IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	§	
MARK NEWBY, et al.,	§	
Plaintiffs,	§	
v.	§	**Civil Action No.: H-01-3624 (consolidated)**
ENRON CORPORATION, et al.,	§	
Defendants.	§	

DEFENDANT LOU L. PAI'S REPLY IN SUPPORT OF MOTION TO DISMISS CONSOLIDATED AMENDED COMPLAINT

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TO THE HONORABLE MELINDA F. HARMON, UNITED STATES DISTRICT JUDGE:

INTRODUCTION

Plaintiffs' 503-page complaint contains nothing to justify keeping Lou Pai in this case. Nothing that Plaintiffs have offered in their papers in opposition to Mr. Pai's Motion to Dismiss ("Pls.' Officer Opp'n") changes this fundamental fact or gives legally sufficient mass to Plaintiffs' claims against him. To be sure, Plaintiffs' task is a daunting one, for Mr. Pai was never a board member; never a publisher of any statement about which Plaintiffs complain; never a signatory of any financial report or filing; never a participant in any specific financial transaction identified by Plaintiffs; and not an actor of significance in the strategic development of Enron's financial affairs. Mr. Pai was an operating unit manager, first at Enron Energy Services (EES) and thereafter at Enron Xcelerator, who left Enron in June 2001. His trading activity coincides almost completely with the division of marital assets that he and his former wife undertook in connection with their divorce in the year 2000 and with his resignation from Enron effective June 2001. This is not the stuff of securities fraud, and Plaintiffs struggle with it both in their Complaint and more recently in their Opposition to Mr. Pai's Motion to Dismiss.

Consider: In Plaintiffs' 503-page complaint, the name "Lou Pai" appears but 16 times. Twelve of the 16 references relate to data that is largely biographical: Mr. Pai's business titles and positions and his securities transactions. The remaining four references are excerpts from three analyst reports that allude to his remarks. The Complaint contains not so much as a single sentence of particularized conduct by Mr. Pai; indeed, it is empty of *all* action attributable to him.

Consider: Mr. Pai, of limited responsibility as an operating unit manager, never served on Enron's board of directors and is not alleged in the Complaint to have signed so much as a single document containing any misleading statement identified by Plaintiffs.

Consider: Mr. Pai, again because of his limited responsibilities, is not even alleged to have been involved in the preparation of any public statement that Plaintiffs contend was misleading.

Consider: Mr. Pai is not alleged by the Complaint to have played any role in any specific financial transaction that Plaintiffs consider improper.

Consider: Plaintiffs, in their Opposition, concede that Mr. Pai is not alleged to have made misstatements in connection with analysts' calls or meetings. Pls.' Officer Opp'n at 33-34.

Consider: The Complaint is wholly lacking any remotely particularized allegations that would support a strong inference that Mr. Pai was aware of the undisclosed facts on which Plaintiffs rest their claims.

Plaintiffs' Opposition is essentially an effort to inflate Mr. Pai's significance and role by a series of claims not supported by the Complaint and not permitted by the law. In this Reply, we demonstrate the emptiness of that effort, in light of the contents of the Complaint, the record properly before the Court and the settled caselaw that governs the pleading requirements in securities cases like this one.

One of Plaintiffs' theories deserves especial and early mention, if only because it is the centerpiece of much of what Plaintiffs argue and because – as we discuss in detail in this Reply – it is so patently incorrect. Plaintiffs found much of their Opposition on the assertion that their Complaint properly and with particularity pleads that Mr. Pai "participated in and authorized the signing of contracts that EES knew would lose hundreds of millions of dollars for Enron, but which were accounted for as profitable endeavors to inflate Enron's stock price." Pls.' Officer Opp'n at 59. It is from this "activity," Plaintiffs assert, that Mr. Pai's principal liability flows. *Id.* at 59-62. Even at their argumentative best, Plaintiffs have some trouble getting out the words that Mr. Pai was involved in this purported fraud. Thus, Plaintiffs first urge that "EES knew" that the transactions it booked were unprofitable, *id.* at 59, and later use the passive voice to assert that these transactions "were known to be unprofitable," *id.* at 60. Plaintiffs finally assert conclusorily that "[i]t is inconceivable that Pai did not know that EES was a fraudulent scheme to inflate Enron's stock price." *Id.*

Plaintiffs understandably choke on this assertion, because it is a claim that flows neither from what Plaintiffs have pled in their Complaint nor from the law that applies to it. First, Enron's disclosures about the parameters of its EES contracts and the costs those contracts required Enron to bear were extensive and have been well documented, just as Enron disclosed repeatedly its use of mark-to-market accounting, the principle it was required to use under applicable accounting doctrine, to value its energy contracts. The public was made aware of the volatility of the costs associated with those contracts, as well as the wide range of outcomes that mark-to-market accounting principles permitted. Second, Plaintiffs have failed to plead, in any cogently particular way, *which* EES contracts were known, at the time they were signed, to be incapable of generating a profit over the life of the contract, why this was so and what the actual known losses were, just as Plaintiffs have failed to plead in any particularized way how specific contracts were accounted for and what the errors in accounting methodology and outcome were. Finally, and most critically, Plaintiffs have failed to plead with particularity how it is that *Mr. Pai* knew – assuming it was knowable at all – that EES entered into any specific identifiable contract that was unprofitable and that the contract in question received accounting treatment that was outside the broad range of outcomes permitted by GAAP and mark-to-market accounting. In short, with respect to the EES contracts, as elsewhere, Plaintiffs have utterly failed to meet their burden to plead specific facts to give weight to their otherwise insubstantial claims against Mr. Pai.

These pleading deficiencies – and others we identify – create legal flaws that doom Plaintiffs' Complaint. First, the allegations of the Complaint fail to particularize conduct by Mr. Pai that is actionable under the securities laws; the references to Mr. Pai and EES are impermissibly general and improperly pled, as are the snippets of analyst reports in which Mr. Pai is mentioned and allusions to Mr. Pai's official positions.

Second, the Complaint, in its pervasive generality, fails to support the required strong inference of Mr. Pai's scienter, a central burden accepted by Plaintiffs in bringing these private securities claims. In their Opposition, Plaintiffs miss the significance of recent case law regarding this burden; fail to acknowledge or deal with Mr. Pai's complete absence from the Powers Report and key interview memoranda of the Powers Committee; fail to acknowledge the anomaly of Mr. Pai's vast purchases of New Power shares in 2000 and 2001 and his desire to buy the company itself at a time when, according to Plaintiffs, the company was "known" to be a sham and its securities were "known" to be worthless; misstate the scienter inferences reasonably to be drawn about EES and Mr. Pai's knowledge of its business activities from the purported statements of two employees, which themselves Plaintiffs' mischaracterize; and fail adequately to explain how the Complaint demonstrates with particularity that specific abuses of mark-to-market accounting occurred with respect to identifiable contracts or how Mr. Pai was made aware of these purported and specified abuses.

Third, Plaintiff's allegations regarding Mr. Pai, even if true, do not overcome the limitations on Section 10(b) liability imposed by the U.S. Supreme Court's decision in *Central Bank v. First Interstate Bank,* 511 U.S. 164 (1994). To state a Section 10(b) claim against Mr. Pai, Plaintiffs must demonstrate that he is a "primary violator" of the statute. Directly and of his own conduct, he must be alleged to have committed *each* of the elements of a 10(b) violation; primarily liability cannot arise derivatively from the conduct of others, whom he is alleged only to have aided and abetted, or to have conspired with in the commission of the fraud. Where claims of liability are premised on the theory that defendants committed a "fraud on the market," a Section 10(b) primary violator is one whose personal conduct demonstrates the elements – among others – of reliance by, and causation of harm to, "the market." *Central Bank* requires these elements to be alleged as to any primary violator, including Mr. Pai. By Plaintiffs' own concession, however, the sole conduct alleged to have been engaged in by Mr. Pai – operating unit conduct, vague management committee status, purported insider trading – did not involve the making of statements to the market or conduct reasonably preparatory to the making of such statements. In these circumstances, Plaintiffs cannot demonstrate the essential elements of market reliance and damage causation as deriving from Mr. Pai's own conduct. Rather, Mr. Pai's alleged conduct, no matter how Plaintiffs characterize their theory of liability, amounts to no more than aiding and abetting, or participation in a conspiracy to commit fraud. Neither of these theories of liability survived *Central Bank.*

Finally, Plaintiffs have failed to plead with particularity any facts from which it could be said that Mr. Pai was a Section 20(a) control person. Their allegations as regards Mr. Pai are merely status-based, made without explanation as to how control might have been exercised, are at odds with the fact that Mr. Pai occupied positions structurally inferior to the Board and without final directive authority, and are otherwise inconsistent with the requirements of the PSLRA and *Central Bank.*

Rather, Mr. Pai's alleged conduct, no matter how Plaintiffs characterize their theory of liability, amounts to no more than aiding and abetting, or participation in a conspiracy to commit fraud. Neither of these theories of liability survived *Central Bank.*

We speak to the foregoing in the argument that follows.[1]

ARGUMENT

I. PLAINTIFFS' ALLEGATIONS REGARDING MR. PAI DO NOT PLEAD WITH PARTICULARITY CONDUCT ACTIONABLE UNDER THE SECURITIES LAWS.

A. Analyst reports.

1. Plaintiffs have not shown that analyst reports mentioning Mr. Pai are actionable against him.

In our Memorandum in Support of Mr. Pai's Motion to Dismiss, we pointed out that the Complaint was exceptionally bare of allegations regarding misstatements or omissions made by Mr. Pai. Pai Mem. at 8-9. Its over 1000 paragraphs contain just three statements by him, or, more precisely, three references to him in stock analysts' reports. NCC ¶¶ 167, 191, 258.

Plaintiffs' Opposition highlights the fact that the Complaint in this case is based upon the statements of others, not of Mr. Pai. Plaintiffs point to a multitude of statements by Defendants that are, Plaintiffs claim, misleading. Strikingly, the voluminous quotations, lists and charts of these statements in Plaintiffs' Opposition do not include a single utterance by Mr. Pai. *See, e.g.*, Pls.' Officer Opp'n at 33 (chart of 15 conference calls and meetings at which statements were

[1] Mr. Pai also adopts, for purposes of this motion to dismiss only, the arguments advanced by other defendants in support of the dismissal of this lawsuit insofar as those arguments are not inconsistent with the arguments of Mr. Pai, himself.

made), 86 (examples of statements relating to statutory safe-harbor), 95-96 (chart of statements relating to puffery). Even in the section of the Opposition *specifically devoted* to Mr. Pai, all of the ten statements that Plaintiffs cite were made by persons other than him. Nine are by others at Enron, and one is by an analyst who alludes to a visit with Mr. Pai. *Id.* at 59-60.

