providing a description of the documentary evidence on which its allegations are based. *Id.* at *30-*32, *46. Plaintiffs specify what was said, who said it, and where and when it appeared. *See, e.g.,* ¶¶126, 134, 140-141, 144, 156, 164-165, 177, 196, 219, 221, 223, 246, 262, 281, 292, 295-297, 316, 328, 336, 899. And plaintiffs plead ample facts showing why Andersen's statements were false when made. *See, e.g.,* ¶¶155(a), (c)-(d), 214(a), (c)-(d), (j)-(k), 300(a), (c)-(d), (i)-(j), (o)-(p), 339(a), (c)-(d), (i)-(j), (n)-(p).

Andersen certified that Enron's 97-00 annual financial statements comported with GAAP and its audits of the Company complied with GAAS. ¶¶899, 903-904. Andersen's unqualified opinions were included in Enron's Form 10-Ks and incorporated – with Andersen's express consent – into the Registration Statements and Prospectuses Enron filed with the SEC. ¶¶126, 134, 141, 163-164, 221, 292, 336, 612, 899, 903-904. Enron's interim financials were included in SEC filings and press releases, which Andersen co-authored. ¶897. Andersen has since disavowed its audit opinions of Enron's financial statements, due to Enron's massive restatements, and has cautioned investors that its opinions "should not be relied upon." ¶956.

Plaintiffs detail the specific transactions that forced Enron to restate its 97-01 annual and interim financial statements and Andersen's connection to them. Plaintiffs explain how CFO Fastow devised Chewco in 11/97 to replace the limited partner in JEDI so Enron could avoid consolidating the SPE, and that Fastow appointed his subordinate Michael Kopper, a managing director of Enron's Global Equity Markets Group, to run Chewco because he believed Kopper's relationship with the SPE would not have to be disclosed in Enron's public filings. ¶¶436, 438. The CC details why Chewco, as originally structured, failed to qualify as an unconsolidated entity – Kopper controlled the SPE and Chewco had no unrelated equity investors – and states that Fastow, just weeks before Enron's 97 fiscal year ended, restructured Chewco's capital structure to make it appear to have an independent (3%) investor. ¶¶429-434, 437-438. On 12/12/97, Kopper transferred his ownership interest in Chewco to his domestic partner William Dodson to create the mis-impression that Kopper, and thus Enron, had no formal interest in Chewco. ¶438.

Plaintiffs explain why Chewco (and consequently JEDI) should have been consolidated with Enron. FASB Statements of Financial Accounting Standards Nos. 94 and 125 require the consolidation of majority-owned subsidiaries unless control rests with another. ¶¶431-433. Kopper and other senior Enron financial executives controlled Chewco. ¶¶435-439. Moreover, Enron guaranteed the $240 million Barclays loaned to Chewco, and JEDI, which was controlled by Enron, advanced Chewco $132 million. In essence, Enron was buying out the limited partner in JEDI (through Chewco) and gaining operational control through its executives who were the general partners of Chewco. ¶¶438-443.

Enron appears to have relied on EITF 90-15, a provision applicable to leasing transactions, to justify its accounting treatment of Chewco and JEDI. ¶433. Under Andersen's and Enron's interpretation of EITF 90-15, a majority owner of an SPE may not be required to consolidate it if an independent party, with at least 3% ownership interest at risk, controls the entity. *Id.* Even if applicable to the Chewco transaction, the controlling partners of Chewco ***never*** owned a 3% independent equity interest. ¶¶440, 946(c). Although Barclays loaned $11.4 million – 3% of Chewco's total capital – to Kopper and affiliated entities which controlled the SPE, Barclays demanded a $6.6 million reserve to secure the loan, which JEDI – in effect Enron – paid on 12/30/97. ¶¶439-440. Kopper's $125,000 contribution also was affiliated equity. By not requiring Enron to consolidate JEDI and Chewco, Andersen enabled Enron to understate its total debt by $711 million in 97, $561 million in 98, $685 million in 99, and $628 million in 00, and to avoid losses of $45 million in 97, $107 million in 98, $153 million in 99, and $91 million in 00. ¶447. Consequently, the CC "sufficiently alleges which portions of the financial statements were overstated ... and which portions were understated ..., such that [Andersen] can prepare a reasonable defense to the allegations." *In re First Merchants Acceptance Corp. Secs. Litig.*, Civ. No. 97-C-2715, 1998 U.S. Dist. LEXIS 17760, at *26-*27 (N.D. Ill. Nov. 2, 1998).

Plaintiffs' allegations of accounting fraud in the LJM transactions, including the Raptor vehicles, the Braveheart deal, Enron's dark-fiber swaps, and the $51 million of ignored adjustments in the 97 audit are pled with great specificity as well, *see* ¶¶448-495, 517, 520-532, 546-548, 941-944, 948-956, and easily meet the PSLRA's particularity requirements. *See Kinney v. Metro Global Media, Inc.*, 170 F. Supp. 2d 173, 179 (D.R.I. 2001); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 821 (N.D. Ill. 2000); *see also In re Leslie Fay Cos. Sec. Litig.*, 835 F. Supp. 167, 174 (S.D.N.Y. 1993) (identification of specific audit violations is sufficient under Rule 9(b)).

Andersen suggests that the CC is defective because it purportedly refers "to the partnership [in general] without identifying specific acts, omissions, or knowledge of particular partners or employees." Mot. at 11. But that level of particularity is not required, because in the Fifth Circuit, the PSLRA does "'not require the pleading of detailed evidentiary matter in securities litigation.'" *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *49. The reason is elementary: "[I]t is untenable to suggest that a plaintiff must, at the pleading stage, be able to identify each individual accountant or researcher who may have worked on a particular project. To do so would make the pleading standard virtually impossible to meet." *In re IKON Office Solutions, Inc.*, 66 F. Supp. 2d 622, 628 (E.D. Pa. 1999).

Moreover, contrary to Andersen's assertions, the CC details the actions of specific Andersen partners. Plaintiffs state that on 12/18/99, PSG partner Carl Bass wrote an e-mail to defendants Neuhausen and Stewart objecting to Enron's accounting for an SPE. ¶928. Two other e-mails from Bass to Stewart, sent 2/1 and 2/4/00, respectively, characterized Enron SPE transactions as "look[ing] like there is no substance." ¶929. In his 2/4 e-mail, Bass also disapproved of Enron's attempts to record revenue from the appreciation in value of capital stock the Company contributed to an SPE. *Id.* In addition, plaintiffs identify other Andersen partners – Bauer, Cash, and Duncan – who knew of Bass' opposition to Enron's fraudulent accounting. *Id.* The Fifth Circuit recently found less detailed allegations sufficient to meet the PSLRA's pleading requirements. *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *49, *54.

Plaintiffs provide even greater detail for other events. On 2/5/01, senior Andersen partners from the firm's Chicago headquarters, the Houston office, and the Gulf Coast Market convened to decide whether to retain Enron – the firm's second largest source of revenue – as a client. ¶¶906, 930. Plaintiffs name the meeting's attendees, including defendants Bauer, Bennett, Duncan, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson. ¶930. And the CC describes the substance of the meeting. *Id.* The partners discussed the LJM-related party transactions and their distortion of Enron's income statement and balance sheet, the conflict of interest posed by Fastow's dual position as Enron CFO and LJM fund manager, Enron's aggressive structuring of SPE transactions, and its mark-to-market accounting, which the partners characterized as mere "intelligent gambling." *Id.* Plaintiffs further explain why Andersen retained Enron as a client despite these significant red flags and known accounting irregularities: it was not "unforeseeable that fees [from Enron] could reach a $100 million per year amount considering the multi-disciplinary services being provided." ¶912.

Although not required, plaintiffs' CC abounds with specific allegations regarding the involvement of individual Andersen partners in the Enron fraud. ¶¶912-913, 926, 928-934, 938, 940, 942, 950, 962-966. "[I]t is untenable to suggest that a plaintiff must, at the pleading stage, be able to identify each individual accountant or researcher who may have worked on a particular project. To do so would make the pleading standard virtually impossible to meet." *IKON*, 66 F. Supp. 2d at 628. Nothing more should be required.

1. The Andersen Individual Defendants' Material Misrepresentations

a. The Andersen Individual Defendants' False Statements About Enron's 97 and 98 Financial Statements

In 3/98, Enron issued its 97 10-K, which reported net income of $105 million, shareholders' equity of $5.62 billion, total debt of $6.25 billion, and earnings per share ("EPS") of $0.16. ¶424. On 1/12/99, Enron filed a Registration Statement with the SEC to sell $1 billion of securities. ¶126. Andersen and the Andersen Individual Defendants consented to the incorporation of Enron's audited financial results for 97 in the Registration Statement. ¶¶126, 899. In 3/99, Enron issued its 98 Annual Report to Shareholders, which Andersen and the Andersen Individual Defendants co-authored. ¶136. The Annual Report included Enron's 97 and 98 financial statements, certified by Andersen and the Andersen Individual Defendants, which reported for 98 net income of $703 million, shareholders' equity of $7.05 billion, total debt of $7.36 billion, and EPS of $1.01. ¶¶140, 424. Enron's certified financial statements for 97 and 98 were published in its 98 Form 10-K, also filed in March – and incorporated into Enron's Registration Statements and Prospectuses. ¶¶141, 425, 617, 899. The Andersen Individual Defendants represented that Enron's 97-98 financial statements complied with GAAP and certified that their audit of the statements comported with GAAS. ¶¶141, 899, 903-904.

Enron's financial statements for 97 and 98 have now been restated, and Andersen and the Andersen Individual Defendants have admitted its audit opinions for these years "should not be relied upon." ¶956. GAAP only allows a restatement of prior financial statements ***based upon information "that existed at the time the financial statements were prepared.*** " APB Opinion No. 20 at ¶13; *see In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1026 (N.D. Ohio 2000)

("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). Here, Enron's certified financials were false and misleading when issued because Enron failed to consolidate JEDI and Chewco into its annual financial reports. ¶155(d). By omitting these entities from its financial statements, Enron understated its total debt by $711 million in 97 and $561 million in 98, and also overstated its income by $45 million in 97 and $107 million in 98. ¶447. Enron, moreover, inflated its 97 net earnings by $51 million – almost 48% of its net income and 10% of recurring income – by refusing to correct improper accounting adjustments that the Andersen Individual Defendants identified during their 97 audit. ¶¶155(a), 517.

b. The Andersen Individual Defendants' False Statements About Enron's 99 Financial Statements

On 3/31/00, Enron issued its 99 Annual Report to Shareholders, which contained its 99 financial statements Andersen and the Andersen Individual Defendants certified. ¶¶215, 219. Enron represented that it generated net income of $703 million in 98 and $893 million in 99, it earned EPS of $1.01 in 98 and $1.10 in 99, and total shareholders' equity exceeded $7 billion at year-end 98 and $9.5 billion at year-end 99. ¶219. These audited numbers were reported in Enron's 99 10-K, which contained Andersen and the Andersen Individual Defendants' purported clean opinions for 98 and 99. ¶¶221, 424. The 10-K represented that Enron's debt was $7.4 billion in 98 and $8.2 billion in 99. ¶424. Andersen and the Andersen Individual Defendants consented to the incorporation of Enron's audited financial statements into Enron's Registration Statements and Prospectuses. ¶¶425, 612, 899. Andersen and the Andersen Individual Defendants represented that Enron's financial statements for 98 and 99 complied with GAAP and they audited the statements in accordance with GAAS. ¶¶221, 899, 903-904.

