United States Courts
Southern District of Texas
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IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

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

DEFENDANTS' REPLY IN SUPPORT OF MOTION TO DISMISS CONSOLIDATED COMPLAINT

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TO THE HONORABLE MELINDA HARMON:

Plaintiffs readily concede that their Complaint is "not a perfect document." Response in Opposition to Joint Brief at 13.[1] They argue, however, that because the Enron case is "exceedingly strong on the merits," *id.*, the Court should ignore their failure to comply with Rule 9(b) and the PSLRA. This argument misses the point. The strength of the case on the merits can be measured only by the contents of the pleadings, and even a cursory review of the allegations in Plaintiffs' Complaint reveals that Plaintiffs' case against the Outside Directors[2] is not strong, on the merits or otherwise. For example, Plaintiffs have no viable fraud claim against the Outside Directors, as evidenced by their failure to allege a single fact to support their claim that the Outside Directors knew Enron's public disclosures were false or misleading when made, or took any action with an intent to deceive.

There is no "Enron exception" to the statute and rules that govern this case. Before their fraud case may proceed, Plaintiffs must "state with particularity facts giving rise to a strong inference that the Defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The "required state of mind" is "severe recklessness," *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 412 (5th Cir.

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[1]Plaintiffs have filed at least three pleadings that respond to arguments made in the Outside Directors' Motion to Dismiss ("Motion to Dismiss"). The first, their "Opposition to Motion of Certain Current and Former Directors to Dismiss Pursuant to Fed. R. Civ. P. 8 and Request for Leave to Amend" is referred to in this reply brief as "Rule 8 Response." Plaintiffs' second brief, "Plaintiffs' Motion to Strike Certain Defendants' Joint Disclosure Brief and Responses to Defendant's Inappropriate Fact Argument," is referred to here as "Plaintiffs' Motion to Strike." Finally, the substantive response to the Outside Directors' Motion to Dismiss is "Plaintiffs' Memorandum of Law in Opposition to Motions to Dismiss filed by Robert A. Belfer, et.al." It is referred to here as "Plaintiffs' Response," or "Response."

[2]This Reply is adopted in full by the separate brief of Urquhart.

2001), a circumstance that is such an "extreme departure from the standards of ordinary care" that it is nearly equivalent to willful fraud. *Broad v. Rockwell*, 642 F.2d 929, 962 (5th Cir. 1981) (citing *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir. 1977)). A complaint that fails to meet this requirement "shall be dismissed." *Id.* at § 78u-4(b)(3). Nowhere--not in their Rule 8 Response, not in their Motion to Strike, not in Plaintiffs' Response and, most critically, nowhere in their Complaint--do Plaintiffs allege particularized facts giving rise to a strong inference that any of the Outside Directors acted with a severely reckless state of mind approaching willful fraud.

This omission is not a mere technicality. The PSLRA requires that Plaintiffs plead the required scienter with particularity as to each defendant. Rule 9(b) has long been held to apply with equal rigor to claims of fraud. In the words of the Fifth Circuit, a court that enforces these pleading requirements:

> neither set[s] springs for the unwary nor insist[s] on 'technical' pleading requirements. We remind that this bite of Rule 9(b) was part of the pleading revolution of 1938. In short, we apply the rule with force, without apology.

Williams v. WMX Technologies, Inc., 112 F.3d 175, 178 (5th Cir. 1997). Only last month, the Fifth Circuit reiterated that pleading the "who, what, when, where and how" of each Defendant's alleged misconduct is required to state a claim under both Rule 9(b) and the PSLRA. *See ABC Arbitrage Plaintiffs Group v. Tchuruk,* __ F.3d __, 2002 WL 975299 (5th Cir. 2002). When Rule 9(b) and the PSLRA are applied here with force, and without apology, the only possible result is the dismissal of Plaintiffs' Complaint against the Outside Directors.[3]

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[3]We recognize this Reply Brief is unusual in length. This is the direct result of Plaintiffs' unauthorized effort to amend their Complaint, in their Response, by adding close to sixty pages of new allegations that they assert support their claims. For obvious reasons, the Outside Directors

I. Plaintiffs' Complaint Does Not Adequately Plead Fraud Against the Outside Directors.

As demonstrated in the Motion to Dismiss, Plaintiffs' 10(b) claim against the Outside Directors must be dismissed because Plaintiffs' allegations are (1) wholly lacking in particularity as to these Directors' claimed wrongful conduct; and (2) fail to raise any inference--much less a strong inference--that any Outside Director acted with an intent to defraud.

Plaintiffs' Response makes arguments that, speaking charitably, mischaracterize their Complaint. First, Plaintiffs offer sweeping assertions that the Complaint "sets out in great particularity the participation of each of the Outside Directors in the Enron scheme." In this section, however, Plaintiffs cite not a single paragraph of their Complaint. *See* Response at 1. Next, at pages 40-43, Plaintiffs set out a laundry list of allegations that they claim support an inference that Enron's financial statements were false. Nowhere, however, do Plaintiffs cite any allegation that the Outside Directors knew Enron's financials were false--because no such allegation exists.

Finally, at pages 90-94 of their Response, Plaintiffs identify three paragraphs--619, 628 and 630-- that they argue sufficiently allege that the Outside Directors knew certain undisclosed facts. *See* Plaintiffs' Response at 90-94. Those paragraphs say nothing of the kind. Paragraph 619 specifically recites that "the bankers and Vinson & Elkins knew the undisclosed facts..." but does not mention any of the Outside Directors. Paragraph 628, likewise, alleges that "the bankers and

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could not let these new allegations stand without a response--not least because someone might infer, incorrectly, that the Directors had no response at all.

This Reply therefore serves two purposes. First, it refutes Plaintiffs' arguments that their Complaint is adequate to state a claim. Second, it demonstrates why Plaintiffs' new assertions would not suffice to state a valid claim of securities fraud against the Outside Directors.

Vinson & Elkins knew" that Enron's hedges were allegedly "bogus," but is <u>silent</u> as to any claim that the Outside Directors knew this. Paragraph 630 alleges that "Enron, its banks and Vinson & Elkins did anticipate a material impact to the Company's financial position due to Enron's credit exposure," but nowhere attributes that state of mind (or any such knowledge) to any Outside Director.

Put bluntly, the paragraphs Plaintiffs cite state no claim against the Outside Directors, and no <u>other</u> paragraph suffices to state a claim either. Nowhere do Plaintiffs allege any fact to suggest that any Outside Director knew Enron's accounting was incorrect or had reason to question Enron's financial statements. Instead, as was pointed out in the Motion to Dismiss, and as is <u>unrefuted</u> in Plaintiffs' Response:

1. The Complaint relies exclusively on impermissible group pleading. In four separate cases, this Court has held that group pleading does not comply with either the PSLRA or Rule 9(b). *See In re BMC Software*, 183 F. Supp. 2d 860, 913 n.50 (S.D. Tex. 2001) (listing cases). The result cannot differ here.

2. The Complaint employs a "puzzle pleading" approach -- especially as to the Outside Directors -- that fails to "specify the statements contended to be fraudulent, the identity of the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *Nathenson*, 267 F.3d at 412; *accord ABC Arbitrage*, 2002 WL 975299. Plaintiffs' suggestion that they have been specific as to the Outside Directors, Rule 8 Response at 8 (citing NCC ¶¶ 122-155), likewise ignores the fact that the cited paragraphs make <u>no allegations at all of fraudulent conduct by the Outside Directors</u>.

3. Plaintiffs' Complaint also fails to set out, with particularity, "what actions each [Outside Director] took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned." *In re BMC*, 183 F. Supp. 2d at 885.[4] "Directly put, the who, what, when and where must be laid out" in the Complaint, *Williams*, 112 F.3d at 178, and as to the Outside Directors it is not. This Court's holding in *BMC* is directly on point:

> The great majority of the targeted, allegedly false and misleading statements by Defendants are paraphrases or summaries by third-party analysts, with no fact pled to indicate their accuracy or Defendants' involvement or control in their preparation. Moreover, Defendants have shown that a substantial portion of the forward-looking statements were protected under safe harbor [language in the PSLRA and were]...on point with the problems that actually materialized...where statements are not protected by safe harbor, the Court fully agrees with Defendants that Plaintiffs have failed to allege specific facts relating to each statement and to each Defendant-speaker sufficient to give rise to a strong inference that the speaker knew his statement was false when it was made. Plaintiffs have also failed to provide the necessary specific allegations to support their lists of 'concealed facts' purportedly known to Defendants when they made misleading statements. Plaintiffs have relied on concepts that have not survived the enactment of the PSLRA, like the group pleading doctrine, pleading by hindsight, or pleading scienter by motive and opportunity alone, which this Court rejects.

In re BMC, 183 F. Supp. 2d 916-917.

4. Plaintiffs also have not alleged any facts that could raise a strong inference that the Outside Directors had an intent to deceive. In fact, Plaintiffs' allegations demonstrate a lack of fraudulent intent. Plaintiffs' Complaint, at paragraph 903-04 and elsewhere[5], alleges repeatedly that Arthur Andersen ("Andersen") assured the Outside Directors that Enron's financial statements were

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[4]Unless otherwise indicated, all emphasis is added throughout this Reply.

[5]*See* NCC at ¶¶ 14, 54, 67, 70(a), 141, 219, 221, 292, 296, 899, 926, 931, 935, 942, 953 and 959.

accurate and not misleading. This allegation conclusively negates any inference of scienter. *See In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1267 and n.9 (N.D. Cal. 2000) (allegation that directors relied on outside auditors "negates a strong inference of negligence"); *Stavroff v. Meyo*, 1997 WL 720475 *6 (6th Cir. Nov. 12, 1997) ("reliance on the guidance of outside auditors is inconsistent with the intent to defraud."). If mere negligence is negated by Plaintiffs' allegation that the directors relied on Andersen's opinions, then severe recklessness--defined by the Fifth Circuit as an "extreme departure from the standards of ordinary care"--is plainly refuted by it. *Compare Broad,* 642 F.2d at 962 (requiring securities fraud plaintiff to prove "extreme departure from the standards of ordinary care") *with McKesson*, 126 F. Supp. 2d at 1267, n.9 (finding that a strong inference of mere negligence is negated by an allegation that directors relied on advice from outside accountants). *See also, In re Sunbeam Sec. Litig.* 89 F. Supp. 2d 1326, 1341 and 1344 (S.D. Fla. 1999) (dismissing claims against Audit Committee members when complaint alleged Arthur Andersen rendered an "Unqualified Audit Opinion validating Sunbeam's financial reports" and was devoid of "any particularized allegations of scienter on the part of the Audit Committee members."). Here, Plaintiffs plead facts that negate any inference--much less a strong inference--that any Outside Director acted with severe recklessness. The Complaint should therefore be dismissed.

The Complaint must stand or fall based on the allegations contained within its four corners. As to the Outside Directors, those allegations amount to nothing more than the generic claim that these defendants served as directors of Enron or on various board committees and so "must have been aware" of Enron's alleged misstatements. The Fifth Circuit has made clear that "a pleading of scienter may not rest on the inference that defendants must have been aware of the misstatements based on their position with the company." *Abrams v. Baker Hughes, Inc.*, 2002 WL 1018944 at *5 (5th Cir. 2002).

Plaintiffs' allegations that some directors sold a fraction of their shares over a three year period (in which most increased their holdings) likewise raises no inference of fraud. As was demonstrated in the Motion to Dismiss, and left unrefuted in Plaintiffs' Response, these sales were not made at suspicious times or prices, or in amounts or circumstances suggestive of an intent to defraud. *See* Motion to Dismiss at 15-16 (analyzing *Nathenson*). In the final analysis, Plaintiffs do not plead "what Wendy Gramm said, what John Duncan knew, when Robert Belfer knew it and where Charles LeMaistre should have disclosed it." Motion to Dismiss at 2. This does not suffice to state a claim under the PSLRA. Plaintiffs' 10(b) and Rule 10(b)(5) claim against the Outside Directors must be dismissed.

II. Plaintiffs Cannot Amend Their Complaint in their Responsive Brief, And the Complaint Does Not State a Claim Against the Outside Directors.

Plaintiffs cannot attempt to cure the deficiencies of their Complaint by adding into their responsive briefs nearly 60 pages of new factual allegations and nearly thirty new factual exhibits. *See* Plaintiffs' Response at 1-35, 55-64, 71-75, 85-95; *see also* Plaintiffs' Motion to Strike at 11-53. Not only do their new allegations betray Plaintiffs' own doubt as to the particularity of their Complaint, for the reasons stated in Part III, *infra*, even if their new allegations were considered, they still do not support any inference that the Outside Directors acted with an intent to deceive.

Consideration of a motion to dismiss is limited to "the facts stated in the complaint and any documents either attached to the complaint or incorporated into it." *In re BMC*, 183 F. Supp. 2d at

881.[6] *Accord Spivey v. Robertson*, 197 F. 3d 772, 774 (5th Cir. 2000). "It is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss." *In re BMC Software*, 183 F. Supp.2d at 915. *See also In re Baker Hughes Sec. Litig.*, 136 F. Supp. 2d 630, 646-47 (S.D. Tex. 2001) quoting *O'Brien v. Nat'l. Prop. Analysts Partners*, 719 F. Supp. 222, 229 (S.D.N.Y. 1989); *Coates v. Heartland Wireless Communications, Inc.*, 55 F. Supp. 2d 628, 642 (N.D. Tex. 1999) (Coates II) (holding plaintiffs cannot avoid dismissal based on an allegation not contained in their complaint). The Court therefore should not consider the wholly new factual material contained in the following pages of the responsive briefs filed by Plaintiffs: Plaintiffs' Response at 1-37, 55-64, 85-95; Motion to Strike at 11-53. Instead, Plaintiffs' effort to amend their Complaint should be considered only for what it is: an admission that the existing Complaint fails to state a fraud claim against the Outside Directors.

When the new allegations are disregarded, Plaintiffs' Complaint still contains only twenty-three paragraphs of allegations against the Outside Directors. When examined meticulously, *cf. In re BMC*, 183 F. Supp. 2d at 916, these do not state a claim of fraud against the Outside Directors because:

1. Mere status as a director or committee member does not state a claim of fraud. *See Abrams*, 2002 WL 1018944 at *5; *Accord Coates v. Heartland Wireless Communications, Inc.*, 26

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[6]In securities fraud cases, the Fifth Circuit also permits the district court to take judicial notice of and consider the contents of relevant public disclosure documents that are required by law to be filed with the Securities and Exchange Commission, *Lovelace v. Software Spectrum, Inc.*, 78 F. 3d 1015, 1017-18 (5th Cir. 1996), and such documents that are "integral to and explicitly relied on in the complaint. *In re BMC* 183 F. Supp. 2d at 861. Plaintiffs are in error, therefore, when they suggest that the court may not consider these materials in evaluating whether Plaintiffs have stated a claim under the PSLRA.

F. Supp. 2d 910, 916 (N.D. Tex. 1998) (Coates I). Thus, paragraphs 1, 86 and 87 do not state a claim of fraud.

2. Signing a public filing alleged to be false or misleading, without particular facts supporting a strong inference that an outside director knew that the public filing was false or misleading at the time, also does not state a claim of fraud. *Nathenson*, 267 F.3d at 406-07; *Coates I*, 26 F. Supp. 2d at 910, 916. Thus, paragraphs 109, 110, 126, 134, 141, 164, 221, 292 and 336 likewise do not state a claim of fraud.

3. Allegations of stock sales, unaccompanied by facts supporting a strong inference that the trades were suspicious in amount, timing and nature, likewise do not state a claim of fraud. "The mere sale of stock by insiders alone will not establish fraudulent intent." *In re Waste Mgm't. Inc. Sec. Litig.*, Slip Op., No. H-99-2183, at 129 (S.D. Tex. Aug. 16, 2001) (citing *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999)). Thus, as the analysis of the Outside Director stock trades in the Motion to Dismiss demonstrates, paragraphs 83, 84, 401, 402, 410 and 415 do not support a claim of fraud.[7]

Taken individually and in the aggregate, *Abrams*, 2002 WL 1018944 at *4, these twenty-three paragraphs do not plead <u>any fact</u> supporting the existence of <u>any statement</u> by <u>any Outside Director</u> that he or she <u>knew to be false</u> when it was made. *Compare Nathenson*, 267 F.3d at 412 *with* NCC

[7]Paragraph 885 of the Complaint, which mentions Dr. Jaedicke, merely recites the fact that in October 2001 he received a report from Vinson & Elkins concerning an internal investigation it performed. Nowhere in the Complaint, however, is it alleged that Dr. Jaedicke believed Vinson & Elkins' investigation was anything other than thorough, independent and above-board. The mere recitation of this fact, therefore, likewise states no claim of fraud. Finally, paragraphs 2, 993, 1006 and 1019 simply identify which claims are being asserted against the Outside Directors.

¶¶ 1, 2, 83, 84, 86, 87, 109, 110, 126, 134, 141, 164, 221, 292, 336, 401, 402, 410, 415, 855, 993, 1006, 1019. The Complaint, therefore, must be dismissed.

III. Plaintiffs' Retreat to Allegations that the Outside Directors Were Part of a "Scheme" to Defraud Does Not Salvage Their Claim.

Unable to plead with particularity that any Outside Director made a misrepresentation with an intent to deceive, or any facts giving rise to a strong inference that each charged director knew that Enron's financial statements or public disclosures were false or misleading, Plaintiffs simply change the subject. Rather than meet their obligation to plead facts as to each defendant, Plaintiffs suggest that generally alleging a "scheme to defraud"relieves them of their obligation to allege particular facts to support a fraud claim against the Outside Directors. *See* Response at 47-54. The law is to the contrary.

All of Plaintiffs' "theories" of 10(b) liability against the Outside Directors, including their "scheme to defraud" theory, suffer from the same defect: Plaintiffs fail to allege any fact that could give rise to a strong inference that each Outside Director made a false statement or engaged in any wrongful conduct with an intent to deceive. Plaintiffs themselves concede the significance of this point. Plaintiffs' Response at 62 ("It is clear that for §10(b) or Rule 10b-5 liability to attach under either theory, ***scienter must be present***, i.e., there must be either intentional or reckless conduct) (emphasis in the original). Because Plaintiffs have not pleaded scienter on the part of any Outside Director charged with fraud, as they must under any "theory", Plaintiffs' 10(b) claims must be dismissed.

A. Plaintiffs Cannot Avoid Pleading Particular Facts Against Each Outside Director Charged With Fraud By Merely Alleging A Scheme To Defraud.