In our moving Memorandum, we explained that this and two other analyst reports referencing Mr. Pai are not actionable against him. That is because Plaintiffs' Complaint does not allege facts showing that Mr. Pai was involved in preparing these reports or controlled their content. *In re Sec. Litig. BMC Software, Inc.*, 183 F.Supp. 2d 860, 872 n. 21, 893 (S.D. Tex. 2001) (collecting cases); *accord In re Landry's Seafood Rest., Inc. Sec. Litig.*, No. H-99-1948, slip op. at 61-62 n. 27 (S.D. Tex. Feb. 20, 2001) (same). Plaintiffs do not seriously contest this point. They merely venture a one-paragraph response to all Defendants' arguments on this issue, asserting that Defendants are liable if they use analysts as conduits. Pls.' Officer Opp'n at 98. That is beside the point as to Mr. Pai; Plaintiffs still must meet their pleading burden as to the alleged misstatements or omissions by him in analyst reports, including this Court's requirement that "there must be alleged facts showing some involvement in and control over the content of the analysts' reports by the defendants to hold [the defendants] liable for misleading statements made in those reports." *BMC*, 183 F.Supp. 2d at 872 n.21. The Complaint contains no such averment as to Mr. Pai.

In our opening Memorandum, we also pointed out that the statements in the analyst reports constitute immaterial puffery. Pai Mem. at 11-13. The three statements are all "soft expressions of optimism and not a guarantee of performance," like the ones that this Court held in *BMC* to be non-actionable. *BMC*, 183 F.Supp. 2d at 891, 917.

Once again, Plaintiffs do not specifically address this argument. Their discussion of puffery is largely concerned with statements by other defendants. Pls.' Officer Opp'n at 91-98. Three points are worth noting, however. First, Plaintiffs cite no post-PSLRA case in which a collection of statements as soft and as few as those alleged against Mr. Pai survived a motion to dismiss. For example, in the *Haack* case cited by Plaintiffs, even after the "few [puffing] sentences from five different paragraphs" were set aside, there remained dozens of pages of detailed allegations about what the defendant said and did which served as an alternative basis for denying the motion to dismiss. *Haack v. Max Internet Communications, Inc.*, No. 3:00-CV-1662-G, 2002 WL 511514, at *4-5 (N.D. Tex. Apr. 2, 2002) (describing remaining allegations in 52-page complaint). Here, if the few puffing sentences in the three paragraphs mentioning Pai are set aside, *no* allegations of misstatements or omissions by him remain.

Second, the cases cited by Plaintiffs generally involve "harder" statements than those attributed to Mr. Pai. For example, in *Weiner v. Quaker Oats*, defendant's projection of "at least 7% real earnings growth" was more specific than anything attributed to Mr. Pai. 129 F.3d 310, 320 (3d Cir. 1997); *compare, e.g.,* NCC ¶ 191 ("Our conversation with Mr. Skilling as well as a very recent visit with...Lou Pai suggested that momentum in the retail business continues to accelerate.").

Third, Plaintiffs studiously avoid this Court's decision in *BMC* because it is unhelpful to them. Instead, they range far afield to glean cases of dubious relevance. For example, *In re Spyglass, Inc.,* upon which Plaintiffs rely heavily, did not even address issues of puffery. No. 99 C 512, 1999 U.S. Dist. LEXIS 11382, *7 (N.D. Ill. July 20, 1999) (denying motion to dismiss on scienter grounds). Moreover, all of the statements by the *Spyglass* defendants that Plaintiffs quote *preceded* the Class Period in that case, and the Court's opinion focused on misleading statements and omissions *during* the Class Period. *Id.* at *8. It appears that the quoted statements were merely background, not an integral part of the Complaint. Under these circumstances, the fact that the *Spyglass* court did not strike the puffery quoted by Plaintiffs is meaningless.[2]

2. Plaintiffs have not met the requirement to plead the allegations concerning the analyst reports with particularity.

In our moving brief, we showed that even if the statements in the three analyst reports were attributable to Mr. Pai, and even if the statements were not immaterial puffery, the claims against him should still be dismissed because the Complaint does not plead his alleged statements with the particularity required by 15 U.S.C. § 78u-4(b)(1) and Rule 9(b). Pai Mem. at 12-13. The reports do not state precisely what Mr. Pai said to the analysts, when or where Mr. Pai made the supposed statements, and, with respect to the 11/30/99 CS First Boston analyst report, NCC ¶ 191, whether Mr. Pai or another referenced Enron employee was the speaker.

In their Opposition, Plaintiffs assert conclusorily that "claims against Pai are pleaded with particularity," Pls.' Officer Opp'n at 59, but they make little effort to address the issues Mr. Pai raises. They repeat several times the general allegation that Pai "made false statements to the market," but quote the 11/30/99 analyst report as their sole example. Pls.' Officer Opp'n at 59-60; NCC ¶ 191. Moreover, Plaintiffs omit those portions of the report mentioning the other Enron employee, creating the misleading impression that Mr. Pai alone was mentioned by the analyst. Pls.' Officer Opp'n at 60.

[2] Nor is *Spyglass* of any relevance to the scienter allegations against Mr. Pai. The plaintiffs there pled that defendants had published financial projections that included revenues from key contracts that they never won. The defendants had admitted including these contracts in the assumptions underlying their predictions. 1999 U.S. Dist. LEXIS 11382, at *7. By contrast, in this case, Plaintiffs have not pled that EES failed to close all the contracts at issue, and Mr. Pai contests allegations of impropriety in the accounting for those contracts.

Plaintiffs' example also suffers from other shortcomings as to particularity. It does not quote or even paraphrase Mr. Pai; rather, it states that a conversation with Mr. Skilling and a visit with Mr. Pai "suggested that momentum in the retail business continues to accelerate." Exactly how the visit with Pai "suggested" this is not explained. The phrase "the visit suggested" is considerably more ambiguous than "Pai said," and demonstrates that the analyst was adding a heavy dose of interpretation. What Mr. Pai actually said is not apparent, and therefore not pled with particularity. *Cf. BMC*, 183 F.Supp. 2d at 893 (analyst reports may not adequately reflect content of defendant's statements); *In re Waste Mgmt., Inc. Sec. Litig.*, No. H-99-2183, slip op. at 132 (S.D. Tex. Aug. 16, 2001).

The analyst report then continues, "[b]acklogs. . . continue to grow,. . . the impressive roster of Enron clients continues to expand, and Enron expects a positive fourth quarter." In their Opposition, Plaintiffs attempt to attribute these allegedly false statements to Mr. Pai. Pls.' Officer Opp'n at 60 ("These statements were false and Pai knew it."). In fact, these are the *analyst's* statements, not Mr. Pai's. The analyst may have gotten this information from Mr. Pai, or from any number of other sources, but it is impossible to tell from the quote alone.

Nor do Plaintiffs allege with particularity *which* of these statements were false. The reader of the Complaint is left to guess whether Plaintiffs allege that momentum in EES's retail business was not accelerating, EES's backlogs were not growing, its roster of clients was contracting, or it did not expect a positive fourth quarter.

The Complaint also fails to explain *why* any of the statements were false when made. Plaintiffs allege generally that Enron overvalued the EES contracts and inflated revenues and profits by using mark-to-market accounting ("MTM"). NCC ¶¶ 36, 38, 214. But, as we discuss more fully in Section I B 2 *infra*, the Complaint does not particularize that allegation. That is, Plaintiffs fail to allege how the MTM calculations were done on specific contracts, what the underlying assumptions were, why they were wrong, what method or assumptions should have been used to value the contracts, or what the correct values were. Nor does the Complaint identify particular overvalued contracts known to Mr. Pai or the total amount of the overvaluations at the time that Mr. Pai made his allegedly misleading statements in 1999 and 2000 or at any point before he left EES. Thus, Plaintiffs have not adequately pled that Mr. Pai's statements were false when made. *See Waste Mgmt.*, slip op. at 30, 185 (where overvaluation alleged, plaintiffs must state the amount by which the valuation was overstated and why or provide details about the accounting method employed); *Lirette v. Shiva Corp.*, 27 F.Supp. 2d 268, 275-76 (D. Mass. 1998) (dismissing claims against company officers for statement that "[w]e are encouraged by the continuing momentum" of sales; complaint did not explain why statement was fraudulent).

For all these reasons, Plaintiffs' lone proffered example of a particularized statement as to Mr. Pai is insufficient.

B. "Bad deals."

1. Plaintiffs' attempt to replead Mr. Pai's involvement in "bad deals" is improper and still lacks particularity.

In our first Memorandum, we also addressed the allegation that, "Pai was a director of EES and was involved in setting up some of the bad deals." Pai Mem. at 14-17; NCC ¶¶ 83(j), 88. Incredibly, this is the *only* individualized allegation in the Complaint that Mr. Pai did anything wrong in connection with the day-to-day business operations of Enron.[3] We earlier

[3] As part of their group pleading allegations, Plaintiffs plead that a large number of Defendants, including Mr. Pai, participated in the Enron Management Committee, which "was aware of and approved all significant business transactions of Enron, including each of the partnership/SPE deals specified herein." NCC ¶ 88. Plaintiffs plead no supporting detail about this allegation as

pointed out the many reasons that this one-sentence allegation was lacking in particularity. Pai Mem. at 14-17.

In response, Plaintiffs attempt to replead their Complaint as against Mr. Pai, proffering in the Opposition a host of new allegations relating to his conduct at EES. Pls.' Officer Opp'n at 59-62. These include new allegations that Mr. Pai "participated and authorized the signing of contracts that EES knew would lose hundreds of millions of dollars for Enron," and that "[i]t is inconceivable that Pai did not know that EES was a fraudulent scheme to inflate Enron's stock price." Plaintiffs also attempt to correct the Complaint's allegation about when Mr. Pai left EES, altering that date from the end of 1999 to the end of 2000. *Compare* NCC ¶ 88 *with* Pls.' Officer Opp'n at 59. Repleading in the briefs is, of course, improper, and the original, single-sentence allegation against Mr. Pai should still be dismissed on particularity grounds.