But Enron has restated its certified financial statements for 98 and 99, and Andersen and the Andersen Individual Defendants have now admitted that their audited reports for these years "should not be relied upon." ¶956. Again, this reversal is an admission that Enron's financial statements were materially false when made. APB Opinion 20 at ¶13; *see Telxon*, 133 F. Supp. 2d at 1026 ("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). ¶¶384, 956. Enron, for instance, overstated its shareholders' equity by $448 million in 98 and $833 million in 99, and understated its debt by $561 million in 98 and $685 million in 99 due to its failure to consolidate JEDI and Chewco. ¶¶384, 447. Enron also improperly accounted for its transactions with LJM and LJM2 – SPEs controlled by CFO Fastow – by improperly recording income from these entities or using them to conceal debt. ¶448. LJM and LJM2 generated "earnings" for Enron of $229 million in the second half of 99, more than 50% of total earnings for the period. *Id.*

c. The Andersen Defendants' False Statements About Enron's 00 and 01 Financial Statements

In 3/01, Enron filed its 00 10-K with the SEC, which contained Enron's 99 and 00 annual financial statements certified by Andersen and the Andersen Individual Defendants and the creditors' clean opinion that Enron's financials complied with GAAP. ¶292. The 10-K reported total revenues of $40.2 billion for 99 and $100.8 billion for 00, net income of $893 million for 99 and $1.3 billion for 00, and EPS of $1.18 for 99 and $1.47 for 00. ¶424. The 10-K also reported total assets of $33.4 billion for 99 and $65.5 billion for 00, debt of $8.2 billion for 99 and $10.2 billion for 00, and shareholders' equity of $9.6 billion for 99 and $11.5 billion for 00. *Id.* These numbers were repeated in Enron's 00 Annual Report to Shareholders. ¶¶295-297. Andersen and the Andersen Individual Defendants certified that Enron's 99 and 00 financial statements complied with GAAP and they audited these statements in accordance with GAAS. ¶¶292, 899, 903.

On 4/17/01, Enron reported robust quarterly results, announcing an 18% increase in EPS to $0.47 for 1stQ 01, a remarkable 281% increase in revenues to $50.1 billion, and a 20% increase in net income to $406 million. ¶316. On 7/12/01, Enron again reported better than expected quarterly results. ¶328. Enron announced a 32% increase in EPS to $0.45 for 2ndQ 01 and a 40% increase in net income to $404 million. ¶328. Andersen co-authored these press releases. ¶897. On 7/13, Enron registered $1.9 billion in Zero Coupon Convertible Notes. ¶336. Andersen and the Andersen Individual Defendants gave express consent for their clean opinion of Enron's 00 annual financial statement to be included in this Registration Statement as well as the offering Prospectus, dated 7/18/01. ¶899.

These statements were materially false when made, as evidenced by Enron's restatement and Andersen's admission that its audit report for Enron's 00 annual finance statement "should not be relied upon." ¶956. By failing to consolidate JEDI's and Chewco's financial statements into its own, Enron misrepresented its income by $153 million in 99 and $91 million in 00 and understated its debt by $685 million in 99 and $628 million in 00. ¶¶339(a), (d), 447. Enron, moreover, was concealing almost a billion dollars of debt through bogus transactions with the Raptor SPEs and misaccounting for the Raptor equity transactions in violation of "basic" accounting principles. ¶¶339(c), 462, 951-952. Further, the Company was inflating the anemic revenues it was generating from its Broadband operations, distorting its financial statements by transacting hundreds of millions of dollars of fraudulent dark-fiber swaps and by recognizing more than $110 million in fictitious revenue from its Blockbuster joint venture. ¶¶339(i)-(j), (o), 521, 531.

Plaintiffs have pleaded and are pursuing theories of recovery against Andersen that are well-grounded in the ***express language*** of §10(b) of the 1934 Act which states:

> Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly ....
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... ***any manipulative or deceptive device or contrivance*** in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[10]

15 U.S.C. §78j(b). Rule 10b-5 promulgated by the SEC flows directly from the language of §10(b) itself and provides:

> §240.10b-5 Employment of manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

[10] Note that §10(b) itself does not expressly prohibit untrue statements of material facts or material omissions. This prohibition, like the prohibition against fraudulent schemes and fraudulent courses of business, is in Rule 10b-5.

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Not only does Rule 10b-5 forbid the making of "any untrue statement of a material fact," it also provides for scheme liability. Scheme liability is authorized by the text of §10(b). According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud.***" In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court referred to the dictionary definitions of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" *Id.* at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***a scheme, plan, or artifice.***'" *Id.* (quoting *Webster's International Dictionary* (2d ed. 1934)); *see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Clearly, "scheme" is encompassed in the broad language of §10(b).

Thus Rule 10b-5 – adopted by the SEC to implement §10(b) – makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***," "***[t]o make any untrue statement[s]***," or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest, Ltd. v. Kimmons*, 228 F.3d 399, 407 (5th Cir. 2000).

Prior to the Supreme Court's endorsement of the presumption of reliance based on the fraud-on-the-market theory for both misrepresentations and omissions in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Fifth Circuit had held that the theory applied ***only*** to omission cases and not misrepresentation cases. Thus, in some instances, securities plaintiffs sought recovery under subsection (1) and (3) of Rule 10b-5 alleging ***fraudulent scheme and course of business liability***. The Fifth Circuit expressly recognized the validity of these theories of recovery.

For instance, in *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), plaintiff sued under §10(b) and Rule 10b-5, claiming that the stock of Docutel was inflated due to false financial reports. According to plaintiff, Olivetti (which owned 46% of Docutel and controlled it), forced Docutel to buy Olivetti's excess inventories at inflated prices so Olivetti could hide losses it was suffering. Docutel concealed this financial manipulation for some time but, when its auditors discovered the financial manipulation and forced a large inventory writedown, huge losses were disclosed and Docutel stock fell. The district court dismissed the complaint against Olivetti and Docutel because plaintiff failed to allege reliance on any of the false statements in Docutel's SEC filings, etc.

> But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). ***We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel....***
>
> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the market place; ***if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3).*** Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).

Id. at 363-64. *Accord Heller v. Am. Indus. Props. Reit*, Civ. No. SA-97-CA-1315-EP, 1998 U.S. Dist. LEXIS 23286, at *14 (W.D. Tex. Sept. 25, 1998) ("The first and third subsections, on the other hand, ***create a duty not to engage in a fraudulent scheme or course of conduct*** ....").

The Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading offering circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that offering circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme."*** *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981).

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale***, and required the skills and active participation of lawyers, bankers and accountants to help design, implement, conceal and falsely account for the deceptive acts and devices, manipulative contrivances and artifices they and Enron were using to falsify Enron's reported profits and financial condition and to continue its fraudulent course of business.

The notion that *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), issued a broad edict that lawyers, bankers and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability ***does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser ... relies may be liable as a primary violator under 10b-5 .... In any complex securities fraud, moreover, there are likely to be multiple violators*** ...." *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme***." *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *accord SEC v. First Jersey Sec. Litig.*, 101 F.3d 1450, 1471 (2d Cir. 1996); *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 699-70 (C.D. Cal. 1994).

In *Central Bank*, a public building authority issued bonds to finance public improvements. Central Bank served as indenture trustee. The bonds were secured by liens covering property. The bond covenants required that the liened land be worth at least 160% of the principal amount of the bonds. Central Bank got a letter expressing fear that property values were declining and that perhaps the 160% value test was no longer met. The bank did nothing. Soon afterwards, the public building authority defaulted on the bonds. The bonds were not publicly traded. Central Bank, which had no commercial lending relationship with the municipal entity involved and which was not an investment bank, issued no analysts' reports about the issuer of the municipal bonds and thus made no statement and took no affirmative act that could have affected the trading price of the municipal bonds in issue. Clearly, this is a significantly different fact pattern from the Enron situation.

The *Central Bank* majority noted that their reasoning was "confirmed" by the fact that if they accepted the plaintiffs' aiding and abetting argument it would impose §10(b) and Rule 10b-5 liability "when at least one element critical for recovery" was absent, *i.e.*, reliance (511 U.S. at 180) (citing *Basic* (the Supreme Court's "***fraud-on-the-market***" decision), for the proposition that a plaintiff must show reliance to recover under 10b-5. "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements ***or actions***." *Id.* at 180. The Court found that allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery as mandated by our earlier cases." *Id.* However, in this case, the alleged scheme and fraudulent course of business ***inflated*** the prices of Enron's ***publicly traded*** securities. ¶¶74, 418-424. Thus, the reliance element is not "***absent***" and the Supreme Court's prior decision in *Basic* is not circumvented – it is satisfied.

Central Bank denied recovery to victims of an alleged securities fraud who pleaded only one theory of recovery against the defendant bank – secondary liability dubbed "aiding and abetting." *Id.* at 191. However, the words aiding and abetting do not appear in §10(b) or Rule 10b-5. The Court said "***[T]he text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation ... that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as plaintiffs do here, plead or pursue recovery under the theory that Andersen made false and misleading statements in audit opinions, Registration Statements or other documents issued to the public ***or*** employ acts and manipulative devices to deceive or engage in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "concede that Central Bank did not commit a manipulative or deceptive ***act*** within the meaning of §10(b)." *Id.* at 191. Thus, because the *Central Bank* plaintiffs pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost***.

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless it made misleading statements because the Court rejected that argument in *United States v. O'Hagan*, 521 U.S. 642 (1997). The Eighth Circuit had held that, under *Central Bank*, "§10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely." *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak. *Id.* Because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules, this reaches "any deceptive device," whether or not the defendant spoke. *O'Hagan*, 511 U.S. at 650-51. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10b/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9.

This Court has stated, citing *O'Hagan*, that: "***A defendant need not have made a false or misleading statement to be liable.***" *In re Landry's Seafood Restaurants Inc., Sec. Litig.*, No. H-99-1948, slip op. at 9 n.12 (S.D. Tex. Feb. 20, 2001); *In re Waste Mgmt. Inc. Sec. Litig.*, Civ. No. H-99-2183, slip op. at 75 (S.D. Tex. Aug. 16, 2001);[11] *BMC*, 183 F. Supp. 2d at 869. But here, of course, Andersen issued false and misleading audit opinions.