"Plaintiffs cannot satisfy Rule 9(b) by masking the lack of factual allegations against each defendant through broad allegations which combine the acts of several defendants to create the impression that all engaged in every aspect of the alleged fraud." *O'Brien v. Nat'l. Prop. Analysts Partners*, 719 F. Supp. 222, 229 (S.D.N.Y. 1989) (quoting *Crystal v. Foy*, 562 F. Supp. 422, 427 (S.D.N.Y. 1983). Even the cases on which Plaintiffs rely establish that they must plead, with particularity, what each defendant did to foster the alleged "scheme" to defraud. *See e.g. In re Health Mgm't., Inc. Sec. Litig.*, 970 F. Supp. 192, 204-05 (E.D.N.Y. 1997) (dismissing claim against outside director because membership on board, and allegations that the "reality of Health Management's true financial condition and fraud was so obvious that [director] must have been aware of the truth or closed her eyes...do not provide specific allegations of fact in support of...alleged fraudulent conduct"); *SEC v. First Jersey Sec. Corp.*, 101 F.3d 1450, 1471 (2d Cir. 1996) (sustaining SEC complaint because evidence established that individual "engaged in the purposeful planning of the pattern [of fraud] and repeated format of trading in which the respective branch offices engaged and that he 'orchestrated every fact of First Jersey's branch office network.' and 'was intimately involved in...[efforts] to keep customers in the dark.'").[8]

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[8]Plaintiffs' invocation of the phrase "Ponzi scheme," Complaint ¶¶ 18, 24, 25 et al; Plaintiffs Response at 10, 14, 20, 24, actually undercuts their argument. In *Cunningham v. Brown*, 265 U.S. 1, 44 S. Ct. 424 (1924), the Supreme Court was careful to catalogue the wrongful acts Charles Ponzi had committed in furtherance of his scheme to defraud:

> In December, 1919, with a capital of $150, he began the business of borrowing money on his promissory notes. He did not profess to receive money for investment

Here, of course, Plaintiffs make no such detailed allegations. To the contrary, "Plaintiffs [have not] specifically alleged how the individual non-speaking Defendants [including the outside directors] have participated in the alleged scheme to defraud." *In re BMC*, 183 F. Supp. 2d at 915. Plaintiffs make only unremarkable allegations that the Outside Directors were members of Enron's Board, served on various board committees, signed SEC filings, and voted to approve various transactions or structures. *See* NCC ¶¶ 1, 86, 87, 109, 110, 126, 134, 141, 164, 221, 292 and 336. Although Plaintiffs criticize these decisions, they nowhere allege any facts raising a strong inference that any of the Outside Directors made these decisions with <u>any degree of wrongful intent</u>–much less while possessed of a state of mind equivalent to willful fraud. *Nathenson*, 267 F.3d at 412. That these decisions later turned out badly does not state a claim for securities fraud; it is settled that allegations of mismanagement are not actionable under the securities laws. *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977).

> for account of the lender. <u>He</u> borrowed the money on his credit only. <u>He</u> spread the false tale that on his own account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100 per cent, profit, and that this was made possible by the excessive differences in the rates of exchange following the war. <u>He</u> was willing, <u>he</u> said, to give others the opportunity to share with him this profit. By a written promise in 90 days to pay them $150 for every $100 loaned, <u>he</u> induced thousands to lend [to] him. <u>He</u> stimulated their avidity....<u>He</u> was always insolvent, and became daily more so, the more his business succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes.

Tellingly, no such allegations of <u>personal</u> wrongdoing by an Outside Director appear anywhere in Plaintiffs' 570 page Complaint.

Plaintiffs' allegation that Defendants received various reports and were "obliged to stay informed" of Enron's financial affairs, Plaintiffs' Response at 62, adds nothing of substance. Nowhere do Plaintiffs allege any facts that:

1. Any outside director "orchestrated" the "scheme to defraud" alleged by Plaintiffs. *Cf. In re Health Mgm't.*, 970 F. Supp. at 204 (sustaining claim against inside director who was alleged to have "convened ...meeting during which the inventory fraud was developed and approved the plan and directed that it be put into effect," but dismissing claim against outside director because allegations that "the fraud was so obvious that she should have known the truth" were insufficient).

2. Any outside director supervised or was "intimately involved in" the day to day implementation of Enron's alleged scheme to defraud. *Cf. First Jersey Securities*, 101 F.3d at 1471(upholding conviction for securities fraud where evidence established defendant "orchestrated every facet" of the fraud).

In the absence of allegations of fact that an individual defendant actually committed a wrongful act, no claim for a "scheme to defraud" is stated against that defendant. *See Dinsmore v. Squadron, Elenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 843 (2d Cir. 1998) ("Where the requirements for primary liability are not independently met, they may not be satisfied based solely on one's participation in a conspiracy in which *other parties* have committed a primary violation."). Any other result would afford Plaintiffs license to avoid their burden to plead fraud with particularity by asserting (as Plaintiffs have done here) generalized allegations of a fraudulent scheme that are "no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision." *In re Oak Technology Sec. Litig.*, 1997 WL 448168 *10; *See also Lemmer v. Nu-Kote*, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001); *In re Petsmart Sec. Litig.*, 61 F. Supp. 2d 982 (D. Ariz. 1999).

Courts that have considered the issue have flatly rejected the suggestion–made here by Plaintiffs–that the Outside Directors may be held liable for violations of Section 10 because they "conspired" with others as a part of an alleged "scheme to defraud." *Dinsmore*, 135 F.3d at 841 (citing cases). Indeed, in the more than one hundred cases we have examined on this point, not one case has sustained a securities claim against an Outside Director based upon her alleged participation in a scheme to defraud in the absence of an allegation that she personally committed a wrongful act in furtherance of the scheme. Plaintiffs have cited none and amicus curiae have cited none–because there are none.

In the absence of particularized allegations that the defendant himself committed a fraudulent or manipulative act, with scienter, Plaintiffs' claim fails as a matter of law. Here, Plaintiffs do not allege a fraudulent act -- let alone the requisite intent -- by even one Outside Director. Plaintiffs' 10(b) claims against the individual Outside Directors should be dismissed.

B. Plaintiffs' Claim That The Outside Directors Are Liable For Material Omissions Fails For The Same Reason: Plaintiffs Have Not Alleged Scienter.

Unable to allege that the Outside Directors made any misrepresentations with scienter, Plaintiffs next suggest that those Directors can still be held liable for failing to disclose material information that they had a duty to disclose. This argument is a red herring. Nowhere in their Complaint do Plaintiffs specify what material, non-public information the Outside Directors supposedly had. Nowhere do they allege that the Outside Directors knew anything about the "problems impacting Enron" (Response at 46) that the Plaintiffs now claim the Directors should have disclosed. Nor do they allege that any of the Outside Directors had reason to question the accuracy or completeness of Enron's public disclosures. *See Cheney v. Cyberguard*, 2000 WL 114306 (S.D. Fla. July 31, 2001) ("Absent knowledge, an outside director has no duty to insure that all material adverse information about a corporation is conveyed to prospective purchasers of the corporation's stock.") *quoting Jacobs v. Coopers & Lybrand LLP,* 1999 WL 101772 *16-17 (S.D.N.Y. March 1, 1999).[9]

Plaintiffs' omissions case against the Outside Directors is thus no different than their misrepresentation case. Under either theory, Plaintiffs must allege scienter, and they have not[10].

IV. Plaintiffs' New Allegations Regarding the "Actual Knowledge of the Outside Directors" Raise No Inference Of Fraudulent Intent.

In tacit acknowledgment of the fact that their Complaint does not allege a fraud claim against the Outside Directors, Plaintiffs offer sixty pages of new assertions about what the Outside Directors allegedly knew, in a vain attempt to demonstrate scienter. These new allegations, about events recorded in board and committee minutes, do not raise a strong inference that the Outside Directors intended to defraud anyone. *See* Response at 31-35 (section titled "Actual Knowledge of the Outside Directors"). Not a single one of these allegations suggests–much less asserts with particular facts–that any Outside Director knew that any statement in Enron's Registration Statements or Forms

[9]Plaintiffs also exaggerate the Outside Directors' potential 10(b) liability for failing to disclose information. For example, Plaintiffs suggest that one ground for liability is the failure to comply with Item 303 of SEC Regulation S-K. Response at 45. Numerous courts have held, however, that violation of Item 303 does not establish a duty to disclose for purposes of 10(b) liability. *See, e.g., Oran v. Stafford*, 226 F.3d 275, 287 (3d Cir. 2000); *In re Boston Tech. Sec. Litig.*, 8 F. Supp. 2d 43, 67 (D. Mass. 1998).

[10]Plaintiffs' argument regarding the alleged insider trading by individual Outside Directors is more specifically addressed in Part V, *supra*.

10-K was false or misleading at the time they signed them. To the contrary, the Complaint alleges that the directors were assured by Arthur Andersen that Enron's audits were done in accordance with GAAS, that Enron's financial statements were prepared in accordance with GAAP, and that they presented fairly, in all material respects, the financial position of Enron Corp. NCC ¶ 903.

An allegation that directors relied on outside auditors "negates a strong inference of negligence." *See In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d at 1267 and n.9. The *McKesson* Court dismissed Section 14 claims because it concluded that an allegation that directors "appear to have relied on accounting done by Arthur Andersen," *id.* at 1267, negated the "strong inference of negligence" required to state a claim for proxy violations, *id.* at n.9. If a claim of mere negligence is refuted (and due care is established) by an allegation that directors relied on Andersen's audited financials, then severe recklessness--defined by the Fifth Circuit as an "extreme departure from the standards of ordinary care"--is plainly refuted by it. *Compare Broad,* 642 F.2d at 962 (requiring securities fraud plaintiff to prove "extreme departure from the standards of ordinary care") *with McKesson*, 126 F. Supp. 2d at 1267, n.9 (finding that a strong inference of mere negligence is negated by an allegation that directors relied on advice from outside accountants).

"Courts have routinely held that complaints disclosing facts negating an inference of scienter must, at the very least, explain such facts in order to support their claims of fraudulent intent." *McKesson*, 126 F. Supp. 2d at 1267 *citing In re Segue Software, Inc. Sec. Litig.*, 106 F. Supp. 2d 161, 169 (D. Mass. 2000). Plaintiffs have never alleged, and do not suggest now, that any director actually knew or had reason to suspect that the unqualified opinions from Arthur Andersen were false or misleading when rendered. Plaintiffs also did not allege, and do not suggest now, that any director included Enron's audited financials in regulatory filings with the willful intention to defraud the investing public. *Cf. Nathenson*, 267 F.3d at 408-09. Plaintiffs have, in fact, plead the very facts that negate any inference (much less a strong inference) of fraud by the Outside Directors. *McKesson*, 126 F. Supp. 2d 1267, n.9. Plaintiffs' allegation thus "repels any conclusion" that the Outside Directors committed fraud, much less did so with the required intent. *O'Brien*, *supra*. Plaintiffs' Complaint must therefore be dismissed. *Id.*

This is made even clearer if one compares Plaintiffs' new allegations about the Outside Directors with the *facts* that Plaintiffs allege establish Enron's fraud. Plaintiffs allege only that the Outside Directors knew and approved of certain transactions. *See* Response at 31-35, 55 ("The Outside Directors' role in the Enron scheme was their approval of the transactions, methods and devices that were the elements of the scheme."). Plaintiffs do not allege that the Outside Directors orchestrated Enron's alleged fraud, *In re Health Mgm't.*, 907 F. Supp. 192, or were responsible for its day to day implementation, *First Jersey Sec. Corp.*, 101 F.3d 1450, or had any knowledge that the transactions or entities they approved were being utilized for an improper purpose. Such allegations are essential if Plaintiffs' complaint is to survive–but they appear nowhere in the Complaint. They are missing, as well, from the new allegations contained in Plaintiffs' Response.

Indeed, Plaintiffs' "approval" and "nondisclosure" claims against the directors bear a striking resemblance to the claims rejected in the *O'Brien* case. *O'Brien v. Nat'l. Prop. Analysts Partners*, 719 F. Supp. 222 (S.D.N.Y. 1989). In *O'Brien*, the plaintiff alleged (as Plaintiffs do here) that fraud had been committed because the transactions being disclosed were not "legitimate." The District Court rejected that claim, noting that:

> the financial projections are alleged to have been false and misleading because they purportedly `contained language and figures designed to induce the reader to believe that the NPA partnerships were legitimate economic transactions.' The allegedly suspect language and figures are nowhere identified, nor is there any articulation of how it would have been false to indicate that the partnerships were `legitimate' economic transactions.

O'Brien, 719 F. Supp. at 229. The same is true here. In fact, Plaintiffs stop short of asserting even the insufficient claim that the directors "must have been aware of the truth or closed [their] eyes to the truth" because the "financial condition and fraud was so obvious." *In re Health Mgm't., Inc. Sec. Litig.*, 970 F. Supp. 192, 205 (E.D.N.Y. 1997).

Thus, although we examine them in greater detail below, Plaintiffs' new allegations would not be sufficient to state a claim against the Outside Directors even were they included in an Amended Complaint.[11]

A. Neither Plaintiffs' Existing Allegations Regarding Chewco, Nor Their New Contentions, Raises a Strong Inference of Scienter.

1. The Existing Allegations About Chewco Were Insufficient to Begin With.

The Complaint alleges that Chewco should have been consolidated on Enron's financial statements because it did not satisfy the GAAP requirements for non-consolidation. NCC ¶¶ 10, 22, 61, 435-47. As a result, according to the Complaint, Enron improperly accounted for Chewco from the fall of 1997 through the fall of 2001. That is the "fraud" that Plaintiffs allege in the Complaint concerning Chewco–but it does not state a claim against the Outside Directors for at least three reasons.

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[11]For this reason, granting Plaintiffs leave to amend would be futile. *See* Section VIII, *infra*.

First, the failure to consolidate debt or to comply with GAAP does not state a claim for securities fraud. *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990); *Vosgerichian v. Commodor Int'l.*, 832 F. Supp. 909, 915 n.8 (E.D. Pa. 1993). Second, "the failure to follow GAAP, without more, does not establish scienter." *Lovelace,* 78 F.3d at 1020. Where Plaintiffs plead <u>not a single fact</u> to support an inference that any Outside Director actually knew the accounting treatment for the Chewco transaction was incorrect at the time, the fact that the accounting treatment was wrong says nothing about an Outside Directors' state of mind. *Compare In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 864-65 (N.D. Cal. 1993) (dismissing claim where plaintiff failed to plead that any individual defendant knew accounting treatment was improper). To the contrary,

> The term `generally accepted accounting principles,' as we have often noted, is a term of art encompassing a wide range of acceptable procedures, such that `an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement.

Lovelace, 78 F.3d at 1020-21. Plaintiffs' own pleading establishes that the Outside Directors were constantly assured that Enron's financial statements were correct and presented fairly. *See e.g.*NCC ¶ 903-04. There is, therefore, no basis upon which to argue that Plaintiffs have alleged a <u>strong inference</u> that the Directors acted with willful, fraudulent intent. 15 U.S.C. § 78u-4.

Third, as was noted in the Officer's Joint Brief Regarding Disclosure, although the Chewco debt was not consolidated, it <u>was disclosed</u> in Enron's financial statements. *See* Forms 10-K for 1997, 1998, 1999, 2000 at n. 9 "Unconsolidated Equity Affiliates" (disclosing debt associated with JEDI and other unconsolidated Equity Affiliates). *See also Joint Brief Regarding Enron's*

Disclosures at 45- 49. A difference in judgment about whether consolidated presentation is required is just that: a difference in judgment does not establish conscious behavior on the part of Defendants." *Lovelace*, 78 F.3d at 1020-21.

Finally, there is no allegation in the Complaint that any of the Outside Directors knew or should have known that anything about Chewco, including Enron's accounting for JEDI, was improper. No inference of conscious behavior by the Outside Directors is raised when Plaintiffs do not allege that any Outside Director actually knew - or had any reason to know - that deconsolidated treatment for Chewco was improper.

2. Plaintiffs' New Allegations About Chewco Also Fail to Raise a Strong Inference of Scienter.

Recognizing that their existing complaint actually negates any inference of fraudulent intent as it pertains to the Chewco transaction, NCC ¶ 903-04, Plaintiffs now allege that the actions of certain directors at an Executive Committee meeting in November of 1997 constitute fraud. Response at 31. Plaintiffs' "new" allegation is as follows:

> Committee recommends that the Board approve the formation of Chewco and JEDI2, and that Enron would provide a bridge loan of $383 million and a guarantee of a $250 million loan to Chewco, which CFO Fastow managed.

Response at 31 (citing Ex. 21) (minutes of the meeting). This bare (and incomplete) summary of what happened at these meetings does not state a claim of fraud against any director.[12] Plaintiffs still do not allege that any Board member: (a) knew that Enron had improperly accounted for Chewco,

[12] This is evident from the fact that, although they note that he attended this meeting, Plaintiffs have not sued Mr. Winokur for fraud. *Compare* NCC at pg. 3, n.1, *with* Response at 31.

or (b) knew that the transaction with Chewco failed the GAAP requirements for non-consolidation. *Id.*

Nor could Plaintiffs make these required allegations in good faith. The very minutes on which Plaintiffs rely to establish their theory reflect that the Executive Committee was told that Chewco was "not affiliated" with Enron. *See* Response, Ex. 21. Of equal importance, nothing in the Minutes of this Meeting indicates that (as Plaintiffs contend) Fastow was to manage Chewco. *Id.* Allegations that the Board approved a single transaction with Chewco, after being told it was an unaffiliated company, raise no inference at all that the Board knew, or was reckless in not knowing, that Enron's accounting for Chewco was improper.

B. The Board's Approval of the LJM Transactions Does Not Raise A Strong Inference of Scienter.

Plaintiffs spend four single spaced pages reciting events that occurred at various Finance Committee and Board meetings regarding the approval of the LJM transactions and general reports about Enron's operations and finances. Response at 31-35. None of these allegations appeared in the Complaint, so they must be disregarded in their entirety. *In re Baker Hughes*, 136 F. Supp. 2d at 646-47.

Even if considered, however, none of these paragraphs alleges facts giving rise to a strong inference that any individual director harbored a fraudulent intent, knowingly participated in a scheme to defraud, or learned at any time that Enron's financial statements or public disclosures might be false or misleading. To the contrary, as with the Chewco allegations, all of the meetings relied on by Plaintiffs were also attended by directors whom Plaintiffs did not sue for fraud. *See* Response at 31-35 (noting that these meetings were also attended by Messrs. Wakeham, Winokur, Pereira, Savage, Meyer and Mendelsohn--none of whom has been sued for fraud). This is no mere oversight: Plaintiffs have made plain that they did not sue these other directors for fraud because they could make no claim of fraud against them (NCC ¶ 3) even considering what occurred at these meetings.[13] Plaintiffs dichotomy--based solely on who sold and who did not--undermines entirely the assertion that anything fraudulent or wrongful occurred in the Board and Committee meetings that Plaintiffs now invoke to support their claim.