Furthermore, even if the new allegations in the Opposition were properly before the Court, they are still far too general to survive a motion to dismiss. Consider the new allegation that Mr. Pai "participated in and authorized the signing of contracts that EES knew would lose hundreds of millions of dollars for Enron." Plaintiffs fail to identify the contracts that Mr. Pai "participated in and authorized," when they were entered, what the alleged loss was on each, how Plaintiffs calculate the alleged losses, how Mr. Pai "participated in and authorized" the contracts, who else was involved, and how Plaintiffs know all of this. In the absence of these particularizing details, Plaintiffs have not met their obligation under Section 78u-4(b)(1) and

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to Mr. Pai. For that reason, this allegation not only fails on group pleading grounds, but also lacks the particularity required by Federal Rule of Procedure 9(b) and the PSLRA. *See* Pai Mem. at 24. Plaintiffs do not include this allegation in the section of the Opposition explaining why "claims against Pai are pleaded with particularity." Pls.' Officer Opp'n at 59-62. Nor do they anywhere else specifically respond to Mr. Pai's point that this allegation fails on particularity grounds as against him. Plaintiffs simply make a general response to all Defendants' arguments about group pleading, which we address *infra.*

Rule 9(b) to "supply sufficient specific facts to support their allegations." *ABC Arbitrage Pls.' Group v. Tchuruk*, 2002 U.S. App. LEXIS 9112, *39 (5th Cir. May 13, 2002) (*quoting Novak v. Kasaks*, 216 F.3d 300, 313-14 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000)). *Accord BMC*, 183 F.Supp. 2d at 917 (plaintiffs must "provide the necessary specific allegations to support their lists of 'concealed facts' purportedly known to Defendants"); *Haack*, 2002 WL 511514, at *3 ("The pleading must include specific details of the time, place, contents, and nature of the activities which form the basis of the allegedly fraudulent conduct. . . .") (*citing Tel-Phonic Servs., Inc. v. TBS Int'l, Inc.*, 975 F.2d 1134, 1139 (5th Cir.1992). *See also Kurtzman v. Compaq Computer Corp.*, No. H-99-779, slip op. at 23 (S.D. Tex. Mar. 30, 2002) (discussing particularity in context of scienter and noting that "no specific facts or numbers to define the problems allegedly being experienced by Compaq are alleged. . . . [Plaintiffs] never state what particular inventory was backlogged and to what extent it affected Compaq's operations, or provide numbers to support allegedly increasing returns of PCs and inventories of spare parts, or explain why the PCs were being returned, which spare parts were involved, and how these problems were related to demand for Compaq products.").[4]

Perhaps in anticipation of this criticism, Plaintiffs attempt in their Opposition to at least tie Mr. Pai to one specific contract. They allege that "when Pai was at EES, Enron announced a huge contract with Eli Lilly, on which it improperly recognized approximately $44 million. ¶¶ 540-543." Pls.' Officer Opp'n at 60. There are a number of problems with this allegation. First, it is new as to Mr. Pai; his name appears nowhere in the discussion of the Lilly contract at ¶¶

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[4] The restated allegations against Mr. Pai in the Plaintiffs' Opposition also fail to support the strong inference of scienter required by Section 78u-4(b)(2), a subject addressed later in this Reply.

540-543 of the Complaint. Second, Plaintiffs merely state that he was *present* at EES when the Lilly contract was announced, not that he participated in the contract. Plaintiffs still have not alleged that Mr. Pai "participated in or authorized" the contract. Third, Mr. Pai was *not* present when the Lilly contract was announced: that happened on February 26, 2001, NCC ¶ 541, and, as Plaintiffs acknowledge, Mr. Pai left EES before that. *See* Pls.' Officer Opp'n at 59 (alleging Mr. Pai's dates of employment at EES).

2. Plaintiffs may not rely on the EES "fraudulent scheme" because it, too, is not pled with particularity in the Complaint.

In their Opposition, Plaintiffs also allege for the first time that Mr. Pai, as the former head of EES, must have known about a "fraudulent scheme" at EES. Pls.' Officer Opp'n at 60-61. The EES scheme allegedly consisted of "abusing" MTM by intentionally using unrealistic assumptions to value its contracts. *See*, *e.g.*, NCC ¶¶ 36, 38, 214; Pls.' Officer Opp'n at 60.

In Section II below, we explain why this new allegation is inadequate to demonstrate Mr. Pai's scienter. There is, however, a threshold flaw in the allegation relating to particularity, which we address here: The Complaint does not plead the details of the alleged EES fraudulent scheme with the particularity required under Section 78u-4(b)(1), Rule 9(b) and this Court's prior decisions, as Defendants explained in their Disclosure Brief at 163-183.

a. Plaintiffs ignore the fact that Enron disclosed the alleged "abuses."

First, the Disclosure Brief explained that Enron made substantial disclosures about the use of MTM, both generally and with respect to particular EES contracts. These disclosures were contained in press releases and SEC filings and reflected in analyst reports. Disclosure Brief at 163-171, 174. Plaintiffs respond that the disclosures are irrelevant because Enron never revealed that it was *abusing* mark-to-market accounting on the EES contracts. Pls.' Mot. Strike at 48. Plaintiffs are playing word games. In point of fact, Enron disclosed the underlying conduct that Plaintiffs claim constitutes the "abuse": that Enron was investing capital in various EES contracts; that future income was being marked-to-market in the current quarter; and that the use of MTM bore substantial financial risk for Enron. Disclosure Brief at 164-171.[5] "[W]here a corporation discloses the underlying data, it is not required under Rule 10b-5 to characterize those facts with pejorative nouns and adjectives." *In re Gap Sec. Litig.,* No. C-87-4895 JPV, 1988 WL 168341, *2-3 (N.D. Cal. Sept. 28, 1988) (*citing Klamberg v. Roth,* 473 F.Supp. 544, 551-52 (S.D.N.Y. 1979)); *see also Fernandez-Montes v. Allied Pilots Ass'n,* 987 F.2d 278, 284 (5th Cir. 1993) (legal conclusions masquerading as factual conclusions will not defeat a motion to dismiss).

Because Enron's disclosures about EES catalogued in the Disclosure Brief are inconvenient for Plaintiffs, they largely ignore them. Plaintiffs challenge only one specific disclosure, the February 26, 2001 press release regarding the EES contract with Eli Lilly. Plaintiffs argue that the disclosure therein is too general because the press release does not reveal Enron's exact obligations to Lilly. Pls.' Mot. Strike at 48.

This purported flaw is, however, irrelevant to the allegations against Mr. Pai, as Plaintiffs allege that he had left EES by the time of the release. *See* Pls.' Officer Opp'n at 59. Moreover, Enron had no legal duty to disclose every detail of its contract with Lilly in the press release. "Although there is a duty to make a corporate disclosure complete and accurate, this does not mean that by revealing one fact about a product, one must reveal all others that, too, would be interesting, market-wise, but means only such others, if any, that are needed so that what was

[5] That all of this was known to the market is, for example, demonstrated by a June 9, 1999 JP Morgan Analyst Report reciting these very facts. Jt. App. Tab 21 at 4; Disclosure Brief at 169. The Complaint quotes from this report but omits the relevant portion, NCC ¶ 153, and Plaintiffs continue to avoid the report in their opposition papers.

revealed would not be so incomplete as to mislead." *Carney v. Cambridge Tech. Partners, Inc.*, 135 F.Supp. 2d 235, 242 (D. Mass. 2001) (dismissing 10(b) claim despite alleged incomplete disclosure) (quotation marks and citations omitted). As Defendants demonstrate in the Disclosure Brief, the Lilly press release was only the latest in a long series of disclosures that EES contracts would "furnish capital," "finance certain energy infrastructure projects," "finance . . . new energy infrastructure " and provide "energy infrastructure upgrades." Disclosure Brief at 163-65. More was not required.

b. Plaintiffs' allegations regarding the "abuse" of MTM do not raise a question of fact.

Second, the Disclosure Brief addressed Plaintiffs' allegation that use of MTM for the EES contracts violated GAAP because EES had no "historical track record" upon which to base MTM calculations and because EES intentionally used unrealistic assumptions to value the contracts. The Brief pointed out that, in fact, GAAP *required* the use of MTM; that the "historical track record" argument is a fiction that appears nowhere in the GAAP authorities that Plaintiffs cite; that those authorities recognized the subjectivity of the judgments necessary for Enron's application of MTM rules and therefore allowed correspondingly wide latitude; and that Plaintiffs have not met their burden to plead in detail how Enron's assumptions and valuations had exceeded those wide bounds. Disclosure Brief at 171-74.

Plaintiffs respond that "[w]hether defendants' false and misleading financial accounting was the product of their 'cooking the books' or was the mistaken application of accounting rules is a factual question that is not appropriately raised here, nor can it be fairly and adequately determined without the benefit of discovery." Pls.' Mot. Strike at 7. This is obfuscation. Defendants raise no such factual question; rather, they argue that *as a matter of law*, Plaintiffs have not even properly pled a GAAP violation.[6] Before Plaintiffs can take discovery, they must first plead a set of facts that, if proven, would show Plaintiffs violated GAAP -- and they must do so with particularity. As this Court noted in *Waste Mgmt.*: "'where plaintiffs allege that defendants distorted certain data disclosed to the public by using unreasonable accounting practices, we have required plaintiffs to state what the unreasonable practices were and how they distorted the disclosed data.'" Slip. op. at 24-25 n. 11 (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417-18 (3rd Cir. 1997)).

As we explained in our first Memorandum, Plaintiffs have failed to meet this threshold requirement. It is not a violation of GAAP to mark contracts to market in the absence of a historical track record. Nor do Plaintiffs allege other required details about "what the unreasonable practices were and how they distorted the disclosed data." The Complaint does not explain how the MTM calculations were done, what the underlying assumptions were, why they were wrong or what method or assumptions should have been used. Nor does the Complaint allege what the total amount of the purported overvaluations were at the time that Mr. Pai made his allegedly misleading statements in 1999 and 2000 or at any point before he left EES; or how Plaintiffs calculate the $500 million "loss" they allege existed as of August 2001 (eight months after they now allege that Mr. Pai left EES).

Where, as here, a complaint purports to allege a GAAP violation but fails to plead it with particularity, no "question of fact" exists, and the complaint is subject to dismissal. *Waste Mgmt.*, slip op. at 185 (dismissing complaint on particularity grounds despite plaintiffs' allegation that

[6] Of course, merely alleging a GAAP violation would not, by itself, satisfy Plaintiffs' pleading burden under the PSLRA. "The mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1020 (5th Cir. 1996); *accord Waste Mgmt.*, slip op. at 139 (*citing Lovelace*).

defendants had overvalued assets in violation of GAAP); *accord In re K-Tel Int'l, Inc. Sec. Litig.*, 107 F.Supp. 2d 994, 1000-01 (D. Minn. 2000) (dismissing complaint on particularity grounds despite plaintiffs' allegation that defendants failed to account for the impairment of assets as required by GAAP) (*cited in Waste Mgmt.*, slip op. at 141-42); *see also Lovelace*, 78 F.3d at 1020-21 (dismissing complaint as a matter of law although "[p]laintiffs allege that Defendants published Software Spectrum's earnings for the first nine months of 1994 in a manner inconsistent with generally accepted accounting principles").