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *SEC v. Zandford*, __ U.S. __, No. 01-147, 2002 U.S. LEXIS 4023 (June 3, 2002). In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case, *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.

[11] Due to the length of the opinions, and the fact that this Court has access to them, they are not being attached to this brief.

- ***"[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).*** *Id.* at *13.[12]
- Allegations that defendant "'***engaged in a fraudulent scheme***'" or "'***course of business that operated as a fraud or deceit***'" stated a §10(b) claim. *Id.* at *13, *14-*17.

Central Bank clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central Bank* is ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad***. Also the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry...." Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be construed broadly to effectuate the statutory policy affording extensive protection to the investing public. *See Tcherepnin*, 389 U.S. at 336 ... *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent ***and speculative schemes***).

Meason v. Bank of Miami, 652 F.2d 542, 549 (5th Cir. 1981). "The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively." *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980).[13]

---

12 To the extent *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001), seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

13 The broad purposes of §10(b)'s prohibition of securities fraud and the Supreme Court's longstanding recognition of such broad purposes also support conspiracy and scheme liability. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("[n]o doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"); *Affiliated Ute Citizens*, 406 U.S. at 151 (proscriptions of §10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'") (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *Capital Gains Research*, 375 U.S. at 186 (§10(b) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"); *Superintendent of Ins.*, 404 U.S. at 11 n.7 ("'[We do not] think it sound to dismiss a complaint merely because the

Andersen's authority is unavailing. First, it conflicts with the Court's ruling in *BMC* that "'[p]rimary liability may be imposed "not only on persons who made the fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration."'" 183 F. Supp. 2d at 905. "A defendant need not have made a false or misleading statement to be liable." *Id.* at 869. Moreover, *Shapiro* and *Vosgerichian* are distinguishing on the facts. In *Shapiro*, the plaintiff alleged that the defendant accounting firm assisted and participated in concealing the principal's criminal background. *Shapiro v. Cantor*, 123 F.3d 717, 721 (2d Cir. 1997). In *Vosgerichian*, the plaintiffs did not allege, as Andersen claims, that the defendant accounting firm participated in structuring deceptive transactions as is the case here. The accounting firm merely advised on the accounting treatment of a transaction the court found to be immaterial. *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1377 (E.D. Pa. 1994). And a third case simply confuses scheme with conspiracy liability. *In re Hi/fn, Inc. Sec. Litig.*, Civ. No. C-99-4531-SI, 2000 U.S. Dist. LEXIS 11631, at *35 (N.D. Cal. Aug. 9, 2000).

2. Andersen Is Liable for Enron's False Statements Because it Played a "Significant Role" in Drafting Them

Andersen is not only liable for its false audit opinions, but also for the misrepresentations in Enron's interim financial reports and press releases. Andersen participated substantially in the drafting of Enron's deceptive quarterly reports and press releases. ¶897. Chief Risk Officer Buy put it: "'Andersen's penetration or involvement in the company is probably different than anything I've experienced .... They are kind of everywhere and in everything.... [Andersen] actually participates in what we do.'" Lanthe Dugan et al., "On Camera, People at Andersen, Enron Tell How Close They Were." *Wall St. J.*, 4/15/02. There is no question that Andersen reviewed and edited Enron's press releases regarding quarterly results. Andersen lawyer Nancy Temple ordered Enron

---

alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that §10 (b) and Rule 10b-5 prohibit ***all*** fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'") (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)) (emphasis in original).

engagement partners to delete their conclusions that an imminent Enron press release was false. ¶966.

Andersen cannot use its role in the fraudulent financial statements and press releases as a shield. As noted by this Court in *BMC*, 183 F. Supp. 2d at 905, "'[p]rimary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration."'" (quoting *First Jersey*, 101 F.3d at 1471). "[S]ubstantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements." *Howard v. Everex Sys.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000). *See also ZZZZ Best*, 864 F. Supp. 960.

Several Texas district courts have adopted the substantial-participation test. Judge Sparks has written that primary liability would attach to purported non-speaking defendants "if a plaintiff explains how the defendant ratified or helped prepare another defendant's misleading public statement." *NetSolve,* 185 F. Supp. 2d at 699. Judge Folsom has ruled that an engineering firm can be held liable for false statements in reports that it "played a significant role in" preparing. *McNamara v. Bre-X Minerals, Ltd.*, Civ. No. 5:97-CV-159, 2001 U.S. Dist. LEXIS 4571, at *132 (E.D. Tex. Mar. 30, 2001). And Judge Kent has ruled: "While Defendants are correct in asserting that there is no aider or abettor liability under 10b-5, *see Central Bank* ..., it is not factually clear that American Century did not have a more substantial role in the alleged misrepresentations." *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914, 921 (S.D. Tex. 1998). Moreover, under analogous circumstances, this Court held that "a company may be liable for allegedly false and misleading statements in analyst's reports if it is sufficiently involved in preparation of those reports." *BMC*, 183 F. Supp. 2d at 872 n.21. The clear weight of authority from this Circuit holds that Andersen can be primarily liable for substantially participating in drafting of Enron's false statements.

Indeed, the Ninth Circuit has held that an accounting firm may be found primarily liable under §10(b) for its "significant role" in preparing the misrepresentations of its client. *In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1995). Plaintiffs accused the accounting firm of violating §10(b) by participating in the drafting of two deceptive letters that its clients, not the firm, mailed to the SEC. *Id.* at 628. The accounting firm's involvement with the letters included "'extensive review and discussions'" with the corporation and a "significant role in drafting and editing" them. *Id.* at 628 n.3. Based on the Supreme Court's decision in *Central Bank*, the district court dismissed the plaintiffs' claims, but the Ninth Circuit reversed. "[P]laintiffs' complaint clearly alleges," wrote the circuit court, "that [the accounting firm] is primarily liable under section 10(b) for the SEC letters" and evidence that it played a "significant role ... sufficient to sustain a primary cause of action under section 10(b)." *Id.*

Likewise, a California district court concluded that primary liability under §10(b) existed against defendants who were "intricately involved" in the drafting of other defendants' misrepresentations. *ZZZZ Best*, 864 F. Supp. at 970. Defendant Ernst & Young argued, as Andersen does here, that "all the financial reports, press releases, supplements to the prospectus, etc., that were released to the public by Z Best and attributable only to Z Best or others, even if reviewed, edited or approved by E&Y, are not actionable against E&Y as violations of Section 10(b)/Rule 10b-5." *Id.* at 966. The trial court disagreed and found Ernst & Young could be held primarily liable under §10(b) and Rule 10b-5 where it was "intricately involved" in the creation of the deceptive statements. *Id.* at 970.

Andersen, ignoring Fifth Circuit authority, urges the Court to find it cannot be held liable for the misrepresentations in Enron's press releases and quarterly reports simply because its authorship is not ascribed in the documents. In essence Andersen wants the Court to fashion a rule of law that allows accounting firms to "avoid liability for misrepresentations they created, as long as their identities were not made known to the public." SEC Amicus in *Klein v. Boyd*, No. 97-1143, at 10 (3d Cir. 1998).

Andersen relies on a line of decisions that restricts liability under §10(b) and Rule 10b-5 to "publicly attributable" statements. *See Ziemba*, 256 F.3d at 1205; *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998). These holdings, however, conflict with *Central Bank*, which held that a "private plaintiff may not maintain an aiding and abetting suit under §10(b)," but emphasized that this "does not mean that secondary actors in the securities markets are always free from liability under the securities Acts." 511 U.S. at 191. "In any complex securities fraud," the Court added, "there are likely to be multiple violators" of §10(b) and Rule 10b-5. *Id.* And "[a]ny person or entity, including a lawyer, accountant, or bank, who ... makes a material misstatement ... on which a purchaser ... relies may be liable as a primary violator under 10b-5 ...." *Id.* Andersen's authority misapprehends this last sentence – nothing requires reliance on the person who makes the misrepresentation. *Ziemba*, 256 F.3d at 1204-06; *Wright*, 152 F.3d at 175. Under any plain reading of *Central Bank*, a purchaser need only establish that he relied on "a material misstatement." 511 U.S. at 191. Indeed, courts "presume[ ] that the plaintiff relied not on the defendants' fraudulent statements directly, ***but on the market's reflection of those fraudulent statements in the value of the stock***." *Fine v American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990). This Court has agreed that nowhere in *Central Bank* did the Supreme Court overturn the fraud-on-the-market theory. *BMC*, 183 F. Supp. 2d at 905 n.46 (applying fraud-on-the-market theory). And Andersen's reliance on *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996), is also misguided because it simply requires a showing that the defendant "knew or should have known that his representation would be communicated to investors." *Id.* at 1226. A document drafted for express release to the press or for filing with the SEC – as Andersen did for Enron – satisfies this requirement.

3. Andersen Had a Duty to Correct its False Opinions

Professional standards require an auditor who discovers, even after the audit concludes, that his audit opinion was false or misleading to take appropriate steps "to prevent future reliance on his report." Codification of Statements on Auditing AU §561.06, Statement on Auditing Standards ("SAS") No. 1 (American Institute of Certified Public Accountants). Courts also impose a duty on accountants "'to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying.'" *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986); *see United States v. Natelli*, 527 F.2d 311, 319 (2d Cir. 1975). The Fifth Circuit has ruled "that, at least facially, it appears that defendants have a duty under Rule 10b-5 to correct statements if those statements have become materially misleading in light of subsequent events." *Rubinstein v. Collins*, 20 F.3d 160, 170 n.41 (5th Cir. 1994). The reasoning is rudimentary: "'The importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted.'" *Rudolph*, 800 F.2d at 1044. "Where financial statements have been certified and released to the public, courts have imposed a continuous duty to disclose after-acquired information which casts doubt on the reliability of the certified figures with respect to the period covered by the audit." *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 549 (S.D.N.Y. 1977) (original emphasis omitted). The PSLRA further requires auditors to notify the audit committee or the board of instances of accounting fraud. 15 U.S.C. §78j-l(b)(1)-(2). If the audit committee and board refuse to take remedial action to rectify the fraud, the auditor must resign within one day and notify the SEC. 15 U.S.C. §78j-l(b)(3)-(4).