The fact that the Outside Directors approved the formation of LJM2 does not support an inference that the directors knew that the accounting for LJM2 would be improper, or that LJM2 would engage in "manipulative transactions," as alleged in the Complaint. *Cf. generally, Santa Fe Indus. v. Green*, 430 U.S. 462 (approval of transactions, even where there are allegations of negligence or poor judgment, do not state a claim for violation of the Securities Act without sufficient allegations of knowledge of falsity or intent to deceive); *Central* Bank, 511 U.S. at 172 ("language of § 10 gives no indication Congress meant to prohibit any conduct not involving manipulation or deception."); *Coates II*, 55 F. Supp. 2d at 644 ("[A]ssertions that would almost universally be true, such as the desire to raise capital ... economic self-interest ... are inadequate of themselves to plead fraud."). Critically, although Plaintiffs allege that LJM2 was used for fraudulent

[13]The allegation that a director "must have known" of the fraud because she was a director does not suffice to state a claim of securities fraud. *See Abrams*, 2002 W.L. 1018944 at *5. Plaintiffs recognize as much and, accordingly, have excluded from their "scheme to defraud" allegations those directors who--though they attended the identical meetings--did not sell any shares. "[P]laintiffs expressly exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct," NCC ¶ 1005, "descriptions herein of the Outside Directors' involvement in Enron's scheme to defraud do not apply to Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham, Walker and Winokur," Response at 1.

purposes in that Enron (i) accounted for LJM2 improperly (NCC ¶¶ 448, 450); (ii) closed a number of hurried deals with LJM2 in 1999 in order to avoid issuing a bad earnings report (NCC ¶¶ 26, 28); (iii) provided "favored investors...a promise of superior returns" (NCC ¶¶31); and (iv) engaged in "manipulative transactions" on unfavorable terms or which involved secret "repurchase" agreements (NCC ¶¶ 32, 466-76), Plaintiffs do not allege that any Outside Director knew any of these facts, much less that any director knew that they would occur when LJM2 was formed.

The new facts alleged in the Response about events at Board Meetings, even if the Court considered them, would not cure the deficiencies in these allegations. If anything, the minutes of these meetings only weaken Plaintiffs' allegations against the Outside Directors. For example, the October 11, 1999 Finance Committee Minutes invoked by Plaintiffs show that the Directors were told that the formation of LJM2 had a legitimate business purpose; namely, to "provide the Company with an alternative, optional source of private equity to manage an investment portfolio risk, funds flow, and financial flexibility." *See* Response at 31 & Ex. 23. The corporate secretary's handwritten notes reflect that the Outside Directors specifically questioned whether Andersen had reviewed the LJM2 proposal, and were assured that they had. *See id.* at Ex. 23, pg. 6. Indeed, the Board was also told that LJM2 "could provide liquidity, risk management, and other financial benefits" to Enron, and that the Office of the Chairman of Enron (which did not include any Outside Directors) had determined that Fastow's involvement in LJM2 "will not adversely affect the interests of the Company." *See* Response, Ex. 24.

These legitimate, non-fraudulent reasons for approving the formation of LJM2 and the express assurances received by the Board--all of which have been proferred by Plaintiffs and therefore must be taken as true--negate a strong inference that the Directors harbored an intent approaching willful fraud. *Cf. In re McKesson,* 126 F. Supp. 2d at 1267 & n.9.

C. The Reports By Andersen to the Audit Committee Do Not Raise a Strong Inference of Scienter.

Plaintiffs' spill most of their ink asserting that events at various Audit Committee meetings establish an intent to defraud on the part of some, but not all of the Audit Committee members. Plaintiffs' claim fails for two reasons: (a) their Complaint (in contrast to their new allegations) contains allegations about these meetings that negate any inference of scienter; and, (b) the "non-public" information Plaintiffs contend was conveyed in these meetings was, in fact, fully disclosed--as is also established in the Forms 10K on which Plaintiffs have relied in their Complaint. We address each of these meeting in turn.

1. The February 7, 1999 Audit Committee Meeting

Plaintiffs, relying on Board minutes not referenced in or attached to their Complaint, suggest that at the February 7, 1999 Audit Committee meeting, Andersen informed the Audit Committee "that the accounting in many of Enron's core businesses are high risk and highly judgmental." Response at 31. Taking that one isolated comment out of context, Plaintiffs conclude that the Audit Committee therefore "knew" about Enron's allegedly fraudulent accounting practices. Plaintiffs' Response at 57. The minutes also reflect, however, that at the same meeting Andersen also told the Audit Committee:

1. That Andersen would "submit an unqualified financial statement opinion as a result of its 1998 audit;"

2. That Andersen had found no need for any "significant audit adjustments or new accounting polices or changes;"

3. That "no modification was needed in Arthur Andersen's opinion, in either management's judgments on accounting estimates or results of reviews of interim financial information;" and

4. That Arthur Andersen was "comfortable with the 1998 Financial Statements."

See Response, Ex. 22.[14]

To use Plaintiffs' words, "With respect to Enron's financial statements...Andersen represented the following....[that] the financial statements referred to above present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries" for the years 1997, 1998, 1999 and 2000. NCC ¶¶ 903-904. In fact, in each of Enron's Forms 10K, including that filed for 1998, Enron stated it had "No disagreements on accounting and financial disclosure" with Andersen. *See e.g.,* 1998 Form 10K at Item 9, SEC App. Tab 6, Pg. 70. In the face of these allegations--raised by or incorporated in Plaintiffs' Complaint--the allegation that the directors were told that Andersen's accounting advice "required professional judgment" does not support an inference of fraud. *See Lovelace*, 78 F. 3d at 1020-21 (noting that GAAP "involves a wide range of acceptable procedures.").

This is particularly true here, because the Outside Directors were assured at every step that "Arthur Andersen concurred" in the judgments being made. Even if the Defendants were mistaken in this belief, a failure to follow "GAAP, without more, does not establish scienter." *Id.* Plaintiffs have alleged <u>nothing more</u> as it pertains to the Outside Directors.

2. The February 2001 Audit Committee Meeting.

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[14]If the Court considered these allegations at all it would, of course, have to consider these incorporated documents, which are expressly relied on by Plaintiffs, in their entirety. *See In re BMC*, 183 F. Supp. 2d at 861.

Plaintiffs next suggest that some, but not all, Audit Committee members received non-public information concerning Enron's use of "highly structured transactions, such as securitizations and syndications, in which there was significant judgment in the application of GAAP at a February 2001 meeting of the Audit Committee." Plaintiffs' Response at 73. Plaintiffs can make this assertion only by ignoring, in their entirety, Enron's extensive disclosures concerning its use of structured finance transactions, including syndications. The existence of these disclosures was set out in detail in the *Joint Brief Regarding Adequacy of Enron's Disclosures* at Section III A, and in particular at pages 19-24.

To make absolutely clear that the facts Plaintiffs contend were concealed were in fact disclosed, the chart below compares Plaintiffs' assertion of the allegedly "undisclosed" facts with the context provided by Enron's actual disclosures. *See Isquith v. Middle South Utilities, Inc.*, 847 F.2d 186, 107-08 (5th Cir. 1988) (finding materiality "must be measured in the context of the statements contained in ...prior public reports"). When the Court compares these disclosures to the allegedly "undisclosed" facts, as it is required to do under applicable law,[15] it is obvious that the information cited by Plaintiffs was not material, non-public information, but instead was disclosed in great detail.

[15] *See In re BMC* at 882, *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435 (5th Cir. 1993).

Plaintiffs' Assertion	Enron's Disclosures
The public did not know that "Enron continued to utilize highly structured transactions, such as securitizations and syndications." Plaintiffs' Response at 73.	1999 Form 10K Note 4 Merchant Activities: From time to time, Enron sells interests in merchant assets and investments. Some of these sales are completed in <u>securitizations</u>, in which Enron retains certain interests thourhg swaps associated with the underlying assets. Such swaps are adjusted to fair value based on <u>management's best estimate</u> of the present value of future cash flow. These swaps are included in Price Risk Management Activities. See Note 3. For the year...ended December 31, 1999, ...pre-tax gains from sales of merchant assets and investments totaling $756 million ...are included in Other Revenues and proceeds were $2,217 million. 2000 Form 10K Note 3: Price Risk Management Activities: "<u>Securitizations</u>: From time to time, Enron sells interests in certain of its finanical assets. Some of these sales are completed in securitizations, in which Enron concurrently enters into swaps associated with the underlying assets which limits the risks assumed by the purchaser. Such swaps are adjusted to fair value using quoted market prices, if available, or estimated fair value based on <u>management's best estimate</u> of the present value of future cash flow. These swaps are included in Price Risk management activities above as equity investments. <u>During 2000, gains from sales representing securitizations were $381 million and proceeds were $2,379 million ($54 million of the proceeds related to sales to Whitewing Associates, L.P. See Notes 4 and 9. Purchases of securitized merchant financial assets totaled $1,184 million during 2000.</u>[16]

[16]The financial impact of these transactions was also disclosed. The 1999 Form 10K disclosed gains of $756 million from these transactions, which constituted 84% of net income for 1999. *Compare* Note 4 *with* Consolidated Income Statement, net income of $893 million. The 2000 Form 10K disclosed gains of $381 million from securitizations, a figure representing nearly 39% of Enron's net income. *Compare* Note 3 *with* Consolidated Income Statement, net income of $979

Plaintiffs' Assertion	Enron's Disclosures
The public did not know "there was significant judgment required in the application of GAAP."[17] Response at 73.	Form 10K for 1999, Note 1: Significant Accounting Policies: The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts and revenues and expenses during the reporting period. Actual results could differ from those estimates. Accounting for Price Risk Management: Enron engages in price risk management activities for both trading and non-trading purposes....The market prices used to value these transactions reflect management's best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments. The values are adjusted to reflect the potential impact of liquidating Enron's position in an orderly manner over a reasonable period of time based under present market conditions....See Note 3 for a further discussion of Price Risk Management Activities. Note 3: Price Risk Management Activities: The fair value as of December 31, 1999 and the average fair value of instruments related to price risk management activities ...is set forth below.... Enron uses the following methods and assumptions in estimating fair values....Judgment

million.

[17]*But see Lovelace*, 78 F.3d at 1021 noting that application of GAAP is "a term of art encompassing a wide range of acceptable procedures." It simply was not news to a reasonable investor, that the preparation of Enron's financial statements involved the exercise of professional judgment.

As this chart makes clear, the information Plaintiffs' claim was "undisclosed" was set out, at length, in Enron's public filings. On that basis alone, Plaintiffs suggestion that the minutes of these Audit Committee meetings indicate that certain members of the Audit Committee were engaged in a scheme to defraud is smear, not substance.

3. The May 1, 2000 Meeting of the Audit Committee

The same analysis applies to Plaintiffs' allegation that at a May 1, 2000 meeting, the Audit Committee learned that Andersen was giving high priority to certain financial reporting areas, including Enron's structured transactions, its merchant portfolio, and inter-company and related party transactions, because of the "inherent risks that were present." Response at 33 & Ex. 25. The fact that Andersen assured the Audit Committee that it was giving high priority to particular financial reporting areas does not raise a 'strong inference' of scienter." *Nathenson*, 267 F.3d at 407. Rather, this allegation is consistent with an inference of due care. It indicates that the directors were attentive to the important accounting issues involved in Enron's business. *Cf. McKesson*, 126 F. Supp. 2d at 1267. Importantly, Plaintiffs do not allege that the Audit Committee was ever told that Enron's accounting was improper, that anyone at Andersen disagreed with any of Enron's accounting, or that Enron's financial reporting or internal controls were inadequate in any way. In sum, Plaintiffs do not allege even a single fact to support an inference that even <u>one</u> Director was <u>aware</u> of fraudulent activity by Enron--much less particular facts showing a strong inference that all of the accused directors harbored a specific intent to defraud.

The sole case cited by Plaintiffs on this point, *Gelfer v. Pegasystems*, 96 F. Supp. 2d 10 (D. Mass. 2000) is easily distinguishable. In *Gelfer*, defendants had restated revenues four times (both before and during the class period) due to improper revenue recognition, they had a dispute with their former auditors (who resigned) over revenue recognition policies, their new auditors specifically warned them of material weaknesses and recommended changes in their revenue recognition policies, and the defendants issued specific assurances that the company's accounting problems had been resolved. *Gelfer*, 96 F. Supp. 2d 10. Based on these facts, the court had no problem finding that plaintiffs' sufficiently alleged that the defendants acted with severe recklessness. The facts in *Gelfer* are not at all akin to those alleged here by Plaintiffs.

Plaintiffs' allegations are more closely akin to those alleged against two outside directors in *In re Sunterra Corp. Sec. Litig.,* 199 F. Supp. 2d 1308 (M.D. Fla. 2002). In *Sunterra*, the court held that plaintiffs failed to raise a strong inference of scienter as to the outside director defendants, noting that the Complaint "does not contend that Arthur Andersen ever informed the board of any deficiencies in internal controls." *Id.* at 1331. As in *Sunterra*, there is no allegation here that Andersen ever informed Enron's Audit Committee, or any of the Outside Directors, of any deficiencies in Enron's internal controls or its financial statements. There is, therefore, no basis upon which the Court could determine that Plaintiffs have plead fraud against the Outside Directors with either with particularity or in compliance with the PSLRA.

The fraud claim against the Outside Directors must be dismissed unless Plaintiffs allege facts raising a strong inference that each Outside Director accused of fraud had an intent to deceive at the time the statements challenged as fraudulent were made. In the face of repeated and unqualified assurances from Andersen that there was no need for any audit adjustments, that Andersen agreed with management's judgments, that Enron's audits and financial statements complied with GAAS and GAAP, and that Enron's financial statements fairly and accurately portrayed the company's financial position, no inference of fraudulent intent can be drawn from the obvious observation that the accounting for a company as large and complex as Enron involves risks and judgments, *see McKesson*, 126 F. Supp. 2d at 1267 n.9, especially considering the fact that Enron disclosed its use of structured transactions and that the preparation of its financials required the use of estimates and judgment.

Whether in their original version, or in their new (but not improved) version, Plaintiffs' claims concerning the material facts known to the Outside Directors simply do not state a claim of fraud.

D. Enron's Restatement In The Fall Of 2001 Does Not Provide A Strong Inference Of Scienter On The Part Of The Outside Directors.

Plaintiffs are left to argue that "the magnitude of Enron's restatements provides a strong inference of scienter." Response at 57. This is an incorrect statement of the law.

The Fifth Circuit has made clear that "the mere publication of inaccurate accounting figures, or a failure to follow GAAP, *without more,* does not establish scienter." *Lovelace*, 78 F.3d at 1020. Even the case that Plaintiffs' cite for this proposition establishes that more than an alleged restatement--even a significant restatement--is required to raise a strong inference of fraud. *In re Microstrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 634-35 (E.D. Va. 2000), one of the cases relied upon by Plaintiffs, makes clear that the size of a restatement is merely one factor a court may consider in determining whether a plaintiff has adequately alleged scienter, because:

> it is settled that `scienter requires more than a misapplication of accounting principles.' The inferences that may be drawn for or against scienter from the mere fact that a company misapplied GAAP and accordingly had to restate its financials

are in equipoise and, therefore, ...such allegations <u>by themselves cannot give rise to a 'strong inference' of scienter</u>.

Id. (citations omitted).[18] The remaining "restatement" cases cited by Plaintiffs share an additional, common feature: In not one of them did the court draw a strong inference of fraud against an outside director based upon the existence of a restatement.[19] The authority cited by Plaintiffs therefore does not support their contention that--contrary to Fifth Circuit law--this Court may draw a strong inference of fraud against the Outside Directors based solely upon the existence of a restatement.

Plaintiffs' argument about Enron's restatement is also notable in that it omits any discussion of the three cases critical to the assessment of directors' liability for securities fraud in the face of a restatement: *Sunbeam*, *McKesson*, and *Waste Management.* In *Sunbeam*, the court rejected a 10b

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[18]The *Microstrategy* Court drew an inference of fraud against a number of parties, including outside directors, based on facts that included <u>but were not limited solely to</u> the existence of a restatement. *See In re Microstrategy*, 115 F. Supp. 2d at 639 (noting that allegations of deliberate fraud by Microstrategy management with regard to its three largest contracts "shed light on otherwise inferentially ambiguous though not barren allegations that there were GAAP violations and restatements of financials").

[19]*See In re Ancor Communications,* Inc., 22 F. Supp. 2d 999, 1000 (D. Minn. 1998) (case against President, Chief Financial Officer and founder of company); *In re Employee Solutions Sec. Litig.*, 1998 U.S.Dist. LEXIS 16444 at *2 (D. Ariz. Sept. 29, 1998) (claim against company and senior officers); *Gelfer v. Pegasystems, Inc.*, 96 F. Supp. 2d 10, 17 (D. Mass. 2000) (case against president and chief financial officer); *Haack v. Max Internet Communications, Inc.*, 2002 U.S. Dist. LEXIS 5652, n.3 (N.D. Tex. Apr. 2, 2002), *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. 1996)(case against Chief Executive Officer and Principal Financial and Accounting Officer); *McKesson*, 126 F. Supp. 2d at 1274-1276 (noting 10b claims had been filed only against chief executive officer, chief operating officer, chief financial officer, general counsel, national sales director and senior employee); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1248 (N.D. Ill. 1997) (case against "executive officers); *Rothman v. Gregor*, 220 F.3d 81, 84 (2d Cir. 2000)(case against company and "its officers"); *SEC v. DCI Telecom.*, 122 F. Supp. 495 (S.D.N.Y. 2000) (claim against president and chief financial officer); *In re Triton Energy Ltd. Secs. Litig.*, 2001 U.S.Dist. LEXIS 5920 (E.D. Tex. Mar. 30, 2000) (claim against chief executive officer and chief financial officer).

claim against Sunbeam's Audit Committee (even in the face of a significant restatement) after noting that "although the Complaint amply demonstrates negligence as to [the Audit Committee's] ineffective monitoring of Sunbeam's accounting mechanisms, the Reform Act requires a much greater degree of culpability to maintain a securities fraud action: extreme recklessness." *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1341 (S.D. Fla. 1999). The *McKesson* court went even further, holding that an inference of simple negligence was negated by an allegation that directors relied on audited financial statements. 126 F. Supp. 2d at 1267 & n.9. This Court's decision in *Waste Management* does not differ. Importantly, all of these cases stand for the proposition that, even in the face of a significant restatement, a plaintiff still must plead facts giving rise to a strong inference of scienter in order to state a claim for securities fraud against an outside director. These pleading requirements must be applied "with force and without apology." *Williams*, 112 F.3d at 78. When this Court does so, it will be apparent that there is an absolute lack of any competent allegation of scienter against the Outside Defendants. Accordingly, Plaintiffs' complaint must be dismissed.