Plaintiffs cite a number of cases in support of their argument that a GAAP violation is a question of fact that cannot now be resolved. Pls.' Mot. Strike at 7. But in each of those cases, the courts were presented with a particularized explanation of *why* GAAP had been violated. *In re Triton Energy Ltd. Sec. Litig.*, No. 5:98-CIV-256, 2001 WL 872019, at *8 (E.D. Tex. Mar. 30, 2001) ("plaintiffs alleged that defendant failed to honor the 'matching principle,' which requires that expenses incurred to generate revenue be recognized in the same accounting period as the resulting revenue"); *Burlington*, 114 F.3d at 1420-21 (plaintiffs alleged GAAP violated because defendants had overstated earnings per share by 2-3 cents per quarter); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 164-65 (2d Cir. 2000) (plaintiffs alleged that GAAP was violated because defendants recorded certain fees as gross revenue when they should have been recorded as net income). Here, by contrast, Plaintiffs do not adequately plead "what the unreasonable practices were" as to MTM. *Waste Mgmt.*, slip op. at 24-25.[7]

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[7] In the Motion to Strike, Plaintiffs make two other allegations which could be construed as theories explaining why MTM was abused at EES: that EES abused MTM by "moving the curve" and "feeding the monster." Pls.' Mot. Strike 35 at ¶1(b), 36 at ¶1(e). We address these theories, *infra*, in Section I B 2 c of this Reply, explaining that they, too, are lacking in particularity.

c. Plaintiffs' specific examples of MTM violations are lacking in particularity.

Third, the Disclosure Brief explained that Plaintiffs have not pled with particularity specific examples of how EES "abused" MTM. Disclosure Brief at 174-83. Plaintiffs respond that "[t]he CC is replete with examples of Enron's MTM accounting abuse. . . ." Pls.' Mot. Strike at 48. Yet Plaintiffs point to only three such examples -- Eli Lilly, J.C. Penney, and Owens Illinois -- alleging that EES improperly used MTM to recognize revenue on these contracts when in fact they were "losing contracts." *Id.*; NCC ¶¶ 300(g)(i)-(iv).

As to Lilly, Plaintiffs claim that "Enron recognized approximately $44 million of the energy supply portion of the [Lilly] contract as revenue, by inappropriately employing mark-to-market accounting, in the quarter the deal was signed. . . . Enron had no legitimate basis for the $44 million figure and the assumptions used to arrive at that figure were not supportable." NCC ¶¶ 542-43. But Plaintiffs offer no explanation as to why that use of MTM was inappropriate, why Enron had no legitimate basis for the figure, what assumptions were used or why they were not supportable. Nor do Plaintiffs provide a documentary or personal source for their allegations, or even for the $44 million figure. That failure, too, is fatal. *ABC Arbitrage,* 2002 U.S. App. LEXIS 9112, at *37-*38 (plaintiffs must meet particularity requirement of Section 78u-4(b)(1) "by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs") (*quoting Novak*, 216 F.3d at 313-14); *see also BMC*, 183 F.Supp. 2d at 886, 916 (dismissing complaint which "does not refer to or cite any internal reports or documentation to support Plaintiffs' alleged 'true but concealed facts.'").

The Complaint, as pled, also does not support Plaintiffs' allegation that the Lilly contract was a "losing contract." Pls.' Mot. Strike at 48; *see* NCC ¶ 300(g)(iv). Plaintiffs fail to plead the amount of the loss, much less how it was calculated or when it occurred. Plaintiffs allege EES *expenditures* totaling $168 million, but every contract involves expenditures – that is not the same thing as a loss. Plaintiffs then allege that, after those expenditures were taken into account, the contract was "actually only worth $267 million." NCC ¶ 300(g)(iv). But if the contract was "actually . . . worth $267 million" after expenditures, then it was profitable, not a "losing contract."

The allegations as to the J.C. Penney contract are also deficient. Plaintiffs plead that J.C. Penney was "a $60 million loss." NCC ¶ 358; *see also* ¶¶ 300(g)(ii)-(iii), 315. Although they assert in their Motion to Strike that this is an example of "abuse," the Complaint never explains why. Perhaps Plaintiffs intend to allege that EES used MTM to *overvalue* the J.C. Penney contract by $60 million, but they certainly do not say so in the Complaint, and they nowhere explain whether a "loss" is the same thing as an overvaluation. As with Lilly, there is no explanation of how the "loss" was calculated or when it occurred (i.e., whether it was based upon current cashflow or predictions about the contract's lifetime value under particular conditions). Also like Lilly, EES entered the contract with J.C. Penney months after Mr. Pai had left EES, so even if these allegations were properly pled, they would not support a claim against him. NCC ¶ 315 (J.C. Penney contract announced 4/03/01).

Plaintiffs' third example, Owens Illinois, is more deficient still. The Complaint alleges that "[i]n the 4thQ 99 EES deal with Owens Illinois, EES recognized a multi-million dollar profit when the deal closed, even though it was known this deal would likely lose money for EES." *Id.* at ¶ 300(g)(iii). Plaintiffs offer neither the amount of the alleged loss, nor any other details, including the identities of the individuals by whom "it was known." As this Court has recognized, such "minimal detail fails to satisfy the PSLRA." *BMC*, 183 F.Supp. 2d at 890 (meeting not pled with particularity despite description of date, name of speaker and subject of meeting; "there is no information about how many sales people came to the meeting, whether the meeting concerned individual sales difficulties or company-wide problems, long-term trends or short-term issues, and what effect, if any, the alleged inability to effect sales would have on BMC's revenues"). Plaintiffs also fail to comply with the requirement that they state the basis for their allegation. *See ABC Arbitrage,* 2002 U.S. App. LEXIS 9112, at *37-*38 (plaintiffs must meet particularity requirement of Section 78u-4(b)(1) "by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs") (*quoting Novak*, 216 F.3d at 313-14).

In the Motion to Strike, Plaintiffs allege two other abuses relating to mark-to-market accounting at EES: "moving the curve" and "feeding the monster." Pls.' Mot. Strike at 35 ¶1(b), 36 ¶1(e). These allegations, too, are lacking in particularity. Plaintiffs complain that moving the curve consisted of using MTM to alter assumptions on existing contracts to recognize more income. They allege that this practice utilized unreasonable assumptions, but do not say what those assumptions were or how they were unreasonable. Pls.' Mot. Strike at 35 ¶1(b); NCC ¶¶ 536-37. Nor do Plaintiffs identify a single EES contract on which the curve was moved, when this occurred, or what effect it had on contract values or on Enron's financial statements – all of which would be necessary to show materiality. Plaintiffs' allegations are patently insufficient.

As for feeding the monster, although Plaintiffs classify it as an abuse of MTM, they do not allege that it involved calculations under that accounting method. Rather, they assert in the Motion to Strike that it was the practice of signing additional contracts to make up for the alleged large losses on EES's books as a result of its use of MTM. Pls.' Mot. Strike 36 at ¶1(e). They claim that this "included deals with J.C. Penney, IBM and CitiGroup," citing to NCC ¶¶

300(g)(i)-(iv). *Id.* In fact, ¶ 300 does not plead these or any contracts as examples of feeding the monster.

Even if it did, we have already explained that the allegations regarding the J.C. Penney contract are not pled with particularity. Nor are the allegations as to IBM or CitiGroup; in both cases, Plaintiffs fail to plead the amount of the alleged loss, when it was incurred, how it was calculated, how Plaintiffs know about it, or any other particularizing details. *See* NCC ¶¶ 214(g)(iii) (setting forth allegations as to the two contracts).

Plaintiffs also fail to meet their obligation to "provid[e] documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs" as to these two additional contracts. *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *37-*38. The IBM contract is mentioned in the August 2001 e-mail quoted by Plaintiffs, but the writer does not allege that it is a loss, just that the recipient of the memorandum "should also check on" IBM. NCC ¶ 358. As for CitiGroup, the Complaint alleges that when it and other "money-losing EES deals were discussed inside EES, people said 'EES always sells at a negative.'" NCC ¶ 214(g)(iii). This is insufficient because the "people" are not "described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged." *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *37.

Having now reviewed the allegations about the EES "fraudulent scheme" in detail, we note that the Complaint fails to mention Lou Pai in any of these allegations. This directly contradicts Plaintiffs' new assertion in their Opposition that Mr. Pai "must have known" about the alleged scheme. Pls.' Officer Opp'n at 60-61. Because Plaintiffs have not pled the EES fraudulent scheme with particularity, as to Mr. Pai or otherwise, the Complaint should be dismissed as to Mr. Pai.

C. Group Pleading.

In their Complaint, Plaintiffs seek to saddle Mr. Pai with liability for misstatements or omissions made by others on a group pleading theory. NCC ¶ 89. Plaintiffs misdirect the Court's attention to public securities filings, none of which Mr. Pai signed, and to analyst conferences in which Mr. Pai did not participate. Plaintiffs also gather a number of these statements by others in their discussion of Mr. Pai in their Opposition, attributing them to Mr. Pai merely because they "continued throughout Pai's tenure." Pls.' Officer Opp'n at 59.

In our moving Memorandum at 17-20, we explained that the law requires the Complaint to specify the person responsible for each misrepresentation, and that Plaintiffs have not alleged that Mr. Pai personally participated in creating or disseminating actionable misleading statements (other than the three non-actionable analyst reports discussed *supra*). Pai Mem. at 17-20. We also pointed out that this Court, like many others in the Fifth Circuit and across the country, has repeatedly rejected the group pleading doctrine.

Plaintiffs do not meet these arguments individually, instead responding globally to Defendants' group pleading arguments. None of Plaintiffs' responses supports holding Mr. Pai liable on a group pleading theory. First, Plaintiffs allege that certain named Defendants signed public filings containing misstatements or made false statements in conference calls. Pls.' Officer Opp'n at 35. Mr. Pai is not, however, among the persons Plaintiffs name and the Complaint contains no such allegations about him. Next, Plaintiffs argue that "Insiders" were involved in the preparation of false statements as part of Enron's fraudulent scheme, pointing to examples in the Complaint. Once again, Mr. Pai is not named and the Complaint pleads no such example involving him.

Finally, Plaintiffs make the incredible assertion that the group pleading doctrine survived the PSLRA, citing *Allison v. Brooktree Corp.*, 999 F.Supp. 1342, 1350. (S.D. Cal. 1998). This argument flies in the face of this Court's clear and repeated holdings. *See Landry's*, slip op. at 52-55; *Waste Mgmt.*, slip op. at 90-92, 187 n.71; *BMC*, 183 F.Supp. 2d at 902 n.45.