The 2/5/01 memorandum written after a conference call with senior Andersen partners shows they were aware of Enron's dubious accounting treatment for the SPEs, knew Enron was distorting its balance sheet with the LJM off balance transactions, and they found Enron's use of mark-to-market accounting to be abusive – indeed mere "intelligent gambling." ¶930. These facts show Andersen knew its prior audit opinions were false and obliged it to disclose this information. *Rudolph*, 800 F.2d at 1044. Not only did Andersen remain silent, it even consented for its 00 clean audit opinion be incorporated into Enron's Registration Statement and Prospectus for $1.9 billion of Zero Coupon Convertible Notes sold in 7/01. ¶¶336, 899. "In connection with a registration statement, an accountant is under an additional obligation to conduct a reasonable inquiry, but not an audit, to discover whether events subsequent to the audit period up to the effective date of the registration require disclosure in order to maintain the integrity of the portrayal." *Ingenito*, 441 F. Supp. at 549. There is no evidence Andersen met this continuing obligation.

Nor did Andersen make a public disclosure or qualify its opinions after Sherron Watkins warned the firm, on 8/20/01, about accounting irregularities at Enron. ¶¶933-934. Watkins explained to a former colleague, who was a senior Houston partner, that Enron's financial disclosures regarding the LJM entities, SPEs controlled by Fastow – as well as by Enron's Chairman – were perplexing and incomplete. *Id.* She disclosed that Enron was omitting its capital-stock contributions to the LJM partnerships from its books and revealed that partnership equity was distributed to LJM investors, including Fastow, soon after the SPE was formed. *Id.* Andersen never disclosed these facts to the investing public. The firm merely tried to conceal its involvement in the fraud by ordering Enron documents destroyed. ¶¶962-966. Therefore, Andersen is liable under Rule 10b-5 for its silence. *Rudolph*, 800 F.2d at 1044. And it "is the jury's role to determine the exact dates on which [Andersen's] failure to correct its previous [audit opinions] became severely reckless." *Bre-X*, 2001 U.S. Dist. LEXIS 4571, at *168-*69.

B. Plaintiffs Have More than Adequately Alleged Andersen's Scienter

1. Standard

In this Circuit, plaintiffs "must plead specific facts constituting strong circumstantial evidence of conscious misbehavior or recklessness and motive and opportunity may be considered as a factor in determining whether a strong inference has been raised." *Abrams v. Baker Hughes Inc.*, Civ. No. 01-20514, 2002 U.S. App. LEXIS 9565, at *7 (5th Cir. May 21, 2002). And the Court should "consider whether all facts and circumstances 'taken together' are sufficient to support the necessary strong inference of scienter on the part of the plaintiffs." *Id.* at *12. Despite Andersen's attempts to isolate them, plaintiffs' scienter allegations are so strong that any one suffices. Taken together, as they must be, they present overwhelming evidence of Andersen's scienter.

2. Andersen Knowingly Committed Fraud

a. Andersen Knew Enron Improperly Hid Debt and Inflated Income Through Use of Captive SPEs

Andersen participated in all areas of Enron's SPE transactions, including structuring and reviewing the details of the deals. ¶942. For advice it rendered on the LJM entities and Chewco, Andersen billed $5.7 million, a sum that corresponds to an incredible ***28,000 hours*** of consulting and accounting work based on an average hourly rate of $200. *Id.* Andersen billed $80,000 for the month when the Chewco transaction was structured. ¶946. In 00 alone Andersen billed Enron at least $335,000 for its work on the Raptor transactions. ¶951. Documents produced to Congressional investigators evidence Andersen's ubiquitous presence in the structuring of Enron's SPEs. As reported by Audit Committee Chairman Robert Jaedicke, Andersen notified the Audit Committee during a 10/99 meeting that it "had spent considerable time during the third quarter reviewing a joint venture [Enron] was forming to assist in monitoring investments." Ex. 14. As reported by Norman

Blake, Andersen "spent considerable time analyzing the Talon [Raptor I] structure and the governance structure of LJM2." Ex. 13.

The accounting decisions relating to the captive SPEs were made at the highest levels of Andersen. ¶942. Enron consulted not only with Houston partners Bass, Bauer, Cash and Duncan, but also with Andersen's National Office Group and the Professional Standards Group – PSG – in Chicago. *Id.* Andersen assured Enron that its partners in Chicago were perusing the SPE transactions. Ex. 14. Enron's internal policies regarding whether certain SPEs should be consolidated, moreover, were driven by Andersen. ¶942. And whenever a question arose about how to structure a deal, Duncan was consulted, who then conferred with Andersen's headquarters. *Id.* It is through "[this] lens ... which [Andersen's] specific GAAS and GAAP violations must be viewed." *In re MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 653 (E.D. Va. 2000).

(1) Andersen Knew the Chewco and JEDI SPEs Were Fraudulent

Significant red flags surrounded Chewco's creation, which raised serious questions about the legitimacy of the entity. ¶946. Andersen knew that Chewco's general partners were senior financial employees at Enron. ¶946(a). Under AU §334, Andersen was required to confirm the transaction was genuine and determine if the Chewco deal received approval from Enron's board or senior officers. ¶943. Minutes from the 11/5/97 Enron Executive Committee meeting also revealed that Enron itself had guaranteed a bridge loan so Chewco could acquire the limited partner's interest in JEDI. Ex. 21. These facts required Andersen to scrutinize the nonconsolidation of Chewco and JEDI. *See* ¶943. Failing in this duty, Andersen's "'egregious refusal to see the obvious, or to investigate the doubtful'" raises a strong inference of scienter. *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314, 334 (S.D.N.Y. 2001); *see Kinney*, 170 F. Supp. 2d at 180 (auditor's "failure to 'investigate the doubtful' gives rise to a strong inference of scienter"); *Bre-X*, 2001 U.S. Dist. LEXIS 4571, at *141 ("The methods to demonstrate extreme departure from the standards of ordinary care may include ... an 'egregious refusal to see the obvious, or to investigate the doubtful.'"). Indeed, as one court observed:

> Because BDO was immersed in Leslie Fay's operations while performing its audit, and because the "red flags" would be clearly evident to an auditor performing its

> duties, one could reasonably conclude that BDO must have noticed the "red flags," ***but deliberately chose to disregard them to avoid antagonizing Leslie Fay*** ....

Leslie Fay, 871 F. Supp. at 699.

Andersen knew that Enron CFO Fastow – through Enron executive Kopper, Fastow's agent – controlled Chewco. Consequently, FASB 94 required Enron to consolidate Chewco (and JEDI) into its financial statements. ¶¶430-432, 946(a). Even applying the purported 3% rule of EITF 90-15, Andersen knew Enron's accounting for Chewco was fraudulent. EITF 90-15 requires, at a minimum, an independent, at risk equity contribution of 3% by an independent party. *See* ¶439. Although Barclays loaned Chewco's general partners $11.4 million dollars for the 3% stake, Barclays required the partners to establish a reserve account of $6.6 million to collateralize the loans which JEDI – in truth Enron and ***not*** the Chewco partners – funded. *Id.* Chewco's general partners thus "contributed" a mere 1.5% of the total capital of the SPE. *See id.* Andersen knew this, for it received copies of the documents establishing the reserve. ¶¶439, 946(b). According to the Powers Report, workpapers for the Chewco transaction reveal that Andersen was aware of a distribution from JEDI. *See* Powers Report at 53. As a consequence, Enron's fraudulent treatment of Chewco was "'so obvious that [Andersen] must have been aware of it.'" *Zonagen*, 267 F.3d at 408; *accord BMC*, 183 F. Supp. 2d at 867 n.18.

Andersen also knew Enron improperly recorded income from the appreciation of its stock. ¶923. This is confirmed by the Powers Report, which states: "Andersen's workpapers for the first quarter of 2000 indicates that Enron recorded $126 million in Enron stock appreciation during that quarter," for Enron stock held by JEDI. Powers Report at 59. Andersen did not require Enron to reverse this income, or an additional $405 million of improperly recorded income, until the end of the Class Period. ¶¶923, 947.

Andersen contends that plaintiffs have failed to plead when it received information about the Chewco reserve, but the CC makes clear that Andersen received the documentation during its examination of the deal at the end of 97. ¶946. Andersen billed Enron $80,000 in late-97 for its work structuring the Chewco deal. ¶946. Given the significance of the transaction, it is reasonable to infer Andersen read all the documents Enron considered sufficiently important to provide. ¶¶435-

39. At a minimum, plaintiffs allege a "'conscious purpose to avoid learning the truthfulness of a statement [, which] is an extreme departure from the standards of ordinary care.'" *Fine*, 919 F.2d at 297. And as discussed above, workpapers reveal Andersen knew of the JEDI distribution used to fund the reserve.

By comparison, in *Reiger v. PriceWaterhouseCoopers LLP*, unlike here, the plaintiff simply contended "that because Price Waterhouse had access to Altris' contract files, it must have known of the GAAP violations." 117 F. Supp. 2d 1003, 1101 (S.D. Cal. 2000), *aff'd sub nom., DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002). Likewise, in *Schiller v. Physicians Resource Group, Inc.*, Judge Lindsay threw out a complaint because the plaintiffs "generally base[d] Andersen's knowledge on its participation in 'audits and reviews,' 'consulting services,' and 'its review of [PRG's] prospectuses and other SEC filings.'" Civ. No. 3:97-CV-3158-L, 2002 WL 318441, at *15 (N.D. Tex. Feb. 26, 2002). And in *In re IKON Office Solutions, Inc. Sec. Litig.*, the court found no evidence – at the summary judgment stage of the proceedings – that the defendant auditor knew of a memorandum directing the company's employees to commit fraud. 277 F.3d 658, 671 n.13 (3d Cir. 2002). Again, at this stage, plaintiffs need not identify who at Andersen knew of the red flags. *See IKON*, 66 F. Supp. 2d at 628.

(2) Andersen Knew the LJM Transactions Were Fraudulent

Andersen and partners Cash, Duncan, Neuhausen, and Stewart knew that Enron's transactions with the LJM partnerships served no economic purpose other than concealing debt and losses and enriching Enron executives. ¶¶948, 950. Specifically, they knew that Fastow and other executives controlled LJM and LJM2 and reaped tens of millions of dollars in management fees and partnership profits. ¶¶944, 948, 949(a), (d), 950. The private-placement memorandum for LJM2, which Andersen read in the course of performing tens of thousands of hours of work on the LJM partnerships, revealed that Enron executives Fastow, Kopper and Glisan owned and controlled LJM2's general partner, and that LJM2 was managed on a daily basis by Enron executives. ¶¶948-949.

The private-placement memorandum disclosed that Enron retained significant economic and operating interests in the LJM2 investments and trumpeted the prospects of superior returns due to the inside information its general partners could obtain from their positions with Enron. ¶¶948, 950. The returns to the LJM2 investors were huge – as much as 2,500% on one deal and 51% overall in the first year of the partnership. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02. Defendant Skilling, Enron's CEO and President, recently told investigators such gargantuan returns were possible only because of fraud. *Id.* In addition, the private-placement memorandum revealed that Enron was carrying at least $17 billion in assets and associated liabilities off its balance sheet – an astounding 33% of its total assets. ¶¶948, 949(b). Andersen and its partners should have thoroughly investigated the business purpose and substantive reasons for accounting for so much of Enron's total assets on an "off-balance sheet" basis. ¶949(b). There is no evidence that the requisite investigation was conducted or, if done, was acted on.