V. Plaintiffs' Claims All Come Down to Trading – But the Stock Sales By The Outside Directors Do Not Support A Fraud Claim Against Any Of Them.

Plaintiffs' fraud claim is thus reduced to the bare allegation that Section 10 and Rule 10b-5 were violated because some–but by no means all or even a majority–of Enron's directors sold a fraction of their Enron stock over a three year period. Plaintiffs implicitly recognize that the viability of their fraud claim against each of the Outside Directors depends exclusively on the question of what inferences, if any, can be drawn from the stock sales of each of those Directors. *See* NCC ¶ 3; Response at 1 (making clear that only the Outside Directors who sold Enron stock during the purported class period are accused of fraud).

Analysis of each Outside Directors' stock sales, however, reveals that <u>no</u> <u>inference</u> of fraud or improper purpose can be drawn against any of them from their stock sales. *See* Motion to Dismiss at 12-44. For that reason, those sales are not probative of any Outside Directors' scienter, and they cannot form the basis of an insider trading claim. Accordingly, the Outside Directors who sold Enron stock during the class period are no different that those who did not. Plaintiffs do not have a fraud claim against <u>any</u> of them.

A. No Inference of Scienter Can Be Drawn From the Outside Directors' Trading.

Plaintiffs have all but abandoned any real argument that the inference of scienter can be based on the Outside Directors' stock sales. Plaintiffs make no individualized effort to analyze each Outside Director's stock trading to argue that an inference of scienter can be drawn from the existence of those trades. Instead, Plaintiffs simply assume their conclusion, insisting that the Outside Directors <u>had</u> scienter and then stating that they sold while they had it. In short, Plaintiffs now acknowledge that **the inference of scienter cannot be derived from the Outside Directors' trades**. Because Plaintiffs' attempts to plead scienter in their Complaint were clearly dependent upon the derivation of the required "strong inference" from the existence of those trades, the Complaint fails to support a strong inference of scienter. All claims requiring scienter must be dismissed.

1. Plaintiffs Fail to Establish the Required "Unusual Trading" Elements Necessary to Infer Scienter from Insider Sales.

As this Court has stated, trading by insiders will be considered probative of scienter only if the plaintiff can delineate: (a) **unusual** trading; (b) at **suspicious times**; (c) in **suspicious amounts**;

and (d) **inconsistent with prior established patterns** (if any). *See Landry's*, slip. op. at 51; *In re BMC,* 83 F. Supp. 2d at 901. Plaintiffs make no real effort to establish these elements for each of the Outside Directors -- because they cannot. The Outside Directors sold non-suspicious portions of their stock, at non-suspicious price points (i.e., non-suspicious times), and did so in very normal fashion.

For example, Plaintiff offers no response to the undisputed fact that the Outside Directors sold no more than about 10% of their holdings in any of the relevant years, a rate of selling that is non-suspicious as a matter of law. Motion to Dismiss at 21. Similarly, Plaintiffs trumpet a supposed artificial inflation of the stock price so that the defendants could sell at high profits, but the Outside Directors sold less than 5% of their stock at $70 or more and less than 10% of their holdings at $60 or more, even though the stock stayed in that range for well over a year. Motion to Dismiss at 23. Finally, even though it is undisputed that most of the Outside Directors actually sold no stock at all, Plaintiffs offer no rebuttal to the ample authorities, including the Fifth Circuit in *Nathenson*, establishing that "the fact that other defendants did not sell during the class period undermines plaintiff's claims" even against those who did sell. *See, e.g.*, 267 F.3d at 421.

2. Plaintiffs' Authorities on Suspicious Trading are Unavailing.

Plaintiffs answer the myriad authorities presented in the Outside Directors' Motion with only passing reference to a handful of cases. Response at 64. Plaintiffs cite, for example, the Second Circuit opinion in *Stevelman v. Alias Research*, 174 F.3d 79 (2d Cir. 1999), for the concept that an officer's sale of 40% of his stock could be "sufficient to establish motive." Response. at 64. While simply establishing motive (and opportunity) may be sufficient in the Second Circuit, the Fifth

Circuit has expressly rejected the idea that the mere existence of motive (or even motive plus opportunity) gives rise to the strong inference of scienter. *Nathenson*, 267 F.3d at 412. Similarly, the *Oxford Health Plans* quote, that sales of tens of millions of dollars of stock were "massive," wholly fails to answer the "strong inference of scienter" question. Response at 64.

Landry's certainly provides no solace for the Plaintiffs here. In *Landry's*, all five of Landry's top executives sold their stock on the exact same day, at a conspicuous peak price very close to the stock's all-time record high. *See* Response at 66 (chart); *Landry's,* slip op. at 17. All five sold at least 30% of their stock that day -- and four of the five sold at least 74%. *Id.* at 18. In contrast, the Outside Directors' sales were sprinkled here and there about a three-year period, averaging no more than about 10 percent of their holdings in any year, and mostly at points in time when the stock was well shy of its peak. *Landry's* bears no resemblance to the Outside Directors' trading here.

3. The Court Must Consider the Lengthy Class Period When Determining if Cumulative Trading Levels are Suspicious In Amount.

Plaintiffs' rebuttal concerning the length of the class period is also unavailing. Response at 68. Whatever Plaintiffs' motives were for establishing a three-year class period, it is beyond dispute that the class period is indeed quite long. In a world where executives are compensated with stock and option proceeds, some level of stock selling is normal, expected and thus wholly non-suspicious. The Court must therefore bear in mind the length of the class period when determining if the individual defendant's cumulative sales in the period constitute a sufficiently large portion of his holdings to be considered suspicious.

For example, sale of 60% of an insider's stock might sound "suspicious in amount" if viewed in isolation, but if the 60% constituted the cumulative sale of 10% per year for six years, the sensible inference of scienter is dramatically weakened. Plaintiffs offer no authority to counter this simple logic. *See* Motion to Dismiss at 19-21; *In re Vantive Corp. Securities Litig.*, 283 F.3d 1079 , 1092 & 1094 (9th Cir. 2002).

4. Plaintiffs Misstate Both the Law and Facts Concerning Pre-Class Period Trading.

To give rise to an inference of scienter, trading must be: (1) unusual; (2) suspicious in amount; (3) suspicious in timing; **and** (4) out of line with prior trading practices. *See In re Landry's Securities Litig.,* slip op. at 51; *In re BMC,* 83 F. Supp. 2d at 901. Apparently recognizing that the Outside Directors' sales constitute non-suspicious portions of their holdings and were typically made at prices well below any suspicious peaks, Plaintiffs attempt to evade those requirements entirely: Plaintiffs wrongly assert that "one method of demonstrating that insider trading is unusual is to plead that insider trading is out of line with prior trading practices." Response at 70. But showing that trading is out of line with prior practice isn't an *alternative method* of showing suspicious trading, it is one of four *required elements*. *See Landry's* at 51; *BMC* at 901.

After distorting the law, Plaintiffs shift to a distortion of facts. Curiously, Plaintiffs name Dr. Gramm and two other Outside Directors in a list of other individuals, claiming that those individuals' "pre-Class Period sales were dwarfed by their Class Period sales." Response at 70. Plaintiffs apparently make no attempt to ensure that their statements to the Court are true. Even Plaintiffs' own Complaint acknowledges that Dr. Gramm, who is alleged to have sold about 10,000 shares in the class period, had sold nearly 8,000 shares earlier in 1998, before the Class period. NCC ¶83(z).[20]

5. Plaintiffs Cannot Retreat to Generic Allegations and Conclusions about "Enron Defendants" Generally; Plaintiffs Must Allege Facts Pertinent to Each Individual Outside Director.

Plaintiffs are left to retreat to generic allegations about the total trading volume of <u>all</u> the "Enron Defendants"combined in order to avoid a close examination of their lack of particular allegations about the individual Outside Directors. By Plaintiffs' logic, one would make a "strong inference" of scienter for <u>every</u> officer and employee of Enron, simply because they were dubbed an "Enron Defendant," even if there were no facts pled about that individual whatsoever that would lead to any individualized inference of scienter.

Dr. Hakala--on whom Plaintiffs place such great reliance--has <u>not</u> provided <u>any</u> facts from which the Court could draw a strong inference that even one Outside Director harbored fraudulent intent. Dr. Hakala's conclusions purportedly confirming there to be "one chance in one thousand" that the trading could have been spurred by motives other than improper insider trading, **are conclusions that Dr. Hakala *does not even purport to reach* as to *any* of the Outside Directors.** *Compare* Response at 67 *with* NCC ¶ 264 (reciting Hakala's actual conclusions). Indeed, Hakala could not even reach a "one chance in one hundred" or even "one chance in ten" conclusion as to

[20]Plaintiffs also include Mr. Foy on this list, ignoring the fact that Mr. Foy's selling was obviously explained by his retirement during the Class Period. *See* Motion to Dismiss at 29. Even ignoring the retirement issue, Foy's sales are not dramatically out of line with his prior practice. He had sold about 10,000 shares in 1995 and 10,000 shares in 1996. He then sold 29,000 shares in early 1999 (at $34 per share, before any significant price runup, and in the year just before he retired), then 9,000 in 2000. *See* Motion at 30-31. Foy thus sold more shares in each of 1995, 1996, and 1999 when the prices were relatively low than he did in 2000 when prices were high.

any of the Outside Directors. The best he can do is "conclude" a toss-up with respect to two of the seventeen -- and no possible statistical inference at all with respect to the rest. *Id.* Hakala (like the Complaint) acknowledges that purported conclusions at that level of confidence are not even close to statistical validity. NCC ¶ 415.[21] Plaintiffs therefore grossly mislead the Court even about the contents of their own Complaint when they assert that Dr. Hakala has "confirmed" insider trading by the Outside Directors.

B. Plaintiffs Have Failed To Plead An Insider Trading Claim.

Unable to refute the innocence of the Outside Directors' stock trading, Plaintiffs' shift gears in their response to press new "insider trading claims." *See* Response at 71-75. As with the other "theories" Plaintiffs put forth for their 10(b) claim against the Outside Directors, the allegations of the Complaint fall far short of stating a claim for insider trading -- and the new factual assertions in the Response do not cure this defect.

[21]An analysis of the statistical implications of Dr. Hakala's sparse references to those two Outside Directors was set out in the Motion to Dismiss at 27.

1. The Allegations In The Complaint Do Not Support A 10(b) Claim For Insider Trading.

"To state a claim for securities fraud based on insider trading in a private cause of action under 10(b) and Rule 10b-5 and §20A of the Exchange Act, a plaintiff must show that a defendant: (1) used material, nonpublic information; (2) knew or recklessly disregarded that the information was material and nonpublic; and (3) traded contemporaneously with defendant." *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 916 (S.D. Tex. 2001). Plaintiffs' Complaint fails to state an insider trading claim, because it does not allege the first two elements at all.[22]

The only allegations of insider trading in the Complaint identify the volume and dollar value of the stock trades, and allege, in conclusory fashion, that each Outside Director sold his or her stock "while in possession of adverse, undisclosed information about the Company." NCC ¶ 83(v) - (cc). A critical element of Plaintiffs' insider trading claim is a required and particular allegation that the insider sold securities based upon "material, non-public information." *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). Nowhere do Plaintiffs allege what material, nonpublic information any of the Outside Directors had when they sold Enron stock. Nor do Plaintiffs allege that any of the Outside Directors knew or recklessly disregarded that any information was material and nonpublic. Absent such allegations, Plaintiffs' Complaint does not state a claim based on insider trading. *See In re Sec. Litig. BMC*, 183 F. Supp. 2d at 916 ("Defendants contend that Plaintiffs' generalized allegation of insider trading fails to satisfy the PSLRA's heightened pleading requirements. There is no specific allegation of what nonpublic information was used by Defendants to trade and how

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[22]The "contemporaneous" requirement is discussed in Part VI, *infra*, in the context of Plaintiffs' 20A claim.

they knew such information was material or nonpublic other than the unacceptable assertion that they knew by virtue of their positions and day-to-day business activities."); *See also, In re Oak Technology Sec. Litig.*, 1997 WL 448168 *12 (N.D. Cal. 1997) (dismissing insider trading claim against outside director because "Plaintiffs fail[ed] to specify what material information these Defendants possessed.").

In their Response, Plaintiffs direct the Court to two paragraphs of the Complaint that they contend support the proposition that the Outside Directors "were present at board meetings throughout the Class Period in which they received adverse, nonpublic information." Response at 47, citing to NCC ¶ 395, 398. Those two paragraphs, however, do not identify any adverse, nonpublic information that the Outside Directors supposedly learned. Instead, they simply recite the type of broad, conclusory allegations that courts universally reject as insufficient to state a fraud claim. *Compare* NCC ¶ 395 ("it is logical, if not obvious, that all of Enron's officers and directors knew") and ¶ 398 ("These directors were also in frequent contact with Lay, Skilling, Fastow, Buy and Causey to receive information from them about Enron's business and they received copies of Enron's internal operating and budget reports."), *with Abrams*, 2002 WL 1018944 at *5 (pleading scienter based on corporate position is not sufficient to state a claim).

Plaintiffs' existing insider trading claim (such as it is) must therefore be dismissed because Plaintiffs have not alleged knowledge or scienter as to any Outside Director. *See In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1427 (9th Cir. 1994) ("To establish section 10(b) liability, however, the plaintiffs must prove that the insider traders acted with scienter."); *Wenger v. Lumisys*, 2 F. Supp. 2d 1231, 1251 (N.D. Cal. 1998) (dismissing fraud claim against individuals because

Plaintiffs' lodged only "conclusory allegations" that defendants "knew the adverse non-public information," and did not "point to any specific documents showing [Defendant] knew any of its statements were false.").

2. Plaintiffs' New Allegations -- Even If Considered -- Do Not State A 10(b) Claim For Insider Trading.

True to form, Plaintiffs respond by offering entirely new allegations that purport to specify what material non-public information each director might have had when he or she sold stock.[23] These new allegations, however, add nothing of substance to Plaintiffs' insider trading claim.

While it is true that insider trading can be a "manipulative device," *United States v. O'Hagan,* 521 U.S. 642 (1997), it requires a "high showing of misconduct." *SEC v. Fox,* 654 F. Supp. 781, 792 (N.D. Tex. 1986). No such "high showing" is made here.

Equally critical to an insider trading claim is that the information in question was in fact undisclosed. "[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of the information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no `deceptive' device." *O'Hagan,* 521 U.S. at 655. *See also Santa Fe Indus. v. Green,* 430 U.S. 462, 97 S.Ct. 1292, 1301-02 (1977) (rejecting insider trading claim because all pertinent facts were disclosed by the persons charged with violating Section 10(b) and Rule 10(b)(5)).

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[23]As discussed, in Part II, *supra,* Plaintiffs' new allegations should be disregarded because they do not appear in the Complaint and a plaintiff is not permitted to amend its pleadings in opposition to a motion to dismiss.

As is demonstrated below, Plaintiffs' new "insider trading" theory fails for at least three reasons. First, they fail to plead with particularity the nature of the allegedly undisclosed information. Second, they plead no facts giving rise to a strong inference that the directors' individual sales were motivated by fraudulent intent or involved the knowing use of material non-public information. Third, and independently, the information Plaintiffs claim was non-public was, in fact, disclosed in Enron's regulatory filings. Plaintiffs' claim as to each director will be addressed in turn.

Wendy Gramm

Dr. Wendy Gramm is a former Chair of the Commodities Futures Trading Commission and has been a director of Enron since 1993. *See* SEC App. Tab 22 at 5.

Plaintiffs' allegation of insider trading against Dr. Gramm is limited to her allegedly "non-public" knowledge about Chewco's investment in JEDI. Plaintiffs admit that Dr. Gramm's sale occurred more than one year after the Chewco transaction was approved. *See* Response at 72 ("[S]ince Gramm was on the Audit Committee she knew, at the very least, of the information about the formation of and accounting for Chewco which was formed in 1997"). Of equal importance, Dr. Gramm's sale occurred after Enron had made a number of disclosures concerning the extent of the assets and debt held in the JEDI partnership. *See e.g.* SEC App. Tab 2 at 89-90 Form 10K for 1997, Note 8, Unconsolidated Equity Interests; SEC App. Tab 6 at 98-99, Form 10K for 1998, Note 9, Unconsolidated Equity Interests.

Plaintiffs do not contend that Dr. Gramm knew that the accounting treatment for the Chewco transaction was improper. *See* Response at 72. They claim only that "since Dr. Gramm was on the

Audit Committee she knew, at the very least, of the information about the formation of and accounting for Chewco which was formed in 11/97." *Id.* This non-specific allegation of scienter fails entirely because it rests solely on Dr. Gramm's corporate position. *See Abrams*, 2002 WL 1018944 at *5. This assertion also does not set out, with particularity, what "information about the formation and accounting for Chewco" was allegedly known to Dr. Gramm, when she learned it, how she learned it and what she allegedly did with the information. *In re BMC Sec. Litig.*, 183 F. Supp. 2d 860, 886 (S.D. Tex. 2001). A bare allegation that Dr. Gramm knew a transaction existed, unaccompanied by any assertion that she knew it was accounted for improperly, does not state a claim for anything--much less state a claim for securities fraud.

Plaintiffs' Complaint actually negates any inference that Dr. Gramm knew the accounting for Chewco was improper. Plaintiffs allege repeatedly that Dr. Gramm was among the members of the Audit Committee who received personal assurances from Arthur Andersen that the accounting for Enron's financial transactions was correct. NCC ¶ 903.[24] When a Plaintiff's claim alleges facts that tend to negate scienter, as these allegations do, it must explain these facts or face the dismissal of its claim. *See In re McKesson*, 126 F. Supp. 2d at 1267; *In re Sunbeam*, 89 F. Supp. 2d at 1341 and 1344. Plaintiffs do not "explain away" these facts. Rather, they allege no facts at all to support an inference that Dr. Gramm harbored fraudulent information, much less a fraudulent intent, as it pertains to Chewco.

Plaintiffs' allegation that Dr. Gramm "sold while in possession of undisclosed information" is equally empty. Whatever this "undisclosed information" was, Plaintiffs do not allege it was

[24]*See* also sections of the Complaint cited at n.41, *supra*.

material. An allegation that the insider possessed material inside information is the gravamen of an insider trading claim. *See SEC v. Hoover*, 903 F. Supp. 1135, 1146 (S.D. Tex. 1995) (no insider trading where insider traded on non-public information that was not material); *SEC v. Fox*, 654 F.Supp. at 791 (same). In its absence, Plaintiffs fail to state a claim for relief.