It also distorts *Allison*. That case did not order repleading to meet the group pleading doctrine. To the contrary, it held that, after the PSLRA, the group pleading doctrine "simply cannot be reconciled with the statutory mandate that plaintiffs must plead specific facts as to each act or omission by the defendant." *Allison*, 999 F.Supp. at 1350. The Court further held that "should plaintiffs decide to file an amended complaint ***they are instructed to plead specific facts as to the misleading statements and omissions as to each defendant***." *Id.* at 1350 (emphasis added). Then, as a second, independent ground for dismissing the complaint, the Court noted that even if the group pleading doctrine were still valid, the case would have to be dismissed "[w]ithout additional allegations demonstrating the reasonableness of applying the presumption to these defendants. . . ." *Id.* at 1351. This is hardly an endorsement of the continued vitality of the group pleading doctrine, and Plaintiffs simply cannot rely on that doctrine here.

II. PLAINTIFFS' ALLEGATIONS DO NOT SUPPORT THE REQUIRED STRONG INFERENCE OF SCIENTER.

Plaintiffs' Opposition reveals the fatal flaw in their scienter allegations against Lou Pai. The Complaint, and Plaintiffs' papers defending it, fail to specify a single document that he reviewed, fail to describe a single meeting that he attended and fail to identify a single person who spoke to him about any fact contrary to one of Enron's public statements. When it comes to Mr. Pai, Plaintiffs tacitly admit that their Complaint does not specify how he supposedly knew each of the offending statements to be untrue, nor does it "specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned." *BMC*, 183 F. Supp. 2d at 866; *see also id.* at 887 (complaint will be dismissed unless allegations demonstrate that defendants knew statements were false when made by stating what defendants knew, when and how they knew it and the basis for plaintiff's allegations). Plaintiffs have utterly failed to satisfy the burden imposed on them by the PSLRA, and recently reconfirmed by the Fifth Circuit, to detail the factual basis for their claims. *See ABC Arbitrage,* 2002 U.S. App. LEXIS 9112 (plaintiffs must describe documentary evidence and personal sources, including specifying the information to which defendant was exposed, that underlie their scienter allegations). They offer nothing—not a single vignette—to support their sweeping assertions that Lou Pai knew hundreds of paragraphs' worth of purportedly true but concealed facts and that he therefore knew Enron's public statements to be false. *No* inference of scienter, let alone a strong one, arises from this absence of fact.

Unable to plead facts about what Mr. Pai knew and when he knew it, Plaintiffs invite the Court to speculate with them about what Mr. Pai "must have known." They ask the Court to find a strong inference of scienter because Mr. Pai, as a member of Enron's Management Committee, had access to a variety of generically described reports of unknown content, attended routine meetings of his colleagues during a four-year period, and spoke with them and other Enron employees. NCC ¶ 399. While admitting that the fraud they allege required the personal attention of only "several" of Enron's top officers—and they do not name Mr. Pai as one of them—Plaintiffs reason that the fraud was so big, complex and important to Enron that it is "logical, if not obvious" that Mr. Pai must have known of it. NCC ¶ 395; Pls.' Officer Opp'n. at 98.

A. <u>The claim that Mr. Pai "must have known" of certain purported material misrepresentations and omissions by virtue of his executive position cannot support an inference of scienter under Fifth Circuit law.</u>

These allegations are nothing more than a re-packaging of the speculative assertions of scienter based on corporate office and access to information that courts consistently reject as insufficient under the PSLRA. This Court has dismissed scienter allegations "based on the officers' positions in the company, [including] the assertion that as officers they must have had knowledge [of] core business activities," recognizing that they "are not sufficiently persuasive, individually nor in concert, to give rise to a <u>strong</u> inference of scienter." *Kurtzman v. Compaq Computer Corp.*, No. H-99-779. slip. op. at 47 (S.D. Tex. Apr. 1, 2002) (emphasis in original). And indeed the Fifth Circuit rebuffed such pleading only last month, affirming the dismissal of a complaint that failed to allege sufficient particularized facts to meet the PSLRA's demanding standard for pleading scienter. *Abrams v. Baker Hughes, Inc.*, No. 01-205147, 2002 U.S. App. LEXIS 9565 (May 21, 2002). In that case, as in this one, plaintiffs filed suit following a restatement of financial reports for a period during which an insider had traded at a substantial profit. The plaintiffs alleged that the company had failed to disclose that pervasive problems in the company's internal controls made its accounting system unreliable and its results overstated, had lied to analysts and had falsely reported that there were no accounting issues following the resignations of two top financial officers. The systemic accounting problems were alleged to have produced accounting irregularities in one of the company's largest subsidiaries, which, when disclosed, caused the cancellation of a planned securities offering and the collapse of the stock price to one-half its class-period high.

In *Abrams*, as in this case, the plaintiffs rested their allegations of scienter on the fact that the individual defendants were senior executives of the company who were intimately familiar with its inner workings, including the inadequacies of its internal controls. Indeed, the individual who sold his stock was the same executive given responsibility for correcting the accounting/internal control problems. *Abrams*, 2002 U.S. App. LEXIS 9565, at *14-*15. The Fifth Circuit, however, upheld the decision of the district court that these facts did not establish a strong inference of scienter. Notwithstanding the importance of the subsidiary in question to the company's financial performance, the court squarely rejected the "must have known" scienter standard urged by the plaintiffs:

> Based on case law in this and other circuits, these allegations fail to reach the required standard. Plaintiffs point to no allegations that the defendants knew about the internal control problems, only that they should have known or that their lack of knowledge based on their corporate positions demonstrates recklessness. A pleading may not rest on the inference that defendants must have been aware of the misstatement based on their positions within the company.

Id. at *15-*16. Nor did the Fifth Circuit permit the plaintiffs to buttress their scienter allegations with a general claim asserting the existence of confidential corporate reports revealing information contrary to the company's public statements. "Such allegations must have corroborating details regarding the contents of allegedly contrary reports, their authors and recipients. . . . The plaintiffs point to no specific internal or external report available at the time of the alleged misstatements that would contradict them." *Id.* at *16-*17 (footnote omitted). As an example of adequately detailed allegations, the court cited *Novak v. Kasaks*, in which the plaintiffs had described specific internal inventory reports that contradicted the company's contemporaneous public statements, as well as the fact that the defendants had secretly adopted inventory practices that violated the company's stated policy. *Id.*

The case that best illustrates the Fifth Circuit's hostility to the presumption that a corporate executive is charged with knowledge of the facts about his core business is *Nathenson* *v. Zonagen*, 267 F.3d 400 (5^{th} Cir. 2001), which is, paradoxically, one of the rare cases in which the court actually allowed such an inference. There, the plaintiffs alleged that the President and CEO of Zonagen falsely stated that the company's patent covered the use of the drug Vasomax as a pill to be swallowed, rather than dissolved in the mouth, when the patent in fact expressly excluded that use. *Id.* at 423. Reaffirming that an officer's position within a company will *not* ordinarily suffice to create an inference of scienter, the Fifth Circuit noted that an unusual combination of special circumstances warranted an exception in the case then before it: Vasomax was Zonagen's only product, on which all of the company's future depended and to which all of its attention and resources were directed, according to its SEC filings. The public filings also acknowledged that the proprietary nature of the company's technology was important, and the President had previously stated that the particular patent in question was crucial. Moreover, the Court relied on the fact that the company was a small operation, having no more than 35 employees. *Id.* at 424-25. Thus, the President and CEO could be expected to be familiar with the coverage of the patent because the company was very small, the patent related to the company's only product to which all of its success was tied and the President and CEO had acknowledged that patent to be critical. Even with this unique combination of circumstances, the Fifth Circuit inferred scienter only reluctantly, characterizing the question as a close one. *Id.* at 424. "Taking all the above factors together, we conclude they suffice, *if perhaps only barely so*, to support the necessary 'strong inference' of scienter." *Id.* at 425. Moreover, the court applied this presumption only to the President and CEO, refusing to find scienter as to other defendants, including one who had traded during the class period. *Id.* at 425-26.

If the Fifth Circuit found *Nathenson*'s "core business" allegations barely sufficient, the ones made by Plaintiffs in this case are manifestly inadequate. Unlike the tiny, one-product, 35-

employee company in *Nathenson*, Enron is, as the Complaint avers, a company with assets around the world, once the seventh largest company in the United States. It had multiple operating subsidiaries (such as EES), which in turn conducted numerous transactions and lines of business. At the time of its bankruptcy filing, Enron and its subsidiaries, including EES, employed a total of 25,000 people. *See* Motion of Debtors for Authority to Pay Prepetition Employee Compensation, Exhibit 10[8] contained in Mr. Pai's Supplemental Appendix ("Pai Supp. App.") submitted herewith, at 2.[9] In fact, the number of Enron officers sued as defendants in this case is almost equal to the total number of employees at the company in *Nathenson.*

Plaintiffs invite comparison of their allegations to those in *In re Landry's Seafood Restaurant, Inc. Sec. Litig.*, cited throughout their Opposition. This Court's decision in that case highlights the inadequacy of the allegations that the Newby Plaintiffs now advance. The *Landry's* plaintiffs claimed that the restaurant chain issued positive statements while it failed to disclose that overexpansion was causing its established restaurants to lose business to cannibalization by its new restaurants, with the result that sales per store were declining. The *Landry's* plaintiffs described the process by which every Landry's restaurant provided revenue and sales data to headquarters each day, from which the chain's central finance department prepared and distributed to each of the defendants detailed daily, weekly and monthly reports comparing actual and budgeted results for each restaurant in a variety of categories, including

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[8] For the Court's convenience, the exhibits in the Supplemental Appendix are numbered sequentially following the last item, No. 9, submitted in the Appendix accompanying Mr. Pai's Motion to Dismiss.

[9] The bankruptcy followed a series of well-publicized layoffs, including the author of one of the letters quoted by Plaintiffs in the Complaint, who describes a large number of layoffs at EES. *See* Pai App. Tab 9 at 1, 6-9. Though Plaintiffs make no direct allegations concerning the size of EES, that letter refers to "hundreds of employees." Pls.' Officer Opp'n at 61. In fact, EES, as a multi-billion dollar company, had employees numbering in the thousands.

new orders and backlogged orders. *Landry's*, slip op. at 29-30. Each of the Landry's executives named as a defendant thus received current information from each restaurant concerning the sale of and demand for Landry's products and was aware of the company's actual performance as compared to its projected performance. *Id.* Moreover, the company's securities filings expressly represented that particular managers compiled and monitored closely data on sales and trends, tracked such information by location on a current basis and took immediate remedial action where possible. *Id.* at 29.