Assets "sold" to LJM2 were quickly repurchased by Enron at a substantial increase in price, though the value of the assets had often declined. ¶949(e). Enron, for example, repurchased the Nowa Sarzyna Power Plant within four months. ¶471. Enron dumped several underperforming investments, such as CLOs, from Enron North America, the Nowa Sarzyna plant, and MEGS, into LJM2 within the last 10 days of the 99 reporting year. ¶¶469-472. The "fortuity" of these "sales" for Enron raised serious questions about the legitimacy of the transactions. *See Telxon*, 133 F. Supp. 2d at 1031.

By early 99, moreover, Andersen itself was characterizing Enron as high risk in its "Selected observations – 1998 Financial Reporting," an opinion presented by partners Bauer, Duncan and Goddard to the Enron Audit Committee. Ex. 17. Andersen would have the Court, as it did, ignore the obvious, but "[a]llegations of obvious 'red flags' or warning signs that financial statements are misstated [, such as these,] ... can give rise to a strong inference of fraudulent intent." *Chu*, 100 F. Supp. 2d at 824; *Health Mgmt.*, 970 F. Supp. at 203 (BDO's six-year audit engagement, the magnitude of the misstatements and "allegations of BDO's ignorance of all these 'red flags' present evidence of its fraudulent intent.").

Plaintiffs provide direct evidence that Andersen knew Enron was manipulating its financial statements through use of SPEs. During the 2/7/99 Enron Audit Committee meeting, Engagement Team Leader Duncan – again in the presence of Bauer and Goddard – characterized Enron's SPEs as "push[ing] limits" and having "a high 'others could have a different view' risk profile." Ex. 18. By 12/99, PSG partner Bass had written Neuhausen and Stewart to express his opposition to Enron's accounting for a certain SPE. ¶928. One month before Andersen certified Enron's 99 financial statements, Bass, in a 2/00 e-mail to Neuhausen and Stewart, described several Enron transactions involving an SPE – "this whole deal looks like there is no substance," which in accounting jargon means that the transactions were bogus. ¶929; *see* Codification of Statements on Auditing Standards, AU§334.02 ("the auditor should be aware that the ***substance*** of a particular transaction could be significantly different from its form and that the ***financial statements should recognize*** the ***substance*** of particular transactions rather than merely their legal form"). Three days later, Bass criticized another Enron SPE in an e-mail to Stewart for having no real substance and disapproved a transaction in which Enron was set to gain from the appreciation of the capital stock it contributed to the SPE. ¶929. Enron Audit Partners Bauer, Cash, and Duncan were privy to these conclusions. *Id.*

Three weeks before Andersen released its clean opinion for Enron's 00 financial statements (issued on 2/23/01), senior partners from the Andersen Chicago and Houston offices met to discuss Enron's serious accounting improprieties. ¶¶903, 917, 930. On 2/5/01, partners Bauer, Bennett, Duncan, Goddard, Goolsby, Jones, Kutsenda, Lowther, Odom, Stewart and Swanson met via teleconference to determine whether to retain Enron as a client. ¶930. A follow-up memo from this meeting reveals that the partners identified and discussed numerous irregularities in Enron's accounting; they questioned Enron's aggressive structuring of deals as well as the propriety of the LJM transactions and the deceptive effect they had on Enron's income statement; they discussed Fastow's conflict of interest as Enron CFO and LJM fund manager; and they expressed concern over Enron's utter dependence on its current credit rating to maintain solvency. *Id.* Nonetheless, Andersen and its partners agreed to issue a clean audit opinion a few weeks later – in the face of the obvious red flags – because of Enron's potential to grow into a $100 million a year client. ¶¶912,

931. These allegations are more than sufficient to plead a strong inference of scienter. *Zonagen*, 267 F.3d at 408; *see Baker Hughes*, 2002 U.S. App. LEXIS 9565, at *19 (finding scienter where "plaintiffs ... point[ ] to ... particular reports or information – available to defendants before the announced financial restatements – that are contrary to the restatements"); *Bovee v. Coopers & Lybrand C.P.A.*, 272 F.3d 356, 362 (6th Cir. 2001) (finding that "specific allegations that [the auditor's] own internal assessments of [the company] showed [it] to have knowledge of the risk that [the company] was misleading [i]t" may support a strong inference of scienter); *Fine*, 919 F.2d at 297 (denying summary judgment where auditor admitted in work papers "that their 'audit team could not accept ASK's position that the existing reserve was adequate'" but stated in public it was "'unable to determine the adequacy of the provision for uncollectible accounts'").

Andersen suggests that the 2/00 e-mail from PSG partner Bass merely demonstrates a difference of opinion. If true, Andersen would never have removed Bass from his oversight position. ¶913. Nor would Causey have pressured senior Andersen management in Chicago, including Chairman Berardino, to remove Bass from the Enron account. *Id.* Indeed, Causey insisted that Andersen replace Bass because he was too "rule-oriented" and "wasn't very flexible at times in some of the accounting matters." 5/9/02 Trial Tr. at 1115:8, 11-12. Moreover, as part of her effort to conceal Andersen's active participation in the Enron fraud, Andersen lawyer Nancy Temple ordered e-mail relating to Bass' disagreements with Enron's accounting practices to be deleted. ¶965. These facts suggest far more than a "debate among auditors." Mot. at 25. In any event, the task of resolving contrary accounts is reserved for the jury. *See Haack v. Max Internet Communs., Inc.*, Civ. No. 3:00-CV-1662-G, 2002 U.S. Dist. LEXIS 5652, at *25 (N.D. Tex. Apr. 2, 2002) ("the Court will not entertain this argument" at the pleading stage "because it concerns a factual dispute").

Andersen also urges the Court to read the memorandum memorializing the 2/5/01 should-we-retain-the-client-conference call as exonerating Andersen. Mot. at 18. The memorandum reveals that Andersen addressed the substantial accounting errors at Enron but decided to ignore them in order to keep a client which senior management believed could generate $100 million in fees. ¶¶912, 930. The Court cannot accept Andersen's "alternative explanation," even if found "more reasonable." *Oran*, 226 F.3d at 286 n.5. Finally, Andersen half-heartedly argues that the LJM allegations are vague. But plaintiffs not only plead exact dates of meetings and e-mail evidencing Andersen's scienter, but also names attendees and recipients along with the substance of the communications. *See, e.g.*, ¶¶928-930, 932. Nothing more is required. *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *53.

Documents offered by the government in the Andersen criminal trial confirm that Andersen knew fraud pervaded the LJM transaction. After CFO Fastow approached him to create the LJM partnership, Duncan consulted with Neuhausen, a partner with oversight responsibilities in the PSG group, who later derided LJM in a 5/28/99 e-mail as being beset with "conflict[s] of interest galore. Why would any director in his right mind ever approve such a scheme?" 5/9/02 Trial Tr. at 1056:5-6. Neuhausen warned that the PSG would be "very uncomfortable" with Enron recording income from selling assets to LJM. *Id.* at 1060:10. And Duncan agreed "the whole thing [was] a bad idea" (*id.* at 1062:20-21) and confessed he did not "love" the idea of Enron recording gains on assets sold to LJM. Anita Raghavan, "How a Bright Star at Andersen Fell Along with Enron," *Wall St. J.*, 5/15/02.

(3) Andersen Knew the Raptor Transactions Were Fraudulent

Andersen and its partners knew the Raptor transactions were deceptive devices when they certified Enron's financial statements as complying with GAAP. Even a cursory review reveals the Raptor transactions violated several fundamental accounting precepts. ¶¶951-952. The substance of the Raptors transactions effectively allowed Enron to report net income and gains on its income statement that were backed wholly by Enron stock or contracts to receive Enron stock, which the Raptors held. ¶¶445-446. In essence, these transactions conjured income from thin air. *Id.* According to Lynn Turner, former SEC Chief Accountant, "What we teach in college is that you don't record equity until you get cash for it, and a note is not cash.... ***It's a mystery how both the company would violate, and the auditors would miss, such a basic accounting rule, when the number is one billion dollars.***" ¶951. The "simplicity of the accounting principles violated in" the Raptor transactions "lend[s] ... probative weight to Plaintiffs' allegations that the GAAP violations in this case raise a strong inference of fraud." *MicroStrategy*, 115 F. Supp. 2d at 651. In this Court the analysis is elementary: the "simpler the violations of GAAP, the more obvious they are and the inference of scienter becomes more probable." *Waste Mgmt.*, slip op. at 156; *accord MicroStrategy*, 115 F. Supp. 2d at 635.

Plaintiffs again provide direct evidence of Andersen's knowing misconduct with respect to approving the Raptor transactions. During the 2/5/01 client-retention conference call, which occurred almost three weeks before Andersen certified Enron's 00 annual financial statements, senior Andersen partners expressly discussed the severe problems with Enron's treatment of the Raptors and similar transactions. ¶¶903, 930. Then on 3/4/01, Bass e-mailed Stewart opposing Enron's accounting for the Raptor transactions. ¶932. But Andersen still allowed its unqualified opinion to be included in Enron's 00 10-K, which is compelling evidence that it acted with scienter. *Zonagen*, 267 F.3d at 408; *see Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

And the removal of Bass soon after he objected to Enron's accounting for the Raptor transactions strengthens the inference of fraud. This decision, as Bass testified during Andersen's trial, was made by Andersen senior management. 5/10/02 Trial Tr. at 1308:11-14. According to notes from Jim Stewart, Bass' supervisor in the PSG, Enron ordered his removal. 5/30/02 Trial Tr. at 5391. "[S]uch attempts at covering-up the truth are probative of a culpable state of mind ...." *MicroStrategy*, 115 F. Supp. 2d at 641.