More to the point, although Plaintiffs contend this unspecified information was "undisclosed," Enron's securities filings did, in fact, disclose the existence of the JEDI partnership, Enron's investment in it and the amount of the debt that Plaintiffs now contend should have been consolidated. *See* SEC App. Tab 2 at 89-90; SEC App. Tab 6 at 98-99. The fact that the JEDI/Chewco debt was not consolidated does not mean it was not disclosed. To the contrary, investors were told a number of times that the "accompanying notes [including those concerning de-consolidated entities] are an integral part of the consolidated financial statements." *See e.g.* SEC App. Tab 2 at 77. No investor could, or should, have read the disclosures about JEDI's debt, therefore, without understanding that they were integral to Enron's consolidated financial picture. *Id.*

At most, therefore, Plaintiffs' "consolidation" claim concerning Chewco alleges a difference of opinion with an accounting judgment made by Andersen, NCC ¶¶ 429-35, coupled with Plaintiffs' own allegation that Dr. Gramm was constantly assured that Enron's accounting treatment was correct. NCC ¶ 903. Differences in accounting judgments do not state a claim for securities fraud. *Lovelace,* 78 F. 3d at 1020-21. Nor do they state a claim for insider trading--particularly when the allegation in question fails to establish: (a) that Dr. Gramm knew this allegedly undisclosed fact;

or (b) had any reason to believe that Enron's existing public disclosures concerning the JEDI debt were incorrect. *O'Hagan*, 521 U.S. at 652 and 655.

Amazingly, even the cases Plaintiffs cite in support of their insider trading claim establish that their allegations concerning Dr. Gramm's sales do not raise an inference of fraudulent intent. *In re Secure Computing Corp.*, 184 F. Supp. 2d 980, 990 (N.D. Cal. 2001) involved a finding that an insider's sales of securities were actionable because they were within a "temporal proximity" of a few months from the "last positive statements regarding the company's financial status." *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85-86 (2d Cir. 1999) similarly upheld a claim of insider trading when the insider sold within months of the allegedly false optimistic statements. Dr. Gramm's single class period sale--made nearly one year after the fraud Plaintiffs attempt to allege--does not support an inference of fraudulent, insider trading.

Plaintiffs also ignore the fact that there was a disclosed and non-suspicious reason for Dr. Gramm's sale: She sold her shares in order to avoid conflicts of interest created by her husband's service on a Senate Committee with regulatory jurisdiction over Enron. *See* Motion to Dismiss at 32; SEC App. Tab 20 at 11 Dr. Gramm's sale is fully explained by reasons unrelated to alleged insider trading, and (though they've had plenty of opportunity to do so) Plaintiffs have not alleged facts giving rise to a "strong inference" that Dr. Gramm's modest sale was made for a fraudulent purpose. The § 10 and Rule 10b-5 claim against her must be dismissed.

Robert Jaedicke

Dr. Jaedicke is the former Dean of the Stanford Business School and was the Chairman of Enron's Audit Committee. NCC ¶ 86. Plaintiffs first contend that Dr. Jaedicke "had access to and control over the most damaging inside information about how Enron was accounting for its earnings." This allegation of "presumed knowledge by status" fails under *Abrams*. *See Abrams*, 2002 WL 975299 at *10. Plaintiffs also do not identify what "damaging inside information" Dr. Jaedicke allegedly possessed even though they are required to allege "what actions each Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it and how Plaintiffs know what he learned. *In re BMC*, 183 F. Supp. at 886. In addition even as an effort to hint at accounting irregularities this allegation fails to pass muster. As this Court noted, "GAAP violations may provide some evidence to raise an inference of knowing, or severe recklessness in not knowing, that a company's financial status was overstated, <u>but only where a plaintiff specifies what the unreasonable practices were and how they distorted the disclosed data in transaction specific detail.</u>" *In re Waste Mgm't.*, Slip op. at 25. Plaintiffs provide no such "transaction specific detail" in their claim against Dr. Jaedicke. In short, Plaintiffs' generic allegation fails under both Rule 9(b) and the PSLRA.

Plaintiffs next suggest that Dr. Jaedicke possessed inside information because one of his sales was "three months after approving the waiver of Fastow's conflict of interest and the setup of LJM2 in 10/99." Response at 72-73. Plaintiffs acknowledge in their Complaint, however, that the first LJM partnership was created in June of 1999 (NCC ¶848) and that its existence was disclosed in Enron's Form 10Q for the Third Quarter of 1999. (NCC ¶836). This allegedly "non-public conflict of interest" was thus disclosed to the marketplace before Dr. Jaedicke's sale of shares on February 24, 2000. *See* SEC Tab 9 at 16 (9/30/99 10Q). Additional disclosures about these partnerships, including disclosures in Enron's March 2000 Proxy Statement, were made to the public prior to Dr.

Jaedicke's second sale on May 21, 2001. *See* SEC App. Tab 10 at 100-01 (1999 10K at Note 16); SEC App. Tab 21 at 25-26 (2000 Proxy Statement).

No valid claim of "insider trading" is made when the relevant securities disclosures establish that the information was public. *O'Hagan*, 521 U.S. at 655 (full disclosure negates claim of insider trading). *See also Hoover*, 903 F. Supp. at 1143-1145 (rejecting insider trading claim because alleged inside information was not material when considered in the total mix of issuer's public disclosures). Here, there were extensive disclosures concerning the very fact that Plaintiffs' claim was concealed; namely, that one of Enron's most senior officers had been permitted to create and invest in a partnership that was engaged in significant, related party transactions with Enron. Plaintiffs do not suggest any other "non-public" information that was known to Dr. Jaedicke concerning the LJM partnerships--and the facts they point to were fully disclosed. Accordingly, even Plaintiffs' new facts would fail to state a claim of insider trading against Dr. Jaedicke.[25]

Plaintiffs never bother to suggest, moreover, that Dr. Jaedicke actually believed that any of this unspecified "non-public" or "damaging information" was not fully disclosed. Insider trading requires a high showing of misconduct," *Fox*, 654 F. Supp. at 792, including facts plead with particularity to show that the insider "knew or recklessly disregarded that the information was non-public." *In re BMC*, 183 F. Supp. 2d at 916. In this case, Plaintiffs' Complaint negates this "high

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[25]Plaintiffs' also suggest that Dr. Jaedicke was aware of "non-public information" by virtue of his attendance at various Audit Committee Meetings. As was demonstrated in Part IV, *supra*, the "facts" Plaintiffs assert were not disclosed about Enron's use of securitizations and its need to make accounting judgments were disclosed, in full, in Enron's Forms 10K. *Id.* These disclosures negate entirely any claim of insider trading arising out of this allegedly undisclosed (but actually disclosed) information. *See O'Hagan*, 521 U.S. at 655.

showing of misconduct" when it alleges, repeatedly, that the Audit Committee was assured by Andersen that Enron's financial statements fairly presented its financial condition in compliance with Generally Accepted Accounting Principles. Plaintiffs also allege <u>no facts</u> to suggest that Dr. Jaedicke did not genuinely believe these assurances when they were given to him. *See In re McKesson HBOC, Inc. Sec. Litig.,* 126 F. Supp. 2d 1248, 1267 (N.D. Cal. 2000). On the facts alleged in their own Complaint, therefore, Plaintiffs have negated any inference of fraudulent intent on the part of Dr. Jaedicke.

Finally, and most critically, Plaintiffs do not <u>dispute</u> in their response that Dr. Jaedicke's sales of Enron stock are fully explained by an entirely non-suspicious fact; namely, that both of his sales were made in conjunction with expiring options. *See* Motion to Dismiss at 33-35. On this basis alone, and in the absence of <u>any</u> particularized facts establishing fraudulent intent, Plaintiffs' insider trading claim against Dr. Jaedicke fails.

<u>Joe Foy</u>

Plaintiffs' assertions about Mr. Foy are a mish-mash of conclusory statements unhinged from any identifiable, material, non-public information. Because they are so lacking in substance, we treat them only briefly below.

First, as is the case with all of the directors, Plaintiffs' <u>existing allegations</u> make no valid claim of insider trading by Mr. Foy. They cite no specific non-public information in his possession, make no allegation that any such information was material, nor do they allege, with particularity, any facts showing that he possessed a fraudulent intent when he sold his shares. Plaintiffs' Complaint, in short, fails to state a claim for relief. *See* Motion to Dismiss at 29-31 (pertaining to Mr. Foy).

Plaintiffs largely acknowledge these deficiencies[26] and are left to resort to new, and equally insufficient, theories to support their claim of securities fraud against Mr. Foy.

Plaintiffs recognize that Mr. Foy's impending retirement is a "non-suspicious circumstance" that undermines any notion that his sales were motivated by a fraudulent intent. *Compare* Motion to Dismiss at 29-30 *with* Response at 72. Plaintiffs assert, however, that Mr. Foy's sales before his departure were "suspicious" because he, like Dr. Jaedicke, received allegedly "undisclosed information at an Audit Committee meeting that Enron's accounting for structured transactions and its use of mark-to-market accounting were highly risky." This allegation fails to raise a strong inference of scienter because:

1. The "undisclosed" information regarding Enron's accounting is not specified, as is required by this Court's holding in *In re Waste Management.*, at 25, n.11 (Plaintiff must specify what the unreasonable practices were and how they distorted the disclosed data in transaction-specific detail).

2. Enron's use of structured transactions and mark-to-market accounting was disclosed fully and frequently in its Form 10Ks and other public disclosures. *See supra* at pp. 27-28; *see also* Joint Brief Regarding Adequacy of Enron's Disclosures at 72-78.

3. Plaintiffs' Complaint <u>admits</u> that Mr. Foy, like the other Audit Committee members, was regularly assured that Enron's financial statements were prepared in accordance with generally

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[26]Indeed, other than their half-hearted slap at Mr. Foy's retirement, Plaintiffs offer <u>nothing at all</u> to refute Defendant's contention that Mr. Foy's sales of Enron stock are non-suspicious as a matter of law. Plaintiffs' Complaint was, and is, wholly insufficient to allege scienter against Mr. Foy--so Plaintiffs' fraud claims against him must be dismissed.

accepted accounting principles, *e.g.* NCC ¶903-04, and alleges no facts to support an inference that Mr. Foy did not actually believe these assurances when they were given to him.

Plaintiffs' claims about Mr. Foy's alleged knowledge concerning the LJM transactions fails for the same reason the identical claims fail against Dr. Jaedicke: They do not plead, with particularity, the existence of any hidden fact, known to Mr. Foy, that was not already fully disclosed in Enron's public filings and that he knew and understood was not disclosed. *O'Hagan*, 521 U.S. at 655; *Hoover,* 903 F. Supp. at 1143-45. In the absence of these allegations, Plaintiffs' pleading is mere purple prose offered in lieu of particularity.

Charles LeMaistre

Dr. LeMaistre is the former Chancellor of the University of Texas system and the former President of the M.D. Andersen Cancer Center. SEC App. Tab 22 at 2-3 (2001 Proxy Statement).

Defendant's Motion to Dismiss established that Dr. LeMaistre's sales of Enron stock were non-suspicious as a matter of law. Dr. LeMaistre actually increased his holdings during the class period; his sales of tiny fractions of his holdings all involved the exercise of expiring options and occurred at a market price more than three times the options' strike price. Motion to Dismiss at 35-36. Plaintiffs' Complaint concedes that sales such as these are non-suspicious as a matter of law. *See id.* Plaintiffs' Response refutes not a single one of these points. Plaintiffs' Complaint must, therefore, be dismissed.

Recognizing that they have plead nothing of substance, Plaintiffs resort to suggesting additional, insubstantial theories of insider trading. They assert that Dr. LeMaistre sold shares "two months after he and other directors approved the waiver of Fastow's conflict of interest, and set up

LJM2," but the existence of both the LJM partnership and the conflict of interest were disclosed in Enron's September 1999 Form 10Q (SEC App. Tab 9 at 16). Plaintiffs go on to assert that this "allowed Enron to fraudulently boost its earnings substantially for 99." Response at 73. Missing entirely from this one-sentence accusation is any suggestion that Dr. LeMaistre knew when he approved the formation of the LJM entities that they would "allow Enron to fraudulently boost its earnings." *Cf. BMC*, 183 F. Supp. at 885, 916. (Plaintiff must allege what actions each Defendant took in furtherance of alleged scheme and specifically plead what he learned, when he learned it and how Plaintiffs know what he learned). Also missing is any indication of the remainder of the "who, what, when, where and why," *ABC Arbitrage*, 2002 WL 975299 at *10, required to comply with Rule 9(b) and the PSLRA. Missing, most importantly, is any attempt at all to plead, with particularity, facts giving rise to a strong inference that Dr. LeMaistre was severely reckless when he sold a small portion of his Enron shares in connection with the exercise of in the money options that were on the verge of expiration. Motion to Dismiss at 35-36.

More is required than this; but more is not forthcoming. Even Plaintiffs' new theory does not suffice to state a claim for relief. Plaintiffs' claim of insider trading against Dr. LeMaistre should be dismissed.

Ronnie Chan

Plaintiffs make no effort to respond Defendant's Motion to Dismiss regarding Ronnie Chan, which established that Mr. Chan's single sale of a fraction of his Enron shares was non-suspicious as a matter of law. Motion to Dismiss at 36-37. Nor do Plaintiffs' dispute that Mr. Chan's single sale at $45 per share "badly missed the boat" as it pertained to the high point of Enron's stock during the putative class period. *Id.* Effectively, therefore, Plaintiffs have conceded that their current pleading against Mr. Chan is insufficient and must be dismissed. Since Plaintiffs have effectively conceded these points, we will not re-argue them here.

Plaintiffs suggest, however, that they might be able to plead a <u>different</u> claim against Mr. Chan based upon his attendance at the identical Audit Committee meeting at which Enron's use of structured transactions was discussed. *See* Response at 73. This assertion has no more substance when lodged against Mr. Chan than it did when lodged against Dr. Jaedicke, Mr. Foy and Dr. LeMaistre. Accordingly, for the reasons stated above, the identical assertions could state no claim of insider trading against Mr. Chan.

<u>John Duncan</u>

Plaintiffs' insider trading allegations against Mr. Duncan suffer from the same defect that pervades Plaintiffs' entire Complaint. Plaintiffs have not identified any information known <u>by Mr. Duncan</u> that was material, non-public information such that he would have been prohibited from selling the fraction of his Enron shares that he sold in 2001.

Citing to Paragraph 87(y) of the Complaint, Plaintiffs argue that Mr. Duncan sold Enron stock "in early 5/01 at a time when he knew Enron's true financial condition was extremely fragile and close to piercing additional stock triggers." Response at 72. Paragraph 87(y), however, does not allege that Mr. Duncan had <u>any</u> material, non-public information about "Enron's true financial condition" or that it was "close to piercing additional stock triggers." Instead, that paragraph states <u>only</u> the date and amount of Mr. Duncan's sale and makes the conclusory allegation that he sold "while in the possession of adverse, undisclosed information." NCC ¶ 87. This does not suffice to state a claim of insider trading. *See In re BMC*, 183 F. Supp. at 916; *Williams*, 112 F.3d at 78; 15 U.S.C. § 78u-4.

Plaintiffs' citation to paragraph 313 of the Complaint serves only to negate an inference that Mr. Duncan knew of any non-public information concerning Enron's allegedly illicit financial dealings. Plaintiffs allege in paragraph 313 that "secretly, behind the scenes, Enron, Andersen, Vinson & Elkins, Kirkland & Ellis and certain of Enron's bankers worked feverishly...to yet again restructure several of the SPE's with which Enron had done illicit transactions to artificially boost its profits and high debt." NCC ¶ 313. Without regard to the veracity of this allegation, there is nothing in this paragraph to suggest that Mr. Duncan was doing any of these things or that he knew any of these supposed facts. Instead, Plaintiffs' allegation is that this occurred secretly and behind the scenes--with no allegation (or suggestion for that matter) that Mr. Duncan was involved in any way. Certainly, allegations about the knowledge of others do not state a claim that Mr. Duncan was in possession of material, non-public information concerning allegedly "illicit" financial dealings at Enron.[27]

Recognizing that their existing allegations are insufficient, Plaintiffs have proffered the additional assertion that Mr. Duncan "knew Enron's true financial condition was extremely fragile and close to piercing additional stock triggers." Response at 73. This does not appear in the Complaint, so the Court should not consider it. *In re BMC*, 183 F. Supp. 2d at 915; *In re Baker Hughes*, 136 F. Supp. 2d at 646-47. Even were the court to consider Plaintiffs' proffer, however,

[27]Plaintiffs' citations to ¶ 324, which pertains to statements by Enron's bankers, and to ¶ 74, which describes "the Enron fiasco," likewise contain no allegations regarding Mr. Duncan--and certainly make no claim that he knew or said any of the things described in these two paragraphs.

it still would not state a claim that Mr. Duncan sold based on material, non-public information. First, a claim that Mr. Duncan knew that Enron's financial condition was extremely fragile does not state "what actions [Mr. Duncan] took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it and how Plaintiffs know what he learned." *In re BMC*, 183 F. Supp. at 886. Nor, as this Court observed in *Waste Management*, does a general pleading about a company's "true financial condition" suffice to specify "what the unreasonable [accounting] practices were and how they distorted the disclosed data in transaction specific detail." *In re Waste Mgm't., Inc. Sec. Litig.,* C.A. No. H-99-2183 at 25 (S.D. Tex. Aug. 16, 2001).

This generic pleading fails to raise any inference (much less a strong inference) that Mr. Duncan knew that Enron's financial condition was other than what had been disclosed in the company's public filings. Plaintiffs' theory amounts to nothing more than an assertion that "the reality of [Enron's] true financial condition and fraud was so obvious that [any director] must have been aware of the truth or closed [his] eyes." *In re Health Mgm't. Inc. Sec. Litig.*, 970 F. Supp. 192, 204-05 (E.D. N.Y. 1997). Of course, that is precisely the claim of "scienter by status" rejected in *Abrams*, 2002 WL 1018944, *5, and dismissed against the outside director defendant in *Health Management.* The result should not differ here--particularly when Plaintiffs have alleged no particularized facts to support their assertion that Mr. Duncan knew Enron "was publishing materially false information," *Lovelace*, 78 F.3d at 1020, concerning its financial condition or knew he was in possession of material, non-public information when he sold. *In re BMC*, 183 F. Supp. 2d at 916.[28]

Norm Blake

Plaintiffs don't bother to cite their Complaint in their response regarding Mr. Blake's single sale of Enron stock. They cannot do so, because the Complaint contains not a single particularized allegation against Mr. Blake raising a valid claim for fraud or insider trading. Indeed, although Plaintiffs now make much of Mr. Blake's single sale, their own expert did not identify Mr. Blake's sale as one the expert believed was based upon material, non-public information. Motion to Dismiss at 38-40. Plaintiffs also do not attempt to rebut--because they cannot do so--the clear demonstration that Mr. Blake's single sale of a fraction of his Enron stock was not suspicious. *Id.* Based upon the allegations in their Complaint, therefore, Plaintiffs' claim must be dismissed.