In concluding that the plaintiffs had established a strong inference of scienter on the part of the Landry's executives, the Court relied heavily upon the plaintiffs' detailed description of the information available to the defendants at the time of the challenged statements and the defendants' admission in the SEC filings that they monitored closely the performance of every restaurant, effectively conceding that they had the information in question. *Id.* at 64.[10] These specific scienter allegations contrasted with the more generic allegations asserted against the underwriters whom the plaintiffs sued for their promotion of the secondary offering in which the executives unloaded their stock on the public. Accepting as true the allegations that the underwriters prepared the registration statement said to contain misstatements and had conducted a comprehensive due diligence review of Landry's operations and future prospects, including access to corporate confidential information, the Court was nevertheless unwilling to find a sufficient basis for scienter. The underwriters, this Court explained

> purportedly had access to confidential corporate information and communicated frequently with [Landry's President and CEO and CFO] about the business, but Plaintiffs fail to provide any details or identify specifically what kind of information, when it was

[10] This is in addition to the coordinated trading by the defendants, which the Court found to be suspicious in context. *Id.* at 49-52, 62.

> conveyed, by whom, and to whom. Plaintiffs have failed to identify any specific information communicated by document or conversation to the Underwriter Defendants or uncovered by them in their due diligence investigation. Instead, they have made general statements that might give rise to speculation, but not particularized facts giving rise to a strong inference that the Underwriters acted with severe recklessness or knowingly to support allegations of fraud under the Exchange Act.

Id. at 66.

Plaintiffs also cite this Court's opinion in *Kurtzman v. Compaq Computer Corp.*, Pls.' Officer Opp'n. at 98-99, but they appear to have overlooked the fact that the Court there rejected the very argument they put forward here. The plaintiffs in that case alleged that Compaq knew, but failed to disclose, declining sales in its core markets, Europe and North America, which were essential to the company's overall performance. The individual officer defendants supposedly received daily and weekly sales reports by geographic region reflecting this decline. *Kurtzman*, slip op. at 35-37. Subordinates reporting to one of the individual defendants also attended monthly sales meetings allegedly directed to the issue of weakening demand. *Id.* at 37.[11] This Court, however, made clear that *a securities plaintiff cannot escape his obligation to allege what each defendant knew, when he knew it, how he learned it and the basis for plaintiff's allegations merely by alleging that the claimed misstatements relate to a core business of the company.* Instead, the Court emphasized that the PSLRA requires the plaintiff to plead a direct link between the individual defendant and the information that allegedly revealed the public statements to be false. An argument that a matter was so important that the defendant must have

[11] In addition to arguing that the defendants were broadly chargeable with knowledge of facts concerning Compaq's core business units, the *Kurtzman* plaintiffs also made many of the other scienter arguments advanced in this case.

known about it is simply too speculative to sustain a strong inference of scienter, or even to bolster other allegations. As this Court stated in *Kurtzman*:

> [T]he Court finds that Plaintiffs also fail to allege any direct link between Pfeiffer and Mason [the individual defendants, officers of Compaq subsidiaries] and the regular, but vaguely and conclusorily described Plan of Record, daily and weekly reports (reflecting conclusorily designated "weakening demand," "declining sales," "inventory backlogs," product returns, and "increasing inventories of service spares"), and monthly five internal meetings focusing on each geographical region. There is no allegation that they personally read any particular report or attended even one of the meetings, or facts that would show someone reported these matters to them. This deficiency makes stronger, more specific allegations elsewhere in the complaint more essential.
>
> Furthermore, Plaintiffs fail to allege with any specificity the actual contents of these claimed sources of information . . . . Instead, Plaintiffs fail to describe the actual substance of a single one of the reports or of any single discussion at any monthly meeting on which Plaintiffs rely to give rise to a strong inference of scienter.

Id. at 46. The Court therefore dismissed the claim, adopting the defendants' view that "Plaintiffs are not permitted to broadly 'charge' Defendants with knowledge, but must create a strong inference of scienter by the pleading of specific facts, not conclusory or speculative allegations." *Id.* at 35. *Kurtzman* removes any doubt about whether a court can presume that an executive has knowledge of facts about his business and makes clear that the *Landry's* decision rested on the express admission in the company's SEC filings that the executives monitored the precise performance measures about which the plaintiffs alleged they had knowledge. *Id.* at 46-47.

B. Not only is the claim that Mr. Pai "must have known" of certain purported material misrepresentations and omissions unsupported by particularized facts, it is contradicted by the cognizable record that Plaintiffs plead, including the Powers Report and exhibits, and by Mr. Pai's New Power investment.

Plaintiffs here have even less basis than did the *Kurtzman* plaintiffs for charging Mr. Pai with knowledge of assertedly "true but concealed facts." They contend, for example, that Mr. Pai must have known the topography of the site selected for construction of a power plant in the Philippines by an Enron subsidiary of which he was neither a director or an officer, NCC ¶ 155(i), and that he must likewise have known what one of his counterparts in still another subsidiary told a potential employee during a job interview about that subsidiary's business prospects. NCC ¶ 523. How or when Mr. Pai is supposed to have learned these things, and the basis on which Plaintiffs allege that he knew them, is left entirely to our imagination.[12] Moreover, the few sources that Plaintiffs now belatedly offer (and impermissibly use to amend their complaint), actually *contradict* their attempt to suggest that Mr. Pai must have known facts in conflict with Enron's public disclosures about the Chewco, JEDI and Raptor transactions that required Enron to restate its financial reports in the first place. Jt. SEC App. Tab 76 (Nov. 8, 2001 8-K). For example, Plaintiffs now seek to draw the Court's attention to the Powers Report and the investigation that produced it. Pls.' Mot. Strike at 27-28 (relying expressly on Powers Report and memoranda of Powers Committee witness interviews). The Powers Committee investigated Chewco, JEDI, the Raptors and other related party transactions claimed by Plaintiffs

[12] The Plaintiffs flagrantly disregard the PSLRA's requirement that the Complaint set forth the basis for any allegations not pled on personal knowledge, 15 U.S.C. § 78u-4(b)(1), a convenient omission that freed Plaintiffs to make extravagant factual assertions that have no foundation. Again in their Opposition, Plaintiffs simply ignore the requirement, and their lack of response is all the more inexcusable in light of the Fifth Circuit's recent decision in *ABC Arbitrage*, holding that *a plaintiff must state with particularity the factual basis for her belief in the facts she avers regarding her claims, including those respecting the defendants' scienter*. 2002 U.S. App. LEXIS 9112, at *34-35 & n.70, *49.

to be fraudulent, including determining the roles played by members of Enron's management in specific transactions.[13] Although Plaintiffs claim that Mr. Pai was a major player at Enron and knowledgeable about all of these transactions, *the Powers Report does not mention Lou Pai once, either by name or by position.* Had Mr. Pai played any role in the transactions under review by the Powers Committee, surely the Report would have at least mentioned him once. And had Mr. Pai been as knowledgeable as Plaintiffs would have the Court presume, surely the Powers Committee would have alluded to his role, interviewed him, and prepared a memorandum that Plaintiffs would have included in their supporting papers (if only as part of the untimely submission they have now made to shore up their Complaint). The absence of any such references makes it "logical if not obvious," to borrow Plaintiffs' phrase, that, after interviewing those Enron executives and employees knowledgeable about the transactions, the Powers Committee and its counsel found no basis to believe that Mr. Pai participated in structuring those deals or knew anything about them inconsistent with the public disclosures. This conclusion is confirmed by the memorandum that Plaintiffs submit of an interview conducted by the Powers Committee's counsel with Rodney Faldyn, Enron's Vice President of Financial Accounting, who participated in the creation of the Raptors and was intimately familiar with transactions related to them. Exhibit 15 to Plaintiffs' Motion to Strike. The memorandum identifies many of the individuals with whom Faldyn communicated about these transactions, including certain of the defendants in this case. There is no mention of Mr. Faldyn having consulted with Mr. Pai concerning any of these transactions. The only mention of Mr. Pai is to note that, at some point

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[13] The Committee retained as its counsel a former Director of Enforcement of the SEC to conduct an extensive investigation, after which it delivered a lengthy report, supported by memoranda of interviews with knowledgeable Enron executives and employees, both current and former, as well as review of documents.

in the third quarter of 2001—after Mr. Pai had left Enron—he expressed interest in purchasing Enron's share of New Power. Pls.' Mot. Strike Ex. 15 at 9.

The attempt to gin up an inference of scienter against Mr. Pai suffers yet another body blow when it comes to the allegations concerning The New Power Company. To draw the inference that Plaintiffs urge, the Court must conclude that Mr. Pai irrationally invested $12 million of his own money in securities that he knew to be worthless and then sought to invest yet more. According to Plaintiffs, "[T]he New Power spin off was a sham and its securities were worthless,"[14] and Enron's management created New Power and offered its shares to the public in an IPO for the purpose of locking in a phony accounting gain on those worthless securities. NCC ¶¶ 42, 83(hh), 395. Mr. Pai clearly believed no such thing: He invested $12 million in New Power--$5 million in June 2000 before the public offering and more than $7 million thereafter to purchase shares on the open market, which he continued to do until February 2001.[15] As the public securities filings show, he has never sold a single one of those 3.5 million shares. Furthermore, along with their Opposition memoranda, Plaintiffs sponsor an exhibit demonstrating that, in the fall of 2001, after his departure from Enron, Mr. Pai approached the company about buying its 40 percent stake in New Power, hardly the act of someone who thought the company to be a sham. *See* Pls.' Mot. Strike Ex. 15 at 9. Plaintiffs do not even attempt to reconcile Mr. Pai's increasing investment in New Power with their unsupported conclusory allegation that he must have known the company to be a sham and its securities to be

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[14] Pls.' Mot. Strike at 6.

[15] Jt. SEC App. Tab 61, at 55 (New Power IPO filed October 5, 2000) (reflecting Mr. Pai's investment of $5 million); Pai App. Tab 3 (Form 4s) (reflecting Mr. Pai's open market purchases of New Power stock between November 2000 and February 2001).

worthless.[16] This example undermines Plaintiffs' remaining allegations as to what Mr. Pai "must have known" and illustrates why the PSLRA requires particularized allegations explaining how a defendant was exposed to the information with which the plaintiffs seek to charge him.

C. The claim that Mr. Pai "must have known" of purported material misrepresentations and omissions regarding EES cannot support an inference of scienter because it is unsupported by particularized allegations of fact.