Andersen criticizes the CC for purportedly failing to name specific auditors who knew of the fraudulent accounting of the Raptor transactions, but this is not necessary either at the pleading stage of the proceedings or at trial. *See United States v. Bank of New England, N.A.*, 821 F.2d 844, 856 (1st Cir. 1987); *IKON*, 66 F. Supp. 2d at 628. Andersen "'cannot plead innocence by asserting that the information obtained by several [accountants] was not acquired by any one individual who then would have comprehended its full import.'" *Bank of New England*, 821 F.2d at 856 (quoting *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. 730, 738 (W.D. Va. 1974)). Rather, Andersen "is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly." *Id.* Nonetheless, the CC identifies specific partners who acquired knowledge about the fraudulent Raptor transactions – all of whom comprehended its full import – including partners Bauer, Cash, Duncan, Lowther, Odom and Stewart. ¶¶929, 932, 952(c). And their scienter is imputed to Andersen. *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1340 (S.D. Fla. 1999).[14]

b. Andersen Knowingly Ignored Material Adjustments in Enron's 97 Audit

During its audits of Enron's 97 financial statements, Andersen compiled $51 million of adjustments for improper accounting by Enron, which together approximated 50% of Enron's total net income ($105 million) for the year. ¶955. Enron refused to make the corrections Andersen urged, because to do so would have slashed its 97 net income in half. *Id.* Reluctant to jeopardize millions in fees from Enron, Andersen truckled to Enron management and never insisted the adjustments be made as GAAS required. ¶¶955, 957. The sheer magnitude of the adjustments, however, precluded Andersen from simply ignoring them. ¶955. The firm instead calculated the $51 million as a percentage of "normalized earnings" rather than net income. *Id.* By contriving a justification for waiving necessary adjustments, Andersen demonstrated the depths to which it would sink to serve Enron. ¶¶517, 955. "One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate." *Green Tree*, 270 F.3d at 665.

Plaintiffs plead that Andersen identified substantial irregularities, totaling approximately 50% of Enron's net income, brought them to Enron's attention and then scrambled to rationalize not making the adjustments when the Company refused to do so. ¶955. In response, Andersen urges the Court to conclude that these allegations demonstrate mere professional judgment. The Court cannot render such a factual determination at this stage of the proceedings. *Zonagen*, 267 F.3d at

---

14 *First Equity Corp. v. Standard & Poor's Corp.*, 690 F. Supp. 256 (S.D.N.Y. 1988), *aff'd*, 869 F.2d 175 (2d Cir. 1989), is distinguishable on the facts because it addressed the level of scienter required to overcome First Amendment protection. *Id.* at 258-59. Under these circumstances, the court required plaintiffs to show that a single employee possessed a culpable state of mind. *Id.* at 260. To the extent *First Equity* properly applies the collective knowledge doctrine – which it does not, *see, e.g.*, *Bank of New England*, 821 F.2d at 856, plaintiffs have shown the individual scienter of several Andersen auditors, including Bauer, Cash, Duncan, Odom, and Stewart.

406; *Oran*, 226 F.3d at 285 n.5. And more important, taken together, Andersen's conduct is outside "that universe of acceptable [auditing] practices," *Fine*, 919 F.2d at 297; *accord Telxon*, 133 F. Supp. 2d at 1031, and indeed amounts to "'no audit at all.'" *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706, 726 (D. Del. 2000).

c. Andersen Knew Enron's Accounting Treatment for Braveheart Transactions Was Improper and the Company Abused Mark-to-Market Accounting

Andersen knew the Braveheart transaction was a phony deal concocted by Enron to generate fictitious revenue. Braveheart failed to qualify as a true independent SPE because Enron guaranteed the vast majority of its seed capital. ¶522. As a consequence, Braveheart should have been consolidated and Enron should not have recognized revenues from the sale of its Blockbuster interest to it. ¶936. Moreover, the value Enron ascribed to its interest in Blockbuster ($124.8 million) was imaginary. ¶¶339(o), 522. Enron employees divined a future cash flow stream from the joint venture without ever conducting any substantive analysis. *Id.* It was simply a guess – and not even an educated one. The sale of Enron's interest to the captive Braveheart occurred although Blockbuster lacked the necessary licenses to distribute movies to residences. *Id.* Andersen knew these facts from its review of the Braveheart transaction, but still approved Enron's accounting for the deal – even after PSG partner Bass sent an e-mail, on 3/4/01, to Stewart expressing his outrage with Enron's accounting treatment of the Braveheart deal. ¶¶932, 935-936. A "prudent auditor would have been on notice to inquire further even if it was not directly responsible for the manipulations." *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1340 (N.D. Ga. 1998).

Employees in Enron's broadband division were astonished with Andersen's acceptance of its accounting for the Braveheart deal. "Nobody in the division could comprehend how [Enron executives] got Andersen to sign off on" the deal, observed a former Enron senior executive, because the Blockbuster venture simply was not "doing business on any scale even close to those numbers." ¶936. Andersen's conduct certainly displays, at a minimum, "an 'egregious refusal to see the obvious, or to investigate the doubtful.'" *Complete Mgmt.*, 153 F. Supp. 2d at 334; *accord Kinney*, 170 F. Supp. 2d at 180.

Andersen also knew Enron manipulated its financial results by recognizing revenue from dark-fiber swaps. ¶935. As part of the tens of thousands of hours Andersen spent on the LJM transactions, Andersen reviewed numerous dark-fiber swaps. ¶¶935, 942. In 6/00, Enron dumped unwanted dark-fiber into LJM2, recognizing $100 million in revenue for it, though it was worth much less. ¶531. Enron recognized $67 million in pre-tax earnings in 00 from the sale. ¶¶531, 935. Andersen approved another dark-fiber deal with LJM2, made in the 3rdQ 00, worth more than $300 million. ¶¶339(j), 531, 935. This deal ignored normal protocols and Enron's own network developers and traders did not even learn about it until after the transaction closed. ¶531.

Andersen ignored Enron's abuse of mark-to-market accounting as well, used to accelerate earnings from a multi-year contract into the current quarter. ¶534. Mark-to-market accounting should be applied ***only*** where the revenue streams from a contract are predictable and based on historical records of similar transactions. *Id.* Despite this firm requirement, Enron applied the methodology to most of its businesses, even where it lacked historical data about revenues, such as with its broadband transactions, and retail and commercial energy demand-side-management contracts. ¶¶534, 544-548. Although Andersen's partners regarded Enron's mark-to-market accounting as mere "intelligent gambling" – as admitted in the 2/01 client-retention call – the firm, including partners Neuhausen, Petersen and Stewart, continued to sign off on this dubious practice. ¶¶930, 938-940. Repeated violations of accounting principles reinforce the inference of fraud. *Fine*, 919 F.2d at 297. That Andersen intentionally destroyed incriminating documents regarding Enron's broadband transactions only strengthens the inference. ¶937; *see MicroStrategy*, 115 F. Supp. 2d at 641 ("attempts at covering-up the truth are probative" of scienter).

Andersen asks the Court to ignore its own partners' admission that Enron abused mark-to-market accounting. According to Andersen, use of the phrase "intelligent gambling" by its senior partners "does not constitute a recognition by Andersen that the use of mark-to-market accounting was inappropriate." Mot. at 27. GAAP forbids revenues from being recognized based on chance alone. It also requires financial statements be predicated on reliable data. ¶610(f), (h). Andersen knew that Enron violated these basic precepts.

Andersen contends that the CC contains no allegations about its knowledge of Enron's abusive broadband transactions. But the CC pleads that Enron applied mark-to-market accounting to virtually all transactions. ¶938. Unable to overcome the strong inference of scienter raised from Carl Bass' vociferous opposition to the Blockbuster deal, Andersen resorts to alleging the transaction may not have been material. The revenue from this fraudulent transaction represented most of the profits reported by Enron's broadband division. ¶936. Considering Enron was trumpeting its broadband division (¶¶281-282), it is very likely that a reasonable investor would have found this information significant. *Rubinstein*, 20 F.3d at 167-68. And, it is not fatal that plaintiffs have not alleged "the precise amount of overstatement on a period by period basis." *First Merchants*, 1998 U.S. Dist. LEXIS 17760, at *25.

d. The Magnitude of Enron's Restatements Raises an Inference of Scienter

The sheer magnitude of Enron's restatements further strengthens the inference that Andersen acted with scienter. *See, e.g.*, *Green Tree*, 270 F.3d at 666 ("the sheer size of the $390 million write-down adds to the inference that the defendants must have been aware the problem was brewing"); *Haack*, 2002 U.S. Dist. LEXIS 5652, at *24 ("the overstatement of significant revenues can support the claim that the defendants acted in a severely reckless manner"); *Leslie Fay*, 835 F. Supp. at 175 ("In cases where small accounting errors only ripple through the corporate books, a court may conclude ... that an accountant's failure to discover his client's fraud was not sufficiently reckless to sustain a 10b-5 claim. On the other hand, when tidal waves of accounting fraud are alleged, it may be determined that the accountant's failure to discovery his client's fraud raises an inference of scienter on the face of the pleading."). Enron restated its annual financial statements for 97-00. ¶384. As a consequence, Enron slashed $600 million of previously recorded profits from its books and $1.2 billion in shareholder equity. *Id.* In 97 alone, for example, Enron overstated its recurring net income by $96 million and shareholders' equity by $313 million, and understated debt by $711 million. *Id.* In 00, Enron overstated its recurring net income by $132 million and shareholders' equity by $1.2 billion, and understated its debt by $628 million. *Id.*

The impact from the 98 and 99 restatements was just as devastating. *Id.* Enron's "GAAP violations and the subsequent restatements are of such great magnitude – amounting to a night-and-day difference with regard to" the Company's debt and shareholder equity "as to compel an inference that fraud or recklessness was afoot." *MicroStrategy*, 115 F. Supp. 2d at 637; *see Carley Capital*, 27 F. Supp. 2d at 1339-40 ("While alleging a misapplication of [GAAP] standing alone is insufficient, such allegation when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter."). *See also Sunbeam*, 89 F. Supp. 2d at 1345; *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997). This inference is strengthened, moreover, when one considers Andersen's pervasive involvement in the LJM transactions, billing Enron $5.7 million for the advice it rendered to LJM, LJM2 and Chewco, that Andersen acted as Enron's internal and outside auditor, and that Enron directed all questions about the consolidations of SPEs to Duncan. ¶¶915, 942; *see MicroStrategy*, 115 F. Supp. 2d at 653 ("the greater [PriceWaterhouseCoopers's] access to and involvement with Microstrategy's operations, the more support an inference of scienter takes on"); *Carley Capital*, 27 F. Supp. 2d at 1339 (finding an inference of scienter against auditor from allegations "[i]t was heavily involved in the management of Medaphis and had unrestricted access to its financial records and data").

Incredibly, Andersen contends that the restatements "tend[] to negate any inference of scienter" because Enron restated three months after Sherron Watkins warned Andersen partner Hecker of accounting irregularities at Enron. Mot. at 17. Yet, after Watkins came forward, for three months Andersen kept silent about Enron's dubious business practices, never exposing the Enron fraud to the investing public, never withdrawing its unqualified audit opinions, and never alerting the SEC. Instead, Andersen moved to conceal its role in the fraud by ordering Enron documents shredded. ¶¶962-966. The Court should reject Andersen's attempt to plead "innocence by hindsight." *Green Tree*, 270 F.3d at 662.

e. Andersen Disregarded Other Red Flags at Enron

Andersen also knew the potential of fraudulent financial reporting by Enron was great. Enron operated hundreds of Byzantine partnerships in foreign countries where complete secrecy is observed. ¶922. Enron devised numerous related-party transactions whose sole purposes were to conceal debt. *Id.* Andersen knew that many of the Fastow-controlled partnerships were formed in offshore tax havens. *Id.* The ownership, complexity, interrelationship, and locales of the countless partnerships was more than enough to set off alarm bells at Andersen.