Plaintiffs now assert, however, that Mr. Blake's sale is "suspiciously timed" because it occurred three weeks after he attended a meeting of the Enron Finance Committee. First, and most important, Plaintiffs do not suggest that any of the information Mr. Blake allegedly learned in this meeting was material, non-public information. Though they recite a series of phrases, Plaintiffs do

[28]Plaintiffs's suggestion that the stock price "triggers" were not disclosed to the public again ignores the disclosures in Enron's Forms 10K. Rather than repeat those disclosures here, we simply refer the Court to the *Joint Brief Regarding the Adequacy of Enron's Disclosures* at 10-14, where the existence and text of those disclosures are discussed in full.

The existence of these disclosures forecloses any claim of insider trading regarding the triggers. *O'Hagan*, 521 U.S. at 655. This is particularly true when Plaintiffs allege no additional facts to support an inference that what Mr. Duncan allegedly knew about the triggers was not disclosed in Enron's public filings, when he learned it or why the information he allegedly had (which Plaintiffs do not specify) would not have been equally available to any investor who read the 10Ks and knew the current market price of Enron's stock. *Cf. In re BMC,* 183 F. Supp. 2d at 916.

not plead why "significant" capital expenditures, a "weighted cost of capital of 17%" or an unspecified "significant increase in Enron's guarantee portfolio" were, in fact, material non-public information. Plaintiffs' claims, therefore, fall far short of the particularity required by this Court's decision in *In re BMC*.

Nor is Plaintiffs' claim saved by their new assertions regarding Mr. Blake's alleged "non-public" knowledge of losses at Enron Energy Services. *See* Plaintiffs' Response at 74. In fact, as has been noted at length in the *Joint Brief Regarding the Adequacy of Enron's Disclosures*, the material facts about Enron Energy Services (EES) were well-documented and well-known. *See* Joint Brief Regarding the Adequacy of Enron's Disclosures at 155-83. At the time of Mr. Blake's sale, Enron's most recent 10K filing disclosed that EES had continued to report repeated and large losses. *See* SEC App. Tab 10, pg. 47 ("Energy Services recognized losses...of $68 million, $119 million and $107 million for 1999, 1998 and 1997, respectively.") The fact that EES had "substantial capital expenditures," Response at 74, associated with infrastructure investments had been thoroughly disclosed as well. *See* Joint Brief at 164-65 (discussing disclosed capital outlays required of EES in order to secure contracts with Owens Corning, the San Francisco Giants, Lockheed Martin and Eli Lilly). Moreover, the poor performance of the EES unit had been discussed openly in the press. *See e.g.* App. Tab 1, at 2-3, Houston Chronicle, July 14, 1999,[29] reporting that "EES continued to lose money in the second quarter as it has since its inception in the first quarter of 1997....Such losses come as no surprise to the market, which has been warned repeatedly to expect them this year.

[29]This article is quoted in NCC ¶ 160.

In short, Plaintiffs have not plead in their Complaint the existence of any material, non-public facts on which Mr. Blake traded unlawfully, so their claim should be dismissed. Their proffer of generic statements about EES relates facts that were already disclosed and part of the total mix of information about Enron. *See O'Hagan*, 521 U.S. at 655 (disclosure defeats claim of insider trading)and *Isquith,* 847 F. 2d at 107-08. (materiality must be examined in context of total mix of information) Thus, whether on their existing allegations, or on their new theory, Plaintiffs have failed to state a claim of insider trading by Mr. Blake.

Robert Belfer

Lastly, Plaintiffs turn their attention to Robert Belfer. They ignore - as they must - the undisputed fact that Mr. Belfer retained the bulk of his Enron holdings, a fact that negates any inference of scienter. Instead, Plaintiffs devote a number of paragraphs to Mr. Belfer's personal wealth and his investment in Enron preferred stock, while remaining absolutely silent as to the required elements of an insider trading claim. First, neither the Complaint nor their Response alleges that Mr. Belfer was in possession of a single piece of material non-public information on which he allegedly sold securities. *O'Hagan*, 521 U.S. at 652, 655. Plaintiffs also have not plead "what" Mr. Belfer knew, much less how he knew it and why it was non-public. *In re BMC*, 183 F. Supp. at 887 ("no details as to what Defendants knew, when and how they knew it, and the basis for Plaintiffs' allegations.")

Second, Plaintiffs ignore entirely their own allegations, as well as the points made in the Outside Directors' Motion, establishing that Mr. Belfer's trading was non-suspicious. Motion to

Dismiss at 40-44.[30] Plaintiffs concede that more than half of the Enron directors who possessed the same information did not sell a single share of Enron stock. *Compare* NCC ¶ 3 *with Nathenson,* 267 F.3d at 421. Plaintiffs also do not cite to any relationship between any sale by Mr. Belfer and any particular piece of information. *Id.* Finally, Plaintiffs' own allegations establish that Mr. Belfer sold only a fraction of his holdings--causing him to sustain catastrophic personal losses on the millions of shares he still owned when Enron went into bankruptcy. These facts, alleged in Plaintiffs' own complaint and in the public documents incorporated in it, conclusively negate any inference that Mr. Belfer acted with fraudulent intent.

Recognizing as much, Plaintiffs advance a new theory attacking Mr. Belfer simply for having owned convertible preferred stock of Enron. Response at 73. Plaintiffs fail to explain, or allege any fact to show, how the mere ownership of that class of stock could support any influence of fraud. Mr. Belfer received his preferred stock as a result of having sold his family oil company to Enron in 1983. *See* Motion to Dismiss at 42 n.54; *SEC App.* Tab 22 at 4. Plaintiffs do not suggest that there was anything untoward about this sale, nor do they contend that Mr. Belfer received his preferred shares for less than fair value. Instead, Plaintiffs suggest that the dividend on the preferred shares "accounts for part of [Mr. Belfer's] hesitancy to part with all his shares." *Response* at 74. This is pure and unplead speculation and, in all events, makes no sense. At a common stock price

[30]Belfer "sold" only tiny fractions of his holdings in any of the years in the Class Period, and did so at inopportune prices, using diversification methods wholly inconsistent with any intent to cash in by selling based on nonpublic information. Motion to Dismiss at 40-44.

of $80 and given the preferred stock's conversion ratio of 27.304 to 1,[31] the dividend on the preferred stock represented a return of less than 1 percent per annum on the underlying common stock, a below market rate of return which could not be a material deterrent to selling. By the same token, the concept (Response at 74) that Mr. Belfer was motivated not to sell either common stock or preferred stock by reason of the prospect of a $21 million liquidation preference on his preferred stock (which it is clear he will never realize in bankruptcy) is logically unrelated to any claim of fraud and makes no sense given the magnitude of his investment in Enron.

One court has defined a "strong inference" as one that is "persuasive, effective, and cogent, compelling, or capable of making a clear or deep impression on the mind." *In re Microstrategy Sec. Litig.*, 116 F. Supp. 2d at 631. That can hardly be said of the utterly implausible inference of fraud Plaintiffs suggest here against Mr. Belfer. For the reasons stated in this brief, and those stated in the Outside Directors' Motion, the claims against Mr. Belfer should be dismissed.

C. Viewed Individually or as a Group, the Outside Directors' Trades Do Not Create a Strong Inference.

Although Plaintiffs assert that the Directors' sales were suspicious "in the aggregate," Plaintiffs never address the aggregate effect of the following facts: (a) more than half of the Outside Directors, possessed of the same information, sold not a single share of stock;[32] (b) the sales by the Outside Directors were at different times and different prices, and none show a relationship to one

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[31]By year end 1999, as the result of adjustments, each share of preferred stock was convertible into 27.304 shares of common stock. *See* SEC App. Tab 21 at 9-10 (chart n.1).

[32]Motion to Dismiss at 17-18. *See* Nathenson 267 F.3d at 421 ("fact that other defendants did not sell ... undermines plaintiffs' claims.").

another or to particular information or events;[33] (c) most of the Outside Directors increased their holdings of Enron stock over the purported class period;[34] and, (d) all of the Outside Directors sustained significant, personal financial losses when Enron failed.[35]

It is not enough, under *Nathenson*, for Plaintiffs to assert that the "five of the eight Outside Directors alleged to have increased their holdings during the Class Period have not been sued for fraud"--as though that were the end of the matter. With respect, that is what is the matter with Plaintiffs' complaint. In the aggregate, or on an individual basis, there is no strong inference that any director traded on inside information. Motion to Dismiss at 17-44.

Plaintiffs simply have not alleged particular facts supporting a strong inference that any Outside Director traded on inside information or had an intent to defraud. Plaintiffs' § 10 and Rule 10b-5 claims must, therefore, be dismissed.

VI. Plaintiffs' Have Failed To State A Claim Under Section 20A.

Because 20A requires an underlying predicate violation of the Exchange Act, Plaintiffs' failure to adequately allege those predicate violations requires dismissal of the 20A claim as well. Plaintiffs have also failed to rebut the independent grounds in the Motion that warrant dismissal of the 20A claim.

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[33]Motion to Dismiss at 21-23.

[34]Motion to Dismiss at 18-19.

[35]Motion to Dismiss at 18-21.

A. At a Minimum, Same-Day Contemporaneity is Required Under 20A.

Ironically, Plaintiffs premise their argument that same-day sales are not required under 20A on a lengthy quote from *In re Microstrategy Securites Litigation,* 115 F. Supp. 2d 620, 662 (E.D.Va. 2000). Response at 76. Plaintiffs apparently failed to read the rest of the *Microstrategy* opinion, which not only imposes a same-day requirement, but also explains why plaintiffs' authorities are outmoded, at least for large public companies like Enron. After acknowledging that reported opinions were split on the same-day issue, it noted:

> The "growing trend . . . is to adopt a restrictive reading of the term 'contemporaneous' at least with respect to shares heavily traded on a national exchange." *In re AST Research Sec. Litig.*, 887 F.Supp. 231, 233 (C.D.Cal 1995). Indeed, an evolution of the contemporaneity requirement to require a shorter temporal separation between the trades of investors and insiders is reasonable, if not inevitable, . . . to satisfy the requirement's privity-substitution function and guard against making the insider liable to all the world.

Id. at 663. The *Microstrategy* Court therefore concluded that a one-day contemporaneity requirement was appropriate for an actively-traded stock, and dismissed the claim where no same-day sale was alleged. *Id.* at 664.

In this Court's most recent reported discussion of 20A, the Court cited and relied upon both *Microstrategy* and *Copland v. Grumet*, 88 F. Supp. 2d 326 (D.N.J. 1999) -- modern cases requiring same-day trading under 20A. *See BMC*, 183 F.Supp. at 916 and n.53. Indeed, the Court quoted at length from *Microstrategy's* analysis of contemporaneity. *Id.* at n. 53. Plaintiff's 20A claims must therefore be dismissed with respect to those alleged sales for which no same-day purchase by a Plaintiff is alleged. *See* Motion to Dismiss at 53 (listing trades).[36]

B. Mr. Belfer's Costless Collar and Exchange Fund Transactions Were Not the Same Class of Security nor in the Same Market

Plaintiffs argue that Mr. Belfer's contractual "costless collar" transactions are within the definition of a "security" because they are the equivalent of put and call options. What Plaintiffs fail to acknowledge is that contemporaneous trading under 20A is expressly limited to plaintiffs who purchased "**securities of the same class.**" 15 U.S.C. § 78t-1(a). Whether or not a private contractual costless collar arrangement is a "security," it clearly is not the *same class of security* as the Enron common stock Plaintiffs are alleged to have purchased.

Plaintiff cites and describes *Moskowitz v. Lopp*, 128 F.R.D. 624 (E.D.Pa. 1989) as standing for the proposition that a plaintiff purchaser of stock "has standing as a contemporaneous trader against [a] defendant who purchased puts and calls." Response at 78. *Moskowitz* is not a 20A case *at all.* Section 20A's contemporaneous trading requirement is not addressed at all; indeed, neither 20A nor its "contemporaneous" trading requirement is ever mentioned.[37] There is simply no support

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[36]Plaintiffs complain of the "defendants' absurd proposition that a single non-contemporaneous trade can destroy plaintiffs' 20A claim as to trades which were undisputedly contemporaneous with defendants' insider sales." Response at 77. The Outside Directors made no such argument, and are, frankly, uncertain what Plaintiffs could be talking about. The Outside Directors' contemporaneity arguments are clearly limited to dismissal of claims *on those sales* for which *no contemporaneous purchase* has been properly alleged.

[37]The *Moskowitz* court noted at one point in its opinion that the any "impact which options trading has on the price of a corporation's shares" was a "tenuous proposition." 128 F.R.D. at 635.

for the idea that a collar agreement -- or a put or call option -- is a security of the "same class" as common stock.

Similarly, Mr. Belfer's transfers to investment partnerships and exchange funds were transfers of Enron Cumulative Second Preferred Stock -- not transfers of common stock and thus not "securities of the same class" as the Plaintiffs allege they purchased. *See* Motion to Dismiss, Ex. K.

Moreover, this court has held that 20A claims are appropriately limited to Plaintiffs who contemporaneously traded "on the same market" with the seller. *BMC* at 916 n.53 (citing and quoting *Microstrategy*, 115 F. Supp. 2d at 662 & n.8). The privately written three-year collar agreements are not even alleged to have been in the same market as the common stock, no doubt because there is no market for such *sui generis* securities. Plaintiffs also make no argument that Mr. Belfer's transfers into investment partnership and exchange funds are "sales" in the same market in which Plaintiffs "purchased," as required by the statute. 15 U.S.C. § 78t-1(a). Finally, Plaintiffs do not allege that they were members of the investment partnerships or private exchange funds into which Mr. Belfer transferred his preferred stock.

Liability under 20A is clearly limited to the specific transactions that fall within the statute's contemporaneous definition. 15 U.S.C. § 78t-1(b)(1). The Court should therefore dismiss Plaintiff's 20A claims with respect to Mr. Belfer's transactions in costless collars, and his transfers to investment partnerships and exchange funds.[38] Both were transactions in different classes of

[38] As designated in the "Belfer" section of NCC Ex. C and as set out in the Motion to Dismiss at n.65, the Belfer "sales" that are in fact costless collars or transfers to investment partnerships or exchange funds are those on the following dates: 9/2/99; 11/2/00; 12/21/00; 12/22/00; 12/26/00; 1/26/01; 2/8/01; 2/14/01; 3/9/01; 5/23/01; 7/27/01; and 9/21/01.

securities and in markets different from the Plaintiffs' alleged purchases. Plaintiffs are not contemporaneous traders with respect to these transactions.

V. Plaintiffs' Section 11 Claims Against the Outside Directors Should Be Dismissed.

The Outside Directors have also moved to dismiss Plaintiffs' § 11 claims. Plaintiffs' response is two-fold. First, Plaintiffs ineffectively -- and impermissibly[39] -- add new facts, and incorporate additional paragraphs of their Complaint, to bolster their § 11 claims. Second, rather than respond head on to the Outside Directors' arguments for dismissal of their § 11 claims, Plaintiffs set up straw men -- unrelated to the Outside Directors' actual arguments -- and then attempt to knock them down without legal support and by manipulating entirely the case law. As argued by the Outside Directors in their (as yet unrefuted) Motion to Dismiss, Plaintiffs' § 11 claims should be dismissed.[40]

In their Complaint, Plaintiffs originally brought their § 11 claims based on four offerings: (1) the May 1999 offering; (2) the August 1999 offering; (3) the May 2000 offerings; and (4) the July 2001 private placement. Plaintiffs have since abandoned their claim based on the August 1999 offering. Response at 97 n.43.[41] The Outside Directors moved to dismiss because: (1) Plaintiffs have

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[39]*In re BMC,* 183 F. Supp. 2d at 915 ("[I]t is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss. *In re Baker Hughes Sec. Litig.*, 136 F. Supp. 2d 630, 646-47 (S.D. Tex. 2001).").

[40]Plaintiffs themselves admit as much as to at least one of their four § 11 claims. They are no longer pursuing § 11 claims on the 7% Exchangeable Notes. Response at 97 n.43.

[41]Plaintiffs have "also withdrawn their § 11 claims against Foy and Meyer as to the 7/01 offering." *Id.* Given these judicial admissions, the claims based on the 7% Notes and the claims against Foy and Meyer on the July 2001 placement should be dismissed. Response at 97 n.43.

themselves established that the Outside Directors relied on experts when they signed Enron's Registration Statements -- a complete bar to a § 11 claim; (2) Plaintiffs have relied on their allegations of fraud to allege material misstatements, but have failed to plead in conformity with Rule 9(b) or the PSLRA; (3) if Plaintiffs have not relied on allegations of fraud, their remaining allegations do not state a claim under § 11; (4) certain of Plaintiffs' claims must be dismissed for failure to plead reliance; (5) Plaintiffs do not have a claim under § 11 based on the July 2001 Private Placement; and (6) the § 11 claims against Walker must be dismissed because the Complaint establishes that he was not a director at the time of the alleged offerings. Plaintiffs' claims based on the May 1999 offering; May 2000 offerings, and July 2001 placement should be dismissed on any one of these grounds.

A. Plaintiffs' § 11 Claims Must Be Dismissed As They Have Affirmatively Plead A Statutory Defense To Their Claims Against The Outside Directors On The Face Of Their Complaint.

Plaintiffs' Complaint alleges the facts that establish the Outside Directors' affirmative defense that they relied on experts when they signed Enron's Registration Statements. *See* Motion to Dismiss at Part V.F. *comparing* 15. U.S.C. § 77k(b)(1)(3) (expertised opinion defense) *with* NCC ¶¶ 14, 32, 67, 70, 141, 164, 219, 292, 296, 610, 613, 801-03, 807, 811, 814-15, 832-33, 896, 899, 903-04, 926, 935, 942, 953, 959, and 1012. Plaintiffs' Response does not refute that they have alleged facts to establish this affirmative defense. Rather, Plaintiffs attack straw men in order to deflect attention from the fact that they have pled themselves out of court.

1. The Plaintiffs' Have Pleaded Themselves Out Of Their § 11 Claims Against The Outside Directors.

Under § 11, a defendant will not be liable for any part of a registration statement "purporting to be made on the authority of an expert" on which he reasonably relied. 15 U.S.C. § 77k(b)(3)(C).[42] Taking as true the allegations in the Plaintiffs' complaint, *see Zephyr Aviation, LLC v. Dailey*, 247 F.3d 565, 573 (5th Cir. 2001), Plaintiffs' *sole* attempt to allege misstatements in the offering documents is their general assertion that they contained false "financial statements and results." *See e.g.*, NCC ¶¶ 121(a);[43] 164; 610(a)-(h). In their response, Plaintiffs' unapologetically *admit* that their § 11 claims are based on nothing more, stating that "Plaintiffs claims here are based on admittedly

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

[43]As noted in the Outside Director's Motion to Dismiss, these statements, in any event, relate to registration statements not even purportedly sued on under § 11, and in fact would be barred by § 11's three year statute of limitations. 15 U.S.C. § 77m. Plaintiffs § 11 allegations, however bare, often include references to registration statements not sued on under § 11 (and barred by limitations). *See, e.g.*, Response at 84.