Plaintiffs next try to salvage their scienter argument by switching to a new theory: Mr. Pai participated in a fraudulent scheme whereby EES entered into long-term energy contracts that were expected to lose money but were reported as profitable through the misuse of mark-to-market accounting. Here, too, Plaintiffs offer no facts to suggest that Mr. Pai knew or intended any such thing. The Complaint does not say *who* at EES knew or expected the contracts to lose money, NCC ¶ 300(g), how firm those numbers were, how the profitability of a proposed contract was evaluated and by whom, whether there was agreement or disagreement about these projections, or who determined how principles of mark-to-market accounting were to be applied to any particular contract. *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *49 (to show scienter based on internal corporate reports containing information alleged to be inconsistent with company's public statements, "a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were or which company officers reviewed them") (citations and internal quotations omitted). Most important, the Complaint nowhere alleges that anyone on any occasion communicated to Mr. Pai facts showing that a particular contract would lose money and that, accepting those facts, he nevertheless caused EES to enter into that contract

[16] Public records show that New Power was no sham, but is instead a bona fide provider of electricity to more than 550,000 customers in nine states, including Texas. *See* Pai Supp. App. Tab 11 (excerpts from New Power's 2001 Form 10-K). Because many of New Power's energy contracts were undertaken through Enron, the Enron bankruptcy had a negative effect on the fledgling New Power and forced it to file for protection in bankruptcy earlier this month.

or to cause it to be reported as profitable by Enron. The Complaint likewise contains no allegation that anyone told Mr. Pai that the methodology used by EES to estimate the future profitability of contracts was flawed or that he was ever informed that the methodology used to calculate its mark-to-market income was incorrect. There is no allegation that Mr. Pai directed anyone to use assumptions or models that he believed to be untrue or unrealistic to value a contract.

1. The Statements of Ceconi and Dickson

Neither of the former EES employees whose remarks are cited in the Complaint claims to have communicated with Mr. Pai at any time or even to have met him. NCC ¶¶ 542 (Glenn Dickson); 59(b) (letter of EES employee to Enron Board), reproduced in full in Pai App. Tab 9 (Ceconi letter). Neither person addresses the role that Mr. Pai played in the valuation of prospective contracts, the information that he had before him with respect to any particular contract or the reasons that he may have believed in the validity of any particular valuation. Indeed, Ms. Ceconi, whose letter the Complaint quotes repeatedly,[17] had virtually no opportunity to observe Mr. Pai; she joined EES in December 2000, just as he was leaving. *See* Pai App. Tab 9. (Plaintiffs averred in their Complaint that Mr. Pai had left EES and become Chairman and CEO of Enron Xcelerator in 1999, but they change this date to the end of 2000 in their Opposition. NCC ¶ 88; Pls.' Officer Opp'n at 59.) Further, she admittedly came to EES with no experience in the energy industry or in commodities and had no basis on which to evaluate the

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[17] NCC ¶¶ 38, 59(b) and cover page.

reasonableness of Mr. Pai's judgments in those areas for the brief period in which they may have overlapped at EES.[18] *Id.* at 5.

Plaintiffs ask this Court to find a strong inference of scienter on the part of Mr. Pai based on mere bootstrapping from a conclusory statement that "everybody knew" that EES was committing fraud. But their own factual allegations do not even say what Plaintiffs claim they say. The Ceconi letter, from which Plaintiffs quote at length as regards Mr. Pai's scienter, does not, for example, say that EES entered into contracts expecting to lose money. It instead criticizes EES for having lost money on the deals that EES had negotiated, stating that, in retrospect, during the management of Mr. Pai's successor, "[i]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked."[19] Ceconi letter, Pai App. Tab 9 at 2. Nowhere does Ms. Ceconi's letter indicate that the contracts were expected to lose money when they were signed. Indeed, her criticisms of EES's business practices (as opposed to her employment grievances) refer to garden variety mismanagement, such as failure to offer products attractive to customers and poor contract negotiating and drafting, resulting in economically burdensome terms. Pai App. Tab 9 at 2-3. She does not cite a single instance of fraud in EES's contracting practices. Moreover, the letter does not once mention mark-to-market accounting and never suggests that EES was knowingly overstating the

[18] Plaintiffs argue in their Opposition Brief that a strong inference of scienter arises partly from the fact that the Insiders were notified by Enron employees of Enron's problems, citing the Ceconi letter, which is dated August 29, 2001, and the letter from Sherron Watkins to Kenneth Lay, also written in August 2001. Pls.' Officer Opp'n at 101-02; NCC ¶ 59; Pai App. Tab 9. That argument cannot apply to Mr. Pai, who had retired from Enron prior to the date of either letter. *See* Pai App. Tab 8 (excerpt from 10-K filed by New Power for year ended 12/31/01 disclosing that Mr. Pai had left Enron by July 2001).

[19] According to Ms. Ceconi, the problems became apparent only at some point after the first management team, including Lou Pai, had left and David Delaney, Mr. Pai's successor, had made changes to EES, changes that she criticizes. *Id.* at 2.

value of its contracts. While Plaintiffs mis-cite Ms. Ceconi's letter for the proposition that "'hundreds of EES employees' knew about this fraud,"[20] her letter actually says that hundreds of employees know of "all of the *problems* I have mentioned." Pai App. Tab 9 at 10.[21]

The only financial reporting issue that Ms. Ceconi raises in her letter is Enron's decision—after Lou Pai left EES—to transfer EES's smaller risk management group to Wholesale and merge it with the large risk management operation of Enron North America. Ms. Ceconi asserts that this change was made for the purpose of somehow concealing $500 million of losses and that the realignment of segment reporting as between Wholesale and Retail is a violation of GAAP. *See* Pai App. Tab 9 at 3, 10. Thus, when Ms. Ceconi claims that "EES has knowingly misrepresented EES' earnings," something she says is common knowledge and joked about, the comment refers to whether the losses she believes to exist appear in the results reported for Enron's Retail segment or are included in the results for Enron's Wholesale segment.[22]

This segment reporting issue, however, lends no support to Plaintiffs' attempt to construct an inference of scienter against Mr. Pai. First, the Complaint pleads no facts to suggest

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[20] Pls.' Officer Opp'n at 61.

[21] This statement appears eight pages after the description of EES having lost money on contracts signed in the last two years, a fact not apparent from the manner in which Plaintiffs excerpt the letter.

[22] "This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, 'Disclosures about Segments of an Enterprise and related information,' EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about..." *See* Pls.' Officer Opp'n at 61; Pai App. Tab 9 at 3.

that Mr. Pai played any role in the decision to transfer the risk management function from EES to Wholesale. To the contrary, the fact that the change occurred after Mr. Pai left EES suggests that he did not. Whatever speculation may have circulated among those remaining at EES about the reasons for the change, there is nothing in the Complaint to indicate that Mr. Pai had a basis to believe that the reasons were other than the legitimate ones stated publicly: the desire to concentrate risk management activities in one unit, under uniform supervision. (Indeed, if Enron believed that better risk management might have controlled losses at EES and that Wholesale was more experienced and better equipped to perform this function, transfer of this responsibility from Retail to Wholesale would seem to be a prudent business decision.)

Second, Ms. Ceconi's views notwithstanding, Enron's public filings show that nothing about the change in segment reporting was "hidden." Enron itself had publicly announced the transfer of risk management, including its financial effect on both Wholesale and Retail, months before Ms. Ceconi's letter. The change was effective in 2001 and was disclosed in Enron's 10-Q for the quarter ended March 31, 2001 and in the first quarter earnings release that preceded it. Jt. SEC App. Tab 17 at 12; Jt. App. Tab 12 at 13. Note 6 to the 10-Q could not be more explicit: "[B]eginning in 2001 the commodity-related risk management activities of the Retail Energy Services (EES) North American customer contracts were transferred to the Wholesale segment, consolidating all energy commodity risk management activities within one segment." (As the 2000 10-K explained, the commodity-related risk management activities in question were EES's futures contracts with its customers and trading activities to hedge those futures contracts.) Note 6 also included a table comparing the results reported by Wholesale and Retail for 2000 with what those results would have been if the transfer had already taken place. As that table showed, had the transfer occurred in 2000, the net income of the Retail segment (EES) would have increased, thus indicating that the transferred risk management activities were operating at a loss. Virtually identical disclosures had previously appeared in Enron's earnings release. These repeated disclosures defeat an inference of scienter. *See, e.g., Lovelace,* 78 F.3d at 1019-20 (partial disclosure tends to negate scienter where disclosure alleged to be merely incomplete).

The Complaint offers even less support for its conclusory allegation that Mr. Pai must have known that EES was overstating its income by "abusing" mark-to-market accounting through the intentional use of unrealistic assumptions to value its contracts. *See, e.g.,* NCC ¶¶ 542-43 (describing what "Enron managers knew" about a particular EES contract and alleging that "the assumptions used...were not supportable.") Plaintiffs neglect to explain precisely how the valuation assumptions were known to be unsupportable or how Mr. Pai purportedly knew them to be so at the time the contracts were valued. Even prior to the PSLRA, the Fifth Circuit held that Rule 9(b) will not tolerate scienter allegations based on such imprecise assertions. It was just such pleading that prompted the Fifth Circuit to caution that "conclusory allegations or legal conclusions masquerading as factual conclusions will not suffice to prevent dismissal under Rule 12(b)(6)." *Shushany v. Allwaste, Inc.*, 992 F.2d 517 (5th Cir. 1993). The *Shushany* plaintiffs claimed that an Allwaste asbestos abatement subsidiary, AAA, had falsely represented its growth prospects and profitability when it had in fact been losing money for more than one year. They alleged that employees were instructed to make arbitrary accounting adjustments for the purpose of overstating earnings and income on Allwaste's financial reports, just as Plaintiffs in this case allege that EES used arbitrary assumptions to value its contracts for the purpose of overstating its income on Enron's financial statements. The Fifth Circuit, however, found these averments deficient, in terms of both scienter and materiality.

> But, the complaint did not identify who in particular was instructing the employees to make the arbitrary accounting adjustments, what particular adjustments were made, how those adjustments were improper in terms of reasonable accounting practices, how those adjustments were incorporated into Allwaste's financial statements, and if incorporated, whether those adjustments were material in light of Allwaste's overall financial position. Although we need not identify which of these deficiencies, standing alone, might render the complaint insufficient under Rule 9(b), we hold that altogether, they do.

Id. at 522 (footnotes omitted). Nor was the court moved by the *Shushany* plaintiffs' contention that they should be excused from having to plead facts within the exclusive control of the defendants. The Fifth Circuit noted that, as in this case, the plaintiffs had access to a great deal of information from other sources, including other litigation and a former employee of Allwaste. *Id.* at 523. Here, the information available to Plaintiffs is many times that available at the pleading stage in most securities litigation, and Plaintiffs have no right to be excused from the standard to which this Court has held prior litigants.