Enron's rapid growth provided another red flag. Between 95 and 00, Enron's net sales surged from $9.2 billion to $100.8 billion per year. ¶924. Enron management also had an excessive interest in maintaining the Company's stock price. ¶923. Andersen knew that Enron was recognizing income from the inflation of its own capital stock and was using its stock to backstop its hedges with the SPEs. *Id.* In addition, Enron executives received multi-million-dollar bonuses for meeting stock-price targets set in the Company's Performance Unit Plan. *Id.* A 10/01 e-mail submitted to Congress reveals that a routine risk analysis of Enron performed by Mark Zajac, an Andersen Chicago "risk management" auditor, triggered a "red alert." ¶926. Indeed, Bauer, Duncan, and Goddard all knew Enron posed substantial engagement risks no later than 2/7/99. Ex. 18. ¶926; *see Bovee*, 272 F.3d at 362 n.8 (finding accountant's assessment of client as the highest risk is relevant to determining scienter). Consequently, under SAS No. 82 (AU §§316, 110), Andersen needed to apply greater skepticism to Enron's financial statements than would otherwise be required. ¶¶921-923. Instead, the firm turned a blind eye to the numerous red flags at Enron and continued to collect tens of millions of dollars in fees for issuing clean audit opinions. ¶926. Andersen's disregard of "'multiple red flags could reasonably support an inference that [the firm] acted with intent.'" *MicroStrategy*, 115 F. Supp. 2d at 654; *Danis v. USN Communs., Inc.*, 73 F. Supp. 2d 923, 942 (N.D. Ill. 1999) ("existence of and Deloitte's awareness of these 'red flags' ... [from which] Deloitte's knowledge or reckless disregard of USN problems maybe inferred").

Andersen contends that audit manager Zajac's determination that Enron was a "red alert" risk is irrelevant to the scienter analysis because it occurred after Andersen's last statement about Enron. These allegations reveal the ease with which Andersen could have discovered the risk of fraud Enron posed had it desired to do so. Andersen also finds nothing suspicious about its dual role as Enron's internal and external auditor. But Andersen was more than just an auditor, it was a facilitator of fraud. As a former Enron employee involved in the transition to Andersen performing internal audits put it, "Going forward, Skilling was left to run a casino for a business, with a day-care center for an auditor." ¶915.

3. Andersen's Intentional Destruction of Documents Raises a Strong Inference of Scienter

Andersen's intentional destruction of "tons" of Enron-related documents raises a strong inference of scienter. Nancy Temple, Andersen's in-house lawyer in Chicago, sent an 10/01 e-mail which reminded Andersen personnel to abide by the document retention and destruction policy – a code for – destroying all damaging documents. ¶965. Immediately after receiving Temple's instruction, senior auditors deleted e-mails related to Enron, including damning messages regarding Carl Bass' objections to Enron's accounting. ¶965. Temple also encouraged the Enron audit team to "add back" Bass' previously-omitted criticisms to earlier memoranda to create the impression Andersen exercised appropriate diligence. ¶966. She has refused to testify about these events, as her testimony would incriminate her. ¶68. A jury is "entitled to draw an adverse inference from the fact that [Temple] has asserted [her] Fifth Amendment rights in a civil case." *SEC v. Cook*, Civ. No. 3:00-CV-272-R, 2001 U.S. Dist. LEXIS 2601, at *12 n.4 (N.D. Tex. Mar. 8, 2001). Duncan and Bauer, lead partners on the Enron engagements, both of whom have likewise refused to testify, stressed the exigency of bringing the Enron files into "compliance," and Willard, another Enron partner, also pushed his managers and staff to ensure "compliance" with Andersen's document retention policy. ¶966. And Chairman Berardino knew of the destruction of Enron-related documents – more than 20 trunks of Enron-related documents were shredded in Houston alone – with Andersen's London and Portland offices also joining the document destruction. *Id.*

Duncan, Andersen's lead auditor on the Enron account, has pleaded guilty to obstruction of justice for destroying documents prejudicial to Andersen. He has testified that he "obstructed justice .... Instructed people on the [Enron] engagement team to follow the document retention policy, which I knew would result in the destruction of documents." 5/13/02 Trial Tr. at 1665:21, 23-25. He also testified that he ordered the destruction of Enron documents to prevent plaintiffs from receiving them. 5/14/02 Trial Tr. at 1791. Andersen's deliberate destruction of documents, as admitted by Duncan, not only is "probative of a culpable state of mind," *MicroStrategy*, 115 F. Supp.

2d at 641, but also entitles plaintiffs to an adverse inference at trial. *See Vick v. Texas Employment Com.*, 514 F.2d 734, 737 (5th Cir. 1975) (permitting "adverse inference to be drawn from destruction of records ... predicated on bad conduct of the defendant").

Andersen faults the CC for allegedly not expressly stating that its destruction of Enron-related documents resulted from the anticipation of litigation. Andersen's objection is desperate. Nancy Temple directed Enron engagement partners to destroy documents only after Sherron Watkins warned Hecker of Enron's substantial accounting irregularities at Enron. ¶¶964-965. It is true plaintiffs do not quote Temple about her motivation for ordering Enron documents destroyed. But this is so only because Nancy Temple refuses to answer such questions under oath. ¶68.

4. Andersen's Motive to Commit Fraud

Plaintiffs' motive allegations "meaningfully enhance" the inference of scienter against Andersen. *Zonagen*, 267 F.3d at 412; *BMC*, 183 F. Supp. 2d at 900. Enron was Andersen's second most lucrative client and in 00 alone paid the firm $52 million in fees, $27 million of which related to consulting. ¶906. This robust level of fees was remarkable, but Andersen wanted more. By continuing to certify its fraudulent financial statements, senior Andersen partners in Chicago and Houston believed the firm could pocket as much as $100 million annually from Enron, predominantly from consulting engagements. ¶¶907, 912. Andersen's lust for substantial consulting fees was the catalyst to abandon its independence and integrity. *See Complete Mgmt.*, 153 F. Supp. 2d at 335; *MicroStrategy*, 115 F. Supp. 2d at 655.

Andersen claims that "an auditor's expectation of continued compensation" is not a cognizable motive. Mot. at 15. The Fifth Circuit has disallowed allegations based on an accountant's motivation to preserve and increase its auditing fees in *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994). But this is not that case. Plaintiffs "have alleged more than just a desire to receive compensation for professional auditing duties on the part of [Andersen]." *MicroStrategy*, 115 F. Supp. 2d at 655. Plaintiffs plead particularized facts to support the inference that Andersen's desire to maintain and increase its considerable consulting fees from the Company "created incentives for the auditors to seek to please [Enron's] management at the expense of accuracy and/or completeness." *Complete Mgmt.*, 153 F. Supp. 2d at 335.

Individual Andersen partners on the Enron account also had a substantial economic interest in perpetrating the Enron fraud. Duncan, Cash, Goddard, Odom and others depended on Enron for their livelihoods. ¶906. Andersen partners received extra units – worth about $200,000 per year – by selling non-auditing consulting services. ¶907. Duncan, for instance, earned as much as $2 million per year from his relationship with Enron. *Id.* These partners held regular "Client Service Team" meetings to discuss ways to generate more revenues from Enron. ¶906. "[S]elf-interested motivation of defendants in the form of saving their salaries" may be evidence of scienter. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999).

Andersen attempts to trivialize this motive, claiming it is irrational to risk its international reputation to commit fraud on Enron's behalf. But in *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 191 (7th Cir. 1993), Judge Easterbrook, who also authored *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990), on which Andersen relies, rejected a similar argument from a large accounting firm that its auditor would never participate in a fraud to collect just $25,000 in fees:

> Why, it asks, would it help Powers hoodwink investors? For the 1983 audit Peat Marwick collected less than $25,000. It would be insane to facilitate a securities fraud, and expose itself to huge liabilities, in exchange for this paltry sum, Peat Marwick insists, adding that when in the course of the 1984 audit it got a whiff of fraud it immediately withdrew. Maybe so, but the state of mind of the local auditors is imputed to the partnership, and one of the auditors in Oklahoma may have been trying to boost Pepco in the hope of enlarging the stream of revenues in future years.

Accord CFS-Related Sec. Fraud Litig., No. 99-CV-825-K(J), Report and Recommendation Regarding Those Claims Pled Against Arthur Andersen at 6 (N.D. Okla. Dec. 21, 2001) ("An individual [auditor] certainly may have a motive to obtain and keep a large client such as CFS. It is, therefore, not outside the realm of possibilities that a partner, in his desire to keep a large client, could choose to ignore facts of which he is aware, or in his zeal to give the client what it wants, recklessly ignore facts."), *adopted sub nom. MPF Ltd. v. Bartmann*, No. 99-CV-829-K(J), slip. op. at 4-7 (N.D. Okla. Mar. 28, 2002).[15] The Andersen partners' financial motivation in this case – current fees of $52 million and projected fees of $100 million – dwarfs the minuscule $25,000 that Judge Easterbrook found significant in *Frymire-Brinati*. ¶¶906, 912.

---

[15] Due to the length of this opinion, it is not being attached to this brief.

Enron is an unparalleled case. Andersen has admitted destroying documents related to Enron, and Duncan, its lead audit partner, has pleaded guilty to obstruction of justice. Andersen's course of conduct in committing fraud on behalf of lucrative clients such as Waste Management undermines the firm's reputation defense. ¶919(a). And as the Court ruled in the Andersen criminal trial, Andersen's fraud in connection with Waste Management is admissible to proving the firm's motive in this case. *See* Fed. R. Evid. 404(b). By taking "on a vested interest in the performance and profitability of" Enron through increased consulting fees, Andersen "has weakened its ability to rely on its reputation in countering as 'irrational' allegations that it participated in a client's fraud." *MicroStrategy*, 115 F. Supp. 2d at 655.

VI. Plaintiffs Have Adequately Alleged Andersen's Violation of §11

To plead a prima facie claim for violation of §11 in this Court, plaintiffs must allege "(1) that the Registration Statement contained an omission or misrepresentation and (2) that the omission or misrepresentation was material, that it would have misled a reasonable investor about the nature of his or her investment." *Landry's*, slip op. at 59. Andersen falsely represented that Enron's annual financial statements for 97-00 were presented in accordance with GAAP and its audits of Enron's financial statements comported with GAAS. ¶899. Andersen consented to the incorporation of its clean audit opinions into the Registration Statements of Enron's Class Period offerings. *Id.* By restating its financial statements for 97-01, Enron has admitted that its financial statements for these years were materially false when made and not in accordance with GAAP. *See* APB Opinion No. 20 at ¶13; *Telxon*, 133 F. Supp. 2d at 1026 ("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). Andersen violated GAAS by failing to remain skeptical and independent, and by ignoring substantial red flags which called for the firm "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud." SAS No. 82 (AU §110); *see* ¶¶911, 921. Therefore, Andersen can avoid liability under §11 only if it demonstrates due diligence. "And this is an affirmative defense that must be pleaded and proved." *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 369 (5th Cir. 2001).

Andersen claims plaintiffs do not allege that it consented to the incorporation of its audit reports in the Registration Statement relating to the 7.375% notes offered 5/19/99 or the 7.875% notes offered in 5/00. Andersen overlooks the allegations that it consented to the incorporation of its reports on Enron's financial statements into the "registration of $1 billion in Enron Debt Securities Warrants, Preferred Stock and Depository Shares filed on 1/12/99." ¶899(iv). The offering of 7.375% notes, 8.375% notes, and 7.875% notes ***total $1 billion and were registered through the same shelf Registration Statement***. ¶¶48, 612, 1006. The CC makes clear that Andersen agreed for its audit opinion to be included in the Registration Statement for the 7.375% notes and the 7.875% notes.

Andersen also contends that 15 U.S.C. §77k(a)(5) requires certain plaintiffs to plead actual reliance on the Registration Statement and that plaintiffs have failed to do so. While Andersen focuses on Amalgamated Bank's purchases, it fails to mention that two other plaintiffs, Local 175/505 and the Washington Board, purchased the 7.375% Notes on the day they were issued. Thus, Local 175/505 and the Washington Board need not plead reliance on the Registration Statement.

Andersen argues that Hawaii Laborers and the Archdiocese of Milwaukee must plead actual reliance for their purchases of the 7.875% notes. The Hawaii Laborers bought the notes at the time of the offering and the Archdiocese made its purchases three days later. Andersen erroneously concludes that for purposes of §77k(a)(5), the effective date of the Registration Statement is 2/5/99. Enron, however, filed a post-effective Registration Statement on 3/1/00 and the Registration Statement for the 7.875% notes incorporated by reference Enron's 1Q 00 10-Q, filed 5/15/00. These filings extended the effective date of the Registration Statement such that neither Hawaii Laborers nor the Archdiocese need to plead actual reliance. *See* 17 C.F.R. §230.158.[16]

VII. Plaintiffs Have Adequately Alleged Andersen's Violation of the Texas Securities Act

Texas law imposes joint and several liability on anyone who "'directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids … [an] issuer of a security" in the violation of the Texas Securities Act. *Frank v. Bear*, 11 S.W.3d 380, 384

---

[16] For the reasons stated at pp. 30-32 of Andersen's Motion, plaintiffs are no longer pursuing the §11 claim on the 7% Exchangeable Notes or the 8.375% Notes.

(Tex. App. – Houston [14th Dist.] 2000, pet. denied). "In order to establish [aiding and abetting liability], plaintiff[s] must demonstrate 1) that a primary violation of the securities laws occurred; 2) that the alleged aider 'had "general awareness" of its role in the violation; 3) that the actor rendered "substantial assistance" in this violation; and 4) that the alleged aider either a) intended to deceive plaintiff or b) acted with reckless disregard for the truth of the representations made by the primary violator.'" *Id.*; *Crescendo Invs. v. Brice*, 61 S.W.3d 465, 472 (Tex. App. – San Antonio 2001, pet. denied). The CC satisfies each of these requirements.

A. Enron Committed a Primary Violation of the Texas Securities Act

An issuer of securities is liable for untrue statements of material fact contained in a prospectus accompanying a public offering. Tex. Rev. Civ. Stat. Ann. art. 581-33C(2). *See Summers v. Welltech, Inc.*, 935 S.W.2d 228, 231 (Tex. App. – Houston [1st Dist.] 1996, no writ) (declining to impose obligation to sue primary violator before plaintiff may sue under Article 581-33F). Enron's offering documents for the sale of $500 million of notes, dated 7/7/98, incorporated Enron's false 97 financial statements, including the representation that Enron earned $105 million in net income and had $6.3 billion in debt and $5.6 billion in shareholders' equity. ¶¶384, 424, 612, 899. By restating these financial statements, Enron and the Enron defendants have now admitted that the offering documents for the 7/7/98 sale included untrue statements of material fact. *See* APB Opinion No. 20 at ¶13; *Telxon*, 133 F. Supp. 2d at 1026 ("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). Enron also misrepresented its ratio of earnings to fixed charges of 2.70 for the three months ended 3/31/98. ¶613. This figure was a false statement of material fact due to the failure of Enron to consolidate Chewco and JEDI as GAAP required. *Id.* Enron thus violated the Texas Securities Act. Tex. Rev. Civ. Stat. art. 581-33C(2).

B. Andersen Had a General Awareness of Its Role in Enron's Violations and Rendered Substantial Assistance to Enron

Andersen expressly consented to the incorporation of its unqualified opinion of Enron's 97 financial statements into the 7/7/98 offering documents despite knowing the financial statements were false by failing to consolidate JEDI and Chewco. ¶¶899, 945-947. It also participated in drafting the financial disclosures in the 7/7/98 offering documents which misrepresented Enron had a ratio of earnings to fixed charges of 2.70 for 1Q98. ¶¶613, 899. These allegations are sufficient to show Andersen "was generally aware of its role in a securities violation by a primary party." *Fine*, 919 F.2d at 300. Moreover, the "knowing issuance of a materially misleading [un]qualified opinion ... would have substantially assisted [Enron] in committing a securities violation," *id.*, as would have misstating the Company's fixed charges to earnings ratio. *See Crescendo*, 61 S.W.3d at 473 (finding substantial assistance in franchise scheme where party acted as reference for perpetrators and another granted franchise to the wrongdoers).

Andersen objects that plaintiffs have not alleged its role in the underwriters' violations of the Texas Securities Act. Mot. at 32-35. This is not necessary for Andersen materially aided Enron's – the issuer's – violations of the Texas Securities Act. "A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids ... [an] issuer of a security is liable under Section ... 33C jointly and severally with the ... issuer, and to the same extent as if he were the ... issuer." Tex. Rev. Civ. Stat. art. 581-33F(2).

C. Andersen Acted with at Least Reckless Disregard for the Truth of Enron's Representations in the 7/7/98 Offering Documents

As shown above, Andersen knew Enron's 97 financial statements were false when it issued its clean opinion. Since senior Enron executives controlled Chewco, the SPE (and consequently JEDI) should have been consolidated. ¶¶943, 946(a). And Andersen knew Chewco's general partners "contributed" a mere 1.5% of the total capital of the SPE, having received and seen the documents establishing the $6.6 million reserve. ¶¶439, 946(b). Yet Andersen consented to allow Enron to incorporate its unqualified opinion letter into the 7/7/98 offering documents. ¶¶899, 945-947. Andersen, moreover, was reckless in drafting the ratio of earnings to fixed charges included in the offering documents for the 7/7/98 sale of $500 million of Enron notes. ¶¶612-613, 899. The reported ratio of 2.70 failed to take Chewco and JEDI into consideration. Andersen knew these two entities should have been consolidated. ¶¶945-947. At minimum, this conduct exhibits a reckless disregard for the truth of the financial statements in the offering documents. *See Fine*, 919 F.2d at 296-97, 300.

Andersen contends that the Texas Securities Act allegations violate Rule 8 and 9(b). Paragraphs 612-613 provide a plain statement of the misrepresentations at issue in the 7/7/98 offering documents, and ¶¶899, 1021, and 1024 describe Andersen's connection to them. This satisfies Rule 8. The CC also details, in accordance with Rule 9(b), how Andersen knew Chewco and JEDI should have been consolidated and why its clean opinion for Enron's 97 financial statements was knowingly false when issued. ¶¶941-947. Contrary to Andersen's claims, plaintiffs need not "allege who the owner of the securities was" that sold in the 7/7/98 offering (Mot. at 34), for it is not just a seller but also an "issuer" who faces liability under Tex. Rev. Civ. Stat. art. 581-33C, and Andersen's aiding and abetting liability derives from both.

VIII. Conclusion

For the foregoing reasons, Andersen's motion to dismiss should be denied.[17]

DATED: June 10, 2002

Respectfully submitted,

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
WILLIAM S. LERACH
DARREN J. ROBBINS
HELEN J. HODGES
BYRON S. GEORGIOU
G. PAUL HOWES
JAMES I. JACONETTE
MICHELLE M. CICCARELLI
JAMES R. HAIL
JOHN A. LOWTHER
ALEXANDRA S. BERNAY
MATTHEW P. SIBEN

WILLIAM S. LERACH

401 B Street, Suite 1700
San Diego, CA 92101
Telephone: 619/231-1058

[17] Based on representations of Andersen's counsel that Andersen Puerto Rico and Andersen-Cayman Islands are divisions of Andersen LLP, and not separate entities, plaintiffs make the same arguments for opposing their motions to dismiss.

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
STEVEN G. SCHULMAN
SAMUEL H. RUDMAN
One Pennsylvania Plaza
New York, NY 10119-1065
Telephone: 212/594-5300

Lead Counsel for Plaintiffs

SCHWARTZ, JUNELL, CAMPBELL
& OATHOUT, LLP
ROGER B. GREENBERG
State Bar No. 08390000
Federal I.D. No. 3932

ROGER B. GREENBERG

Two Houston Center
909 Fannin, Suite 2000
Houston, TX 77010
Telephone: 713/752-0017

HOEFFNER BILEK & EIDMAN
THOMAS E. BILEK
Federal Bar No. 9338
State Bar No. 02313525
Lyric Office Centre
440 Louisiana Street, Suite 720
Houston, TX 77002
Telephone: 713/227-7720

Attorneys in Charge

BERGER & MONTAGUE, P.C.
SHERRIE R. SAVETT
1622 Locust Street
Philadelphia, PA 19103
Telephone: 215/875-3000

Attorneys for Staro Asset Management

WOLF POPPER LLP
ROBERT C. FINKEL
845 Third Avenue
New York, NY 10022
Telephone: 212/759-4600

SHAPIRO HABER & URMY LLP
THOMAS G. SHAPIRO
75 State Street
Boston, MA 02109
Telephone: 617/439-3939

Attorneys for van de Velde

THE CUNEO LAW GROUP, P.C.
JONATHAN W. CUNEO
MICHAEL G. LENETT
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

Washington Counsel