'incorrect financials.'" Response at 80 n.35 (further citing as analogous a case "**based on the use of incorrect accounting rules.**").

In the 72 paragraphs incorporated into Plaintiffs' § 11 claim, *every* allegation of an untrue statement or omission involves an accounting decision. In fact, Plaintiffs' Complaint alleges a violation of § 11 against Andersen on the *exact same* facts as it does against the Outside Directors, noting "Andersen consented to the inclusion or incorporation of its report on Enron's false financial statements in *each* of the Registration Statements and Prospectuses issued in connection with the offerings" sued on under § 11. NCC ¶ 1012; *see also id.* ¶ 899 (alleging that prior to the issuance of <u>each</u> registration statement, Andersen represented to the Outside Directors that "Enron's financial statements . . . were presented in accordance with GAAP and that Andersen's audits of Enron's financial statements had been preformed in accordance with . . . GAAS" and Andersen "consented to the use of its name as an **expert** in each Prospectus filed and issued pursuant to these offerings, including the Prospectus for the Zero Coupon Notes filed on 7/25/01"). In their Motion to Dismiss, the Outside Directors point to dozens of admissions by the Plaintiffs throughout their Complaint that the accounting decisions were scrutinized by experts, and that the Board was so informed. *See* Motion to Dismiss at 65-68 & n.78-79. Plaintiffs can point to no allegations, indeed no facts, to the contrary.

Having pleaded that the directors received and relied upon the certified expert opinions of Andersen and others, *e.g.* NCC at 903,[44] Plaintiffs have conclusively established the Outside Directors' defense under § 11. Based on Andersen's unqualified certifications, and the multiple

[44]*See also* NCC at ¶¶ 14, 32, 67, 70, 219, 296, 903-04, 935, 942, 953, 959, 1012.

expert accounting and legal opinions cited by Plaintiffs, the Outside Directors had "no reasonable ground to believe and did not believe at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert." 15 U.S.C. § 77k(b)(3)(C).

Finally, despite Plaintiffs' claim to the contrary, nowhere do the Outside Directors argue that Plaintiffs carry the burden of proof. Instead, the Outside Directors rely on controlling case law in the Fifth Circuit holding that where (as here) the plaintiff raises the affirmative defense on the face of the complaint, dismissal is appropriate.

> Although we must accept as true the well-pleaded allegations of a complaint dismissed for failure to state a claim, we do not accept as true conclusionary allegations in the complaint. *Associated Builders, Inc. v. Alabama Power Company*, 505 F.2d 97, 100 (5th Cir. 1974) Further, a complaint that shows relief to be barred by an affirmative defense, such as the statute of limitations, may be dismissed for failure to state a cause of action. *United Transportation Union v. Florida East Coast Railway Company*, 586 F.2d 520, 527 (5th Cir. 1978); *Mann v. Adams Realty Company, Inc.*, 556 F.2d 288, 293 (5th Cir. 1977); *Joe E. Freund, Inc. v. Insurance Company of North America*, 370 F.2d 924, 924 (5th Cir. 1967); *J. M. Blythe Motor Lines Corporation v. Blalock*, 310 F.2d 77, 78 (5th Cir. 1962); *Herron v. Herron*, 255 F.2d 589, 593 (5th Cir. 1958).

Kaiser Aluminum & Chem. Sales v. Avondale Shipyards, Inc., 677 F.2d 1045, 1050 (5th Cir. 1982). As the Fifth Circuit has found time and again, *id.*, dismissal is no less appropriate simply because plaintiffs, rather than the defendants, have satisfied the burden of proof. The burden is satisfied in any event.

As Plaintiffs concede in their Complaint that the Outside Directors have a statutory defense, the § 11 claims against the Outside Directors should be dismissed.

2. Plaintiffs' Response Erects Straw Men That Do Not Support Their Claims.

Plaintiffs' first straw man is their citation to *Murphy v. Hollywood Entertainment Corp.*, 1996 WL 393662 at *7 (D. Or. May 9, 1996), which they assert holds that an expertised opinion defense to a § 11 claim "cannot be resolved at the 12(b)(6) stage." Plaintiffs' Response at 96. Plaintiffs' citation to *Murphy* is misleading. First, the quotation invoked by Plaintiffs involved a defense to scienter under § 10(b). The case does not address whether a statutory affirmative defense can be resolved on a motion to dismiss in a § 11 claim. *Id.* Second, unlike here, the Plaintiffs in *Murphy* had not judicially admitted the facts giving rise to the expertised opinion defense. To the contrary, the *Murphy* Plaintiffs alleged that the parties invoking the "expertised opinion defense" were "direct, knowing participants in the drafting of documents which included material misstatements and/or omissions." *Id.* Plaintiffs make no such allegations against the Outside Directors here. Instead, Plaintiffs limit themselves to the assertion that the Outside Directors received assurances from Arthur Andersen (the identified expert in the Registration Statement) that Enron's financial statements were "fairly presented in all material respects." *See e.g.* NCC ¶ 903-04 and other paragraphs cited *supra*. Plaintiffs go on to concede the good faith of most of the Directors they have sued, *cf. NCC* at pg. 3; Response at 1 (Plaintiffs "do not allege fraud against Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham, Walker [or] Winokur."), and as to the remainder disavow any obligation to plead fraud with particularity. In these circumstances, where a Plaintiff has plead the existence of the facts giving rise to an affirmative defense, Fifth Circuit law makes clear that dismissal is the proper remedy. *See Kaiser Aluminum & Chem. Sales v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982); *see also* Moore, *Moore's Fed. Prac.*, ¶ 12.07[2.5] (2d ed. 1991). In contrast, *Murphy* provides no guidance when, as here, the Plaintiffs have judicially admitted the facts giving rise to the affirmative defense in their Complaint.[45]

3. Plaintiffs Have Not Pleaded Any Alleged Misstatement In The Registration Statement That Was Not Expertised.

Plaintiffs' next straw man is their citation to *Escott v. Barchris Constr. Co.*, 283 F.Supp. 643, 684 (S.D.N.Y. 1968). Plaintiffs suggest that because Enron's Registration Statements incorporated unspecified, allegedly misleading quarterly financial results that were not audited by Arthur Andersen, the Outside Directors have no basis upon which to invoke the expertised opinion defense. This argument ignores the admitted fact that Andersen did audit Enron's Forms 10K which were incorporated in the Registration Statements in reliance on Andersen's opinion. *Compare* NCC ¶ 903 with SEC App. Tabs 43 & 65. Accordingly, all of the § 11 claims premised on alleged misstatements in the incorporated Forms 10K must be dismissed. Plaintiffs' assertion that Forms 10Q are not certified by Andersen sidesteps what is alleged in their Complaint.

Plaintiffs acknowledge that the financial data reflected in every challenged Form 10Q cited in their § 11 claim was subsequently audited and reported in a Form 10K.[46] Plaintiffs also allege, as is set out above, that these Forms 10K were incorporated in the challenged Registration

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[45] *Murphy* was also decided prior to the enactment of the PSLRA, and thus applied a much more generous pleading standard than this Court must apply today, after the enactment of the PSLRA.

[46] *Compare, e.g.*, NCC ¶¶ 164-65, citing Forms 10Q for 2nd and 3rd Quarters of 1999 with NCC ¶¶ 903-04 citing audited Forms 10K for 1197, 1998, 1999 and 2001.

Statements in reliance on the expert opinion of Arthur Andersen. *See* NCC ¶ 903-04; SEC App. Tabs 46, 65 (Registration Statements). Plaintiffs therefore have not pleaded the existence of any alleged misstatement in the Registration Statement that was not, in fact, audited by Arthur Andersen and set out in an incorporated into the Registration Statement in the form of an expertised Form 10K. *See* NCC ¶¶ 1005, *et. seq*. In fact, according to the Complaint, for every transaction or misstatement--whether incorporated into the § 11 claim or not--Andersen "approved," "certified," "structured," "reviewed," "crafted," "audited," "presented," "signed off on," or "offered Enron advice at every step."[47] It is these pleadings, of course, that establish the affirmative defense that the Outside Directors relied on expertised opinions when they signed the Registration Statements. Plaintiffs' Complaint, having established the Outside Directors' § 11 affirmative defense, must be dismissed.

Finally, although Plaintiffs seek to salvage their § 11 claim by reliance upon incorporated Forms 10Q, a review of the paragraphs in question reveals that not a single paragraph in the Complaint actually identifies a misstatement or material omission in a Form 10Q. *See e.g.* NCC ¶¶ 164 -65 (identifying Forms 10Q and asserting "these financial results were false."). As was pointed out in the Motion to Dismiss, this pleading tactic fails to provide fair notice of the § 11 claim because the Outside Directors are at a loss to know what financial results Plaintiffs contend were false. *See* Motion to Dismiss at Part V.D. Plaintiffs' allegations about Forms 10Q must therefore be dismissed for the independent reason that they are not pleaded, do not place the Defendants on fair notice under Fed. R. Civ. P. 8, and were asserted for the first time in the response to a motion

[47]NCC ¶¶ 14, 31, 67, 70, 219, 296, 903-04, 935, 942, 953, 959, 1012.

to dismiss. *See In re BMC*, 183 F. Supp. 2d at 915; *In re Baker Hughes Sec. Litig.*, 136 F. Supp. 2d 630, 646--47 (S.D. Tex. 2001).

B. Plaintiffs' § 11 Claims Must Be Dismissed For Failure To Meet The Pleading Requirements Of Rule 9(b).

Plaintiffs' § 11 claims fail in any respect to comport with the pleading requirements of Federal Rule of Civil Procedure 9(b). Plaintiffs do not dispute this; rather, they argue they need not plead in compliance with Rule 9(b). Response at 79-80. This is incorrect.

To be sure, Plaintiffs attempt to plead around fraud by incorporating only 72 paragraphs of their Complaint into their § 11 claim. NCC ¶ 1005. The Outside Directors noted in their Motion to Dismiss that despite this attempt, Plaintiffs had nonetheless incorporated their allegations of fraud into their § 11 claims. Motion to Dismiss at 68. In response, Plaintiffs not only fail to address the Outside Directors' argument, but indeed -- in the few instances in which they have pointed to actual allegations in the Complaint -- they now cite as support for their § 11 claims many paragraphs of the complaint alleging fraud that were not previously incorporated into their § 11 claims. *See e.g.,* Response at 85, 86, 89, 96. In fact, Plaintiffs now contend "the Outside Directors' brief also *ignores the <u>hundreds</u> of paragraphs of the CC that explain exactly why Enron's financial statements were false.*" Response at 42. Those paragraphs, of course, were ignored only because Plaintiffs *directed* that they be ignored. NCC ¶ 1005 (incorporating only 72 paragraphs into § 11 claim). Plaintiffs cannot have it both ways. They cannot on the one hand attempt to plead around their allegations of fraud -- going so far as to disavow all allegations of fraud[48] -- and on the other hand, specifically *rely* on their insufficient allegations of fraud in order to state their claims under § 11.

1. Plaintiffs Have *Not* Disavowed Their Allegations of Fraud, as They Specifically *Rely* on Them When Stating Their § 11 Claim; and If Plaintiffs Insist That They Do Not Allege Fraud, Then They Have Failed to State a Claim under § 11 Altogether.

In fact, Plaintiffs' disavowal of their fraud claim is not without consequence. If the claims constituting fraud are to be disavowed, then they must be *ignored* when evaluating the sufficiency of Plaintiffs' complaint. *Lone Star Ladies Inv. Club*, 238 F.3d at 368 (finding where inadequate claims of fraud are made in support of a claim for which fraud is not an element, "[t]he proper route is to disregard averments of fraud not meeting Rule 9(b)'s standard and then to ask whether a claim has been stated"). Here, if the Court disregards the inadequately pled allegations of fraud, all that remains are Plaintiffs' conclusory allegations that <u>somewhere</u> in four (now three) separate offering documents, Enron's "financials were misrepresented." *See* NCC ¶¶ 121(a), 164, 610, 613. This conclusory allegation wholly fails to place any of the defendants on notice of what facts were allegedly misrepresented or to what extent that might be material. Accordingly, the claim is not pleaded in compliance with Fed. R. Civ. P. 8 and fails to state a claim for relief under Fed. R. Civ. P. 12(b)(6).[49]

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[48]NCC ¶ 1005 ("For purposes of this claim, Plaintiffs expressly exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct").

[49]The cases relied on by Plaintiffs in their 9(b) arguments *support* the Outside Director's arguments in their Motion to Dismiss. Each of the three cases cited by Plaintiffs holds that in cases where, without regard to Plaintiffs' contentions to the contrary, Plaintiffs have relied on allegations of fraud to state a claim under section 11, dismissal is appropriate. In *Lone Star Ladies*, 238 F.3d at 368-69, the Fifth Circuit found, "a district court is not required to sift through allegations of fraud

2. Plaintiffs' § 11 Claims Fail to Meet Rule 9(b) Pleading Requirements.

If Plaintiffs now claim the right to rely on fraud allegations, Response at 42, their claim still fails. This is so because Plaintiffs do not deny their failure to plead their § 11 claims with any degree of particularity. Response at 79-80. With respect to any alleged fraudulent misstatements or omissions in the offering documents, therefore, Plaintiffs concede they have failed to allege the "specific time, place, and contents of the false representations, along with the identity of the person making the misrepresentations and what the person obtained thereby" required under Rule 9(b). *Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir. 1994). Critically, Plaintiffs have certainly failed to provide these details with respect to the individual Outside Directors who are named only as signatories to certain financial documents. Plaintiffs' claims therefore should be dismissed independently for failure to satisfy Rule 9(b).

C. Plaintiffs § 11 Claims Must Be Dismissed For Failure To Plead Reliance As To Certain Offerings.

in search of some 'lesser included' claim of strict liability. It may dismiss." In *Landry's*, slip op. at 64, the Court found that not only did Plaintiffs expressly disavow claims of fraud, but also, absent those allegations of fraud, plaintiffs must have "identified *specific purportedly untrue statements* in Landry's Prospectus, and alleged that Defendants, who were directors . . . negligently breached their duty to make a reasonable investigation or possess reasonable grounds for believing that the representations were true and not materially misleading." Plaintiffs here, unlike in *Landry's*, have failed to satisfy the second part of that test. Finally, Plaintiffs rely on *Collmer v. U.S. Liquids*, No. H-99-2785, 2001 U.S. Dist. LEXIS 23518 (S.D. Tex. Jan. 23, 2001), which, like *Lone Star Ladies* and *Landry's* specifically contemplates the application of Rule 9(b) *unless* the complaint does not allege that the defendants are liable for fraudulent or intentional conduct [*and*] disavows and disclaims any allegations of fraud." *Id.* at *108. No case has ever held that a disavowal of fraud alone is sufficient to satisfy. *See Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994).

In their Motion to Dismiss, the Outside Directors also noted that four[50] of the sub-class representatives' claims failed because they did not allege the required element of reliance. Motion to Dismiss at 63-64. Plaintiffs respond with a convoluted argument that is simply incorrect. Plaintiffs do not, however, contend that they actually plead reliance. Because Plaintiffs have failed to plead reliance, a required element for certain claims, these specific claims must be dismissed.

As the Outside Directors argued in their Motion to Dismiss, if, between the registration statement and the plaintiff's purchase, the issuer files "an earnings statement covering a period of at least twelve months beginning after the date of the registration statement," Plaintiffs cannot recover for misrepresentations in a registration statement unless they prove reliance. 15 U.S.C. § 77k(a). Plaintiffs now contend that Rule 158, 17 C.F.R. § 230.158, leads to a different result. It does not. Plaintiffs argue that under Rule 158, they need not prove reliance because Enron filed a post-effective date registration statement, and thus the effective date of the registration statements was altered. Plaintiffs do not have a single citation to support this proposition -- not to their Complaint, not to an SEC filing, not to anything -- no authority does.

The Outside Directors did *not* "calculate the effective date" in any way inconsistent with Rule 158 -- *nor* inconsistent with the Plaintiffs' Complaint. The shelf registration pursuant to which Plaintiffs Amalgamated Bank, Archdiocese of Milwaukee, and Hawaii Laborers bring their claim was *not* amended on "3/1/00" as Plaintiffs claim without support. In fact, *Plaintiffs' own Complaint* alleges that the "**<u>Effective Date</u> of Registration Statement**" was "02/05/99." NCC ¶ 612. After the

[50]Plaintiffs have abandoned the claims based on the July 2002 7% Notes, and do not address the Outside Directors' discussion of the 7% notes sub-class representative M. van de Velde. Therefore, the Outside Directors do not address those claims again here.

effective date, February 5, 1999, a Form 10-K (which, unlike a 10-Q, is "an earning statement covering a period of at least twelve months," 15 U.S.C. § 77k(a)), was filed each year in March. The 1999 10-K was filed in March 2000; the 2000 10-K was filed in March 2001.

"As detailed in its certification previously filed with the Court," NCC ¶ 54, one of Amalgamated Bank's purchases, made on June 29, 2001, occurred after Enron filed its Form 10-K for 2000. *See* Certificate of Amalgamated Bank. Amalgamated must, therefore, prove reliance. The Hawaii Laborers claim to have purchased pursuant to a registration statement filed on February 5, 1999. *See* Hawaii Laborers' Certificates. They did not buy their notes, however, until an offering in May 2000. Importantly, this offering occurred after Enron filed its Form 10-K for 1999. The Archdiocese of Milwaukee has the same difficulty: It bought securities offered pursuant to the February 5, 1999 registration statement, *see* Archdiocese Certificate, but did not do so until an offering in May that was made <u>after</u> Enron filed its Form 10-K for 1999. Both the Hawaii Laborers and the Archdiocese must also, therefore, prove reliance.

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

D. Plaintiffs' Aftermarket Purchasers Argument Is Inapposite and Their Claim Based On the July 2001 Private Placement Should Be Dismissed.

Plaintiffs dedicate another substantial portion of their § 11 response to refuting yet another straw man. Response at 81-84. Plaintiffs' diversionary exercise concerning secondary market purchasers misses the point of the argument made in the Motion; namely, that the § 11 claim based on the July 2001 private placement must be dismissed because private offerings are not covered by § 11.