2. Claims of "Abused" Mark-to-Market Accounting

Moreover, Plaintiffs have chosen to allege that Mr. Pai harbored fraudulent intent in connection with EES's "abuse" or "misuse" of a method of accounting that requires certain subjective judgments, does not require any single methodology, and in which a wide range of outcomes may all be considered correct. Plaintiffs acknowledge that the use of MTM required EES to make certain assumptions. Pls.' Mot. Strike at 35 ("MTM requires companies to make reasonable assumptions."). They have provided no authority for their *ipse dixit* proposition that MTM for energy contracts must be based on historical track record and have conceded that EITF 98-10 concerning such contracts does not impose such a standard. Pls.' Mot. Strike at 35-36. To the contrary, the later-issued EITF 00-17 explicitly confirms that alternative approaches to measuring the fair value of energy contracts may provide "significantly different answers" and that "two companies in similar circumstances might apply different methods to estimate the fair value of their energy-related contracts and may arrive at widely different values." EITF 00-17 at ¶¶ 1, 7. In choosing to plead their case based on MTM abuses, Plaintiffs undertook the burden of making particularized factual allegations that would show that Mr. Pai knew that EES's mark-to-market accounting methods would produce results outside the wide range of variation contemplated by the accounting literature. *Shushany*, 992 F.2d at 521 ("'What constitutes 'particularity' will necessarily differ with the facts of each case.'") (*quoting Guidry v. Bank of LaPlace*, 954 F.2d 278, 288 (5th Cir. 1992)). Here, that requires allegations specifying what assumptions were unreasonable or unsupportable and why, who used them, on which contracts and when, how they were known to be unsupportable and, most important, how Mr. Pai knew them to be unsupportable, including what contrary information he was given on a contemporaneous basis.

3. The Lilly Contract and Other Miscellany

As for the allegations about the Lilly contract, Plaintiffs' numbers are not only incomprehensible, but they contribute nothing to an inference about Mr. Pai's scienter. Contradicting themselves in the space of two pages, Plaintiffs make conflicting statements about whether Mr. Pai was even in charge of EES at the time of the Lilly contract. First, they say that Mr. Pai left EES for Enron Xcelerator at the end of 2000. Pls.' Officer Opp'n at 59. On the very next page, they say that Mr. Pai was at EES when Enron announced the Lilly contract, which they correctly note occurred in February 2001. Pls.' Officer Opp'n at 60; *see also* Jt. App. Tab 13 at 1 (Enron's press release announcing Lilly contract dated February 26, 2001). The press release announcing the contract quotes someone other than Mr. Pai on behalf of EES. *Id.* In any event, the Plaintiffs have presented no facts to suggest that Mr. Pai was responsible for or even familiar with the negotiation, valuation or accounting for the Lilly contract, and he was certainly no longer at EES when the results for that quarter were reported. Nothing in either the Complaint or Plaintiffs' brief suggests that Mr. Pai knew anything about the Lilly contract inconsistent with the public statements or that, whatever he may have known about the capital investments or discounts to which EES may have agreed in order to sign a mammoth lucrative agreement, he had any reason to think that the contract was not valued properly because of them.

The other makeweight scienter allegations that Plaintiffs offer against the Enron Officers as a group lend no support to an inference of scienter in the case of Mr. Pai. Although Plaintiffs assert that internal complaints made to insiders contradicted their contemporaneous optimistic statements about Enron, the internal communications that they identify were made after Mr. Pai left his employment at Enron, and none of them was directed to him. *See* n.18, *supra*. Similarly, without distinguishing among the defendants, Plaintiffs argue that "[t]he temporal proximity of Enron's demise to highly inconsistent statements evidences scienter." Pls.' Officer Opp'n at 102. They have not, however, identified a single positive statement by Mr. Pai made close in time to Enron's demise. To the contrary, the few analyst reports for which Plaintiffs seek to hold Mr. Pai liable were each issued more than one year prior to Enron's bankruptcy. The latest of the three is dated September 2000, 14 months before Enron's demise, and, it is worth noting, eight months before Mr. Pai's next sale of Enron securities. *See* NCC ¶ 258 (Bank America analyst report dated 09/19/00). The other two analyst reports that mention him were both issued in the fall of 1999, also months before his subsequent stock sales and more than two years before the bad news that sunk Enron. *See* NCC ¶¶ 167 (CSFB report dated 09/02/99), 191 (CSFB report dated 11/30/99). And, insofar as Plaintiffs' scienter claim depends on Enron's restatement of its financial reports,[23] they have not alleged that any of the restatement pertained to EES or to Enron Xcelerator, the two operating units directed by Mr. Pai, nor have they pled facts that would establish that he knew of the GAAP violations that they allege.

III. PLAINTIFFS' ALLEGATIONS REGARDING MR. PAI'S TRADING DURING THE CLASS PERIOD ARE LIKEWISE INSUFFICIENT TO SUPPORT A STRONG INFERENCE OF SCIENTER.

Having little else to offer concerning Mr. Pai, Plaintiffs evidently hope that the Court will be so impressed with the number of options that he exercised that no critical thought will be given to the circumstances in which those trades occurred. This Court, however, has shown itself to be immune to such blandishments, recognizing that it is the *context* in which the trading occurs that determines whether it is "unusual" or "suspicious" enough to suggest an inference of fraud.[24] Because corporate executives may sell their stock for any number of legitimate reasons unrelated to inside information,[25] a plaintiff who relies on trading activity to establish scienter must show the trading to be irregular in light of the surrounding circumstances.[26] Although

[23] Plaintiffs contend that the magnitude of Enron's restatement supports a strong inference of scienter. Pls.' Officer Opp'n at 103.

[24] *BMC*, 183 F.Supp. 2d at 901; *see also Abrams,* 2002 U.S. App. LEXIS 9565, at *24; *Nathenson*, 267 F.3d at 420-21.

[25] *E.g.*, *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001) (recognizing that "not every sale of stock by a corporate insider shows that the share price is about to decline" and summarizing some of the reasons why insiders might sell); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir. 1999) (recognizing that because "[a] large number of today's corporate executives are compensated in terms of stock and stock options . . . [i]t follows . . . that these individuals will trade those securities in the normal course of events") (citation omitted).

[26] *BMC,* 183 F.Supp. 2d at 900 (the "'mere pleading of insider trading, *without regard to context or strength of inferences to be drawn*, is not enough'") (*quoting Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999) (emphasis added)); *see also In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1093 (9th Cir. 2002) ("[I]t is [the plaintiffs'] burden under the PSLRA to provide a clear context from which [the court] can find a strong inference of fraud."); *In re Carter-Wallace, Inc. Sec. Litig.*, No. 94 CIV. 5704 (KTD), 1999 WL 1029713, *5 (S.D.N.Y. Nov. 10,

Plaintiffs would have it otherwise, "even large sales with large profits, without more, are not enough to satisfy a plaintiff's burden of pleading scienter." *In re First Union Corp. Sec. Litig.*, 128 F.Supp. 2d 871, 897 (W.D.N.C. 2001); *see also Abrams,* 2002 U.S. App. LEXIS 9565, at *11 ("Allegations of motive and opportunity, standing alone, are no longer sufficient to plead a strong inference of scienter."); *In re Party City Sec. Litig.*, 147 F.Supp. 2d 282, 314 (D.N.J. 2001) (fact that CFO sold all his stock during the class period was "insufficient, by itself, to support scienter"). Were the law otherwise, any corporate executive who traded successfully would be at the mercy of fraud by hindsight claims.

Fearing the results of an examination of each defendant's trading, individually, Plaintiffs once again resort to group pleading, this time to suggest that the volume of the Enron Defendants' stock sales in the aggregate establishes scienter. Citing *Freidberg v. Discreet Logic Inc.*, 959 F. Supp. 42, 50-51 (D. Mass. 1997), and *In re Landry's Seafood Rest., Inc. Sec. Litig.*, Plaintiffs note that courts have found scienter properly pled in cases in which the defendants' trading, collectively, was relatively small. Pls.' Officer Opp'n at 106-10. But these cases do not, as Plaintiffs imply, establish a numerical trading threshold above which scienter is presumptively shown. It is hardly necessary to remind this Court of the importance that it attached to the context of the insiders' sales, and not merely the volume of shares sold, to determine whether the trading was unusual or suspicious in *Landry's.* The *Freidberg* court was even more explicit, emphasizing that "*[o]ne cannot lose sight of the context in which the five individual defendants' sales were made*." 959 F. Supp. at 51 (emphasis added). In both cases, the defendants' sales were highly coordinated, occurring on the same day, in the same secondary offering. *Landry's*,

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1999) ("'[N]o inference of scienter should be drawn from insider trading activity unless that activity is unusual.' . . . The circumstances surrounding each sale should be examined.") (citation omitted).

slip op. at 18; *Freidberg*, 959 F. Supp. at 51. And in both cases, plaintiffs had made highly particularized allegations, based on identified sources, that at the time of the offerings the defendants possessed identified detailed information that the company's stock was about to decline.[27] In these circumstances, the defendants' substantial participation in the secondary offerings was probative of their fraudulent intent.

A. When viewed in context, Mr. Pai's trading during the class period does not support a strong inference of scienter because it was neither unusual nor suspicious.

In the memorandum of law accompanying Mr. Pai's motion to dismiss, we demonstrated, based solely on facts in the public record, that the circumstances surrounding Mr. Pai's trading during the class period suggest that those trades were driven by events unrelated to information about Enron. *See* Pai Mem. at 41-47. In particular, we showed that Mr. Pai traded in 1999 because certain of his options were about to expire; that his trading in 2000 related to his ongoing divorce and division of marital assets; and that his 2001 trades were undertaken in connection with his departure from Enron. *Id.* Tellingly, Plaintiffs say little about these explanations in their opposition, all but conceding the validity of the explanations for Mr. Pai's trading in 1999 and 2001, and making only a weak attempt to rebut Mr. Pai's explanation for his trading activity in 2000. Where, as here, the facts suggest that a defendant's trading was driven

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[27] The defendants in *Landry's* had promoted the secondary offering by making false and misleading statements about the company's business at a time when they possessed detailed information regarding the company's true (and far worse) performance, the sources for which included the company's own admission to having "monitored the business continuously and closely on a daily basis from internal spreadsheets and reports from each . . . restaurant." *Landry's*, slip op. at 18, 29-30, 64. In *Freidberg*, the defendants had planned the offering while in possession of specific nonpublic information that a competitor's product was about to make one of the company's main product lines obsolete, the source of which the defendants had acknowledged in SEC filings. 959 F. Supp. at 50-51.

by something other than inside information, Plaintiffs have not met their burden to "provide a clear context from which [the court] can find a strong inference of fraud," *Vantive*, 283 F.3d at 1093, and the trading cannot support the requisite strong inference of scienter. *Bryant v. Avado Brands, Inc.*, 100 F.Supp. 2d 1368, 1376 (M.D. Ga. 2000) ("[I]f the facts alleged do