As the Outside Directors explained in their Motion to Dismiss, the July 2001 Placement was made "only to qualified institutional buyers (as defined under Rule 144A under the Securities Act)." See SEC App., Tab 81 p.1. A Rule 144A private offering is an exemption from the usual requirement to file a registration statement. *See* Motion to Dismiss at Part V.B. In the absence of a public offering pursuant to a registration statement, no section 11 claim exists. This is so because:

> The 1933 Act is a far narrower statute [than the 1934 Act,] chiefly concerned with disclosure and fraud in connection with offerings of securities -- primarily . . . initial distributions of newly issued stock from corporate issuers.

See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975) (citing, *Securities Regulation* 130-31 (2d ed. 1961). Because it is possible for someone asserting claims under § 11to recover "without proof of fraud or reliance," it is improbable that Congress "would have extended that liability to every private or secondary sale without a whisper of explanation." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 582 (1995). As noted in the Outside Directors' Motion to Dismiss, a private 144A offering falls outside the reach of the statute. Put bluntly, Section 11 simply does not apply to private placements and Plaintiffs cite no case to support their claim that it does.

In sum, to afford standing to private placement purchasers would "effectively gut [t]he cabining of § 11 to initial offerings and [give] that section essentially the same reach as the Exchange Act, but without its scienter requirement." *Warden*, 1998 WL 725946 *3 n.2. That was not Congress' intent and the statute authorizes no such result. The § 11 claims based on the private placement must be dismissed.

E. Walker Should Be Dismissed Entirely from the § 11 Claims, Including Those Based on the May 1999 and May 2001 Offerings, Because He Was Not a Member of the Board at the Time of These Offerings.

The Outside Directors previously argued that the claims against Walker should be dismissed as mandated by statute. 15 U.S.C. § 77k(b)(1). Under § 11, an individual is not liable if "before the effective date of the *part* of the registration statement with respect to which his liability is asserted (A) he had resigned from . . . office." Plaintiffs' Complaint alleges a § 11 claim against Walker for the offerings made on May 19, 1999 and May 18, 2001, NCC ¶ 1006, but alleges elsewhere that Walker was not a member of the Board of Directors on May 19, 1999. NCC ¶ 86. Documents required to be filed with the SEC, and cited by the Outside Directors in their motion to dismiss, confirm that Walker was not a member of the Board in May 1999, and certainly not two years later in May 2001. *See* SEC App. Tab. 8, at 41 (noting at the May 4, 1999 Annual Meeting, Walker was no longer on the Board). Plaintiffs do not dispute this fact. Because Walker was not a member of the Board <u>when</u> "such part [of the Registration Statement] became effective" the statute requires his dismissal from these claims. 15 U.S.C. §§ 77k(a), 77k(b)(1).

VI. Texas Securities Act Reply Claims Against the Outside Directors Must Be Dismissed.

Plaintiffs' Texas Securities Act ("TSA") claims are fatally flawed in every respect. Any one of the following reasons demands complete dismissal:

1. The control person and aider and abettor claims asserted against the Outside Directors in the Responses were not plead in the Complaint, nor are the elements of such a claim established even in the Response;

2. The Outside Directors are not sellers within the meaning of the TSA;

3. Plaintiffs have, as they assert in the Response and Complaint, grounded their TSA allegations in fraud, but have admittedly failed to comply with Rule 9(b); and/or

4. Plaintiffs fail to allege that they purchased the securities on which their TSA claims

are based "by means of" a misrepresentation or omission made by an Outside Director.

For any one of these reasons, Plaintiffs' state law securities claim must be dismissed.

A. Control Person and Aider and Abettor Liability Claims Against The Outside Directors Must Fail.

In their response to the Outside Directors' Motion to dismiss, *for the very first time*, Plaintiffs assert aider and abettor and control person liability claims against the Outside Directors. Response at 102. Despite its appearance in Plaintiffs' response memorandum, this allegation does not appear anywhere in Plaintiffs' *Complaint*.[51] Because Plaintiffs have not plead a claim for relief, this assertion of liability should be ignored. Moreover, Plaintiffs' response memorandum itself demonstrates the utter insufficiency of this claim.

Plaintiffs argue that to establish aider and abettor liability, "Plaintiffs 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."

Response at 102 (quoting *Frank v. Bear Stearns*, 11 S.W.3d 380, 383 (Tex. App. - Houston [14th Dist.] 2000, pet. denied). Plaintiffs do not even attempt to meet the elements they have laid out.

Astonishingly: (1) Plaintiffs have not alleged a single element of an aider and abettor claim

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[51]Without commenting on the sufficiency of their allegations, Plaintiffs' Complaint alleges control person liability under the TSA *only* against "Defendants Lay, Causey, Buy, Fastow and Skilling." NCC ¶ 1028.

against any Outside Director in their Complaint; (2) in their argument, Plaintiffs do not cite a single paragraph of their Complaint; and (3) other than setting forth the test, Plaintiffs make absolutely no further mention of the required element of intent; nor do they address the third element -- rendering substantial assistance. Plaintiffs' attempt to assert *sub rosa* an aider and abettor claim against the Outside Directors unaccompanied by <u>any allegations at all</u>. The Court should, therefore, enter an Order striking all references to this claim so it will be clear the the Outside Directors need not defend it.[52]

Further, any attempt to allege an aider and abettor claim against the Outside Directors would be futile because Plaintiffs' arguments do not state a claim. Plaintiffs recognize that they must plead each individual's general awareness of his role in the violation; each actor's rendering of *substantial* assistance in this violation; and the *intent* to deceive. As demonstrated in the Outside Director's Motion to Dismiss and elsewhere in this brief, in the over one thousand paragraphs of the complaint plaintiffs <u>nowhere</u> assert adequately an intent to deceive. Moreover, Plaintiffs can point to no allegation of either substantial assistance or general awareness of a primary violation -- because no such allegations, or facts, exist.

If the Court is inclined to accept Plaintiffs' *sub rosa* aider and abettor or control person claim amendments to their Complaint, the Outside Directors respectfully request the opportunity to Move to Dismiss this new, albeit entirely insufficient, claim in separate briefing.

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[52]Technically, an aider and abettor claim cannot be *dismissed* as it was never asserted, but it should nevertheless be disregarded.

B. Seller Liability Claims Against The Outside Directors Must Fail.

The Outside Directors also are not sellers within the meaning of the TSA. Plaintiffs cite no authority to the contrary. Throughout their TSA arguments, Plaintiffs rely heavily on *Frank v. Bear Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App. -- Houston [14th Dist.] 2000, pet. denied). That case sums up the impact of the 1977 amendments to the TSA on seller liability claims. Under the TSA, to impose seller liability, a defendant must have been <u>in privity</u> with Plaintiffs. *Frank v. Bear Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App. -- Houston [14th Dist.] 2000, pet. denied) (rejecting argument that claims of primary violation of the TSA extend beyond those in contractual privity with plaintiffs). In the comments to the 1977 revisions to the TSA, the commentators noted that the untruth or omission liability provision "**is a privity provision**, allowing a buyer to recover from his offeror or seller." Tex. Rev. Civ. Stat., Art. 581-33, cmt. (1977). In reaching its decision in *Frank*, the Fourteenth Court of Appeals noted that "commentators at the time of the revision [to the TSA in 1977] had little doubt that the revision was intended to contain a privity provision." *Frank*, 11 S.W.3d at 383. Privity is not alleged here, not could it be, because the Outside Directors did not pass title to anyone.

The cases cited by Plaintiffs are not contrary. First, Plaintiffs cite *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 922 (Tex. App. - Houston [1st Dist.] 1976, writ ref'd n.r.e.). In that case -- a pre-1977 amendment case -- the alleged sellers were <u>salesmen</u> actively engaged in "telephone negotiations" who "told their prospective purchasers to mail in their check." Plaintiffs next cite *Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App. - Houston [1st Dist.] 2001, pet. denied). In *Texas Capital*, the *brokerage firm* who sold the securities was found, unsurprisingly, to be a seller. *Id.* Finally, Plaintiffs cite *Anheuser-Busch Cos. v. Summit Coffee Co.*, 934 S.W.2d 705, 707-08 (Tex. App. - Dallas 1996, writ dism'd). There it was "undisputed that the subject transaction was accomplished through the sale of securities as those terms are used in the Texas Securities Act," *id.* at 708, and that the alleged sellers were the *issuing corporation* (Campbell Taggart) and its parent corporation (Anheuser-Bush). These cases, the only ones cited by Plaintiffs, demonstrate that only *sellers* in privity, unlike the Outside Directors, are liable under 581-33(A) of the TSA.

It is also relevant that Plaintiffs bring their TSA claim on the basis of a firm commitment offering. SEC Tab 82. As demonstrated in the Outside Directors Motion to Dismiss, in a firm commitment underwriting, neither Enron, the issuer, nor the Outside Directors passed title to these notes to the Plaintiffs. *See e.g., Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1215 (1st Cir. 1996). Rather, in a firm commitment underwriting, title passes from the issuer to the underwriter and only <u>then</u> to the buyer. *Id.* This sequence of ownership makes clear that the Outside Directors -- who are never <u>in</u> the chain of title -- are not in privity with anyone and certainly are not in privity, and thus sellers, as to the plaintiffs. This is not, as Plaintiffs' contend, a matter of inapplicable federal law. Response at 100. It is a matter of admitted fact established by the very documents Plaintiffs incorporate in their Complaint and rely on to make their claim. *See In re BMC, supra.* Plaintiffs have alleged no facts to controvert the allegations <u>in their Complaint</u> that establish that the Outside Directors are not sellers.

Because Plaintiffs fail to allege the Outside Directors were sellers -- a required element of their TSA claim -- their claims of seller liability against the Outside Directors named must also be dismissed. Moreover, as seller liability is the *only* basis of liability alleged in the complaint against the Outside Directors, the TSA claims against the Outside Directors should be dismissed entirely.

C. Plaintiffs Have Admittedly Grounded Their TSA Only In Allegations Of Fraud, And Do Not Dispute That They Have Failed To Comply With Federal Rule of Civil Procedure 9(b) in Pleading Their TSA Claims, And Thus Their TSA Claims Must Be Dismissed.

Plaintiffs TSA claims are also grounded in fraud, and so must meet the pleading requirements of Rule 9(b). Plaintiffs do not refute this. Rule 9(b) applies even to claims grounded in state law. *See* Rule 9(b) (covering "all averments of fraud"); *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177 (5th Cir. 1997) (applying Rule 9(b) to state law claims alleging fraud); *Rubinstein v. Collins*, 20 F.3d 160, 165-66 and n.11 (5th Cir. 1994) (same); *see also Simon v. U.S.*, 891 F.2d 1154, 1156 (5th Cir. 1990) (The Federal Rules of Civil Procedure govern procedure in federal courts, whether state or federal claims are at issue); *Morgan Guarantee Trust Co v. Blum*, 649 F.2d 342, 344-45 (5th Cir. 1981) (same).

Plaintiffs expressly incorporate into their TSA claims the fraud allegations in the preceding 1,016 paragraphs of the *Newby* Complaint. NCC ¶ 1017. This incorporation mandates compliance with Rule 9(b). *See Lone Star Ladies Inv. Club*, 238 F.3d at 368 (citing *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) ("the application of Rule 9(b) was fatal because of 'the complaint's *wholesale* adoption of the allegations of the securities fraud claims for purposes" of the claims where fraud was *not* a required element). Moreover, Plaintiffs' only arguments that there were alleged misrepresentations in connection with the July 1998 offering are allegations of fraud. Response at 101-02 (citing, e.g., "*fraudulent* creation" of SPEs; and "another example of *fraud* occurring in 97"). While none of these allegations of fraud is alleged to have been contained in the prospectus involved in Washington Board's claim, they are the only allegations raised by Plaintiffs. Thus, because they actually rely on allegations of fraud, Plaintiffs TSA claims must be plead with particularity against *each* individual director in compliance with Rule 9(b). Plaintiffs have not done so as to any Outside Director, so their TSA claim must be dismissed.

D. Plaintiffs Cannot Now Allege Allegations Of Fraud Against Meyer, Wakeham, Walker, Or Winokur, And The Fraud Based TSA Claim Must Be Dismissed Against Them And Cannot Be Repleaded.[53]

Plaintiffs have failed to plead fraud with particularity against *any* individual Outside Director, and thus the TSA claims must be dismissed. Moreover, Plaintiffs have *expressly* stated that they do not have fraud claims against four defendants named in their TSA claims: Meyer, Wakeham, Walker, and Winokur. They have so stated, no fewer than *three* times. NCC p. 3 n.1 (These directors "are not sued for fraud. . . [n]o allegations of fraud are made against or directed at these defendants."); Response at 1 (as against these directors, "the Consolidated Complaint expressly excluded and disclaimed allegations that could be construed as alleging fraud."); *id.* ("[D]escriptions herein of the Outside Directors' involvement in Enron's scheme to defraud do not apply to . . . Meyer, Urquhart, Wakeham, Walker, and Winokur."). Having stipulated they have no fraud claim against these four directors, Plaintiffs have also stipulated that their farud-based TSA claims against them must be dismissed as well.

[53]The same is true of Urquhart.

E. Plaintiffs have not alleged their purchase was "By Means Of" a misrepresentation or omission.

Any claim under the Texas Securities Act also requires a plaintiff to prove one of two things: (a) that he was induced to buy a security from a seller "by means of" an untruth or material omission; or (b) that he was induced to buy a security based upon a misleading registration statement. *See* Tex. Civ. Stat. Ann. Art. 581-33A(1) and (2). Washington Board does not allege either -- anywhere. As this ground for dismissal is unrefuted -- and unrefutable -- the Outside Directors stand on the argument in their Motion to Dismiss.

VII. The Outside Directors Are Not Liable As Controlling Persons.

Plaintiffs' only response to the Motion to Dismiss their "control person" claims is that they "need ***not*** allege the controlling person actually participated in the securities violation." Response at 98. That statement is not only incorrect, it also does not respond to the other inadequacies in Plaintiffs' control person claims.

This Court has made clear what a plaintiff must do to allege a claim for control person liability: Plaintiffs "may allege a primary §10(b) violation by a person controlled by the defendant and culpable participation by the same defendant in the perpetration of the fraud." *In re BMC,* 183 F. Supp. at 869 (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir.1996). As pointed out in the Motion to Dismiss, the requirement that a Plaintiff allege"culpable participation" by a defendant to state a claim for "control person" liability is widely recognized.[54] Because Plaintiffs

[54]*See* Motion to Dismiss at Part VI, *citing, In re CINAR Corp. Sec. Litig.*, 2002 WL 334734 (E.D.N.Y. Feb. 25, 2002); *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, 2001 WL 1111508, *10 (S.D.N.Y. Sept. 20, 2001); *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 426 (S.D.N.Y. 2001); *In re Equimed, Inc.*, 98-CV-5374, 2000 WL 562909, at *10 (E.D.Pa. May 9, 2000).

have failed to allege any facts establishing "culpable participation" or scienter on the part of any of the Outside Directors, Plaintiffs' control persons claims should be dismissed.

Finally, as pointed out in the Motion to Dismiss, Plaintiffs have not sufficiently plead "control" -- either actual or abstract -- as to the Outside Directors. Motion to Dismiss at Part VI. Plaintiffs understandably ignore this in their Response, because they cannot identify any competent allegations in their Complaint. The lack of these required allegations likewise mandates dismissal of Plaintiffs' control person claims.

VIII. Plaintiffs' Response to the Rule 8 Motion Does Not Suffice to Avoid Dismissal of Their Claims and Further Amendment of the Complaint Is Not Warranted.

In a separate filing, the Outside Directors joined in a motion seeking dismissal of Plaintiffs' Complaint under Fed. R. Civ. P. 8.[55] Plaintiffs's response leaves largely unrebutted the arguments made in that motion.[56]

Rather than grapple with the fact that their intentionally confusing pleading requires the Court to sift more than a thousand paragraphs in the hope of finding the needle of an alleged fact against the Outside Directors somewhere in the haystack of Plaintiffs' Complaint, Plaintiffs boldly claim their obfuscation doesn't matter. They should be permitted to do this, they assert, because the

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[55] *See* Motion of Certain Current and Former Directors to Dismiss and Memorandum in Support Pursuant to Fed. R. Civ. P. 8.

[56] In addition to the arguments set out in this section, the Outside Directors adopt as if set out in full the legal arguments made by Rebecca Mark-Jusbache in Sections VI and VII of her Reply Memorandum in Support of Her Motion to Dismiss. Urquhart also adopts Mark-Jusbache's arguments into his motion to dismiss.

case against Enron is "exceptionally strong." Rule 8 Response at 13. As has been demonstrated, however, the case against the Outside Directors is not only not exceptionally strong--it does not even exist.

The Court in *In re MCI WorldCom, Inc. Sec. Litig.* made clear that one must avoid the temptation to assume, from the massive nature of a complaint like this one, that a fraud has been adequately alleged:

> On first reading, the instinctive reaction is exactly what is intended by Plaintiffs. The numbers are so large, the stakes were so high, and the fall of the dollar value of WorldCom stock so precipitous, that the reader reacts by thinking that there must have been some corporate misbehavior. However, after a thorough examination, it becomes apparent that the Complaint is a classic example of `puzzle pleading' and that it does not attain the heightened requirements for this type of case.

191 F. Supp.2d 778, 781-82 (S.D. Miss. 2002). This temptation is surely greater when, as here, Plaintiffs respond to the demonstrated deficiencies in their Complaint with sixty new pages of factual allegations and a plea that they be allowed to amend their Complaint yet again.[57] *See* Rule 8 Response at 13.

Amendment, however, is not warranted. As has been demonstrated in this Reply, even Plaintiffs' new allegations would fail to state a claim for relief had they been plead in the Complaint--and they were not. The pleading rules are well known to Plaintiffs' skilled lead counsel.[58] The Fifth

[57]Though Plaintiffs suggest that they have not yet been granted leave to amend, it is beyond dispute that the Consolidated Complaint is an amended Complaint, filed pursuant to court order, by Lead Counsel who had previously filed, on behalf of a number of plaintiffs, existing class action complaints arising out of Enron's collapse.

[58]As was pointed out in the Rule 8 motion, it was Lead Counsel's complaint structure (employed again in this case) that was dismissed as a violation of Rule 8 by multiple district courts across the country and by the Ninth Circuit. *See* Rule 8 Motion at 3-8.

Circuit has made clear that these rules are to be applied with force and without apology. *Williams*, 112 F.3d at 178. The only inference to be drawn is that Plaintiffs have not alleged a sufficient claim under the securities laws against the Outside Directors because one just cannot be alleged.

This Court does no injustice when it dismisses a lawsuit against parties who, as a matter of law, have not violated the law. For the reasons stated in their Motion to Dismiss and those set out in this Reply, the Outside Directors respectfully submit that the Complaint against them should be dismissed with prejudice.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the forgoing was served on all counsel of record on this the 24th day of June, 2002, via e-mail, website posting, certified mail, return receipt requested, federal express and/or facsimile.

Jeremy L. Doyle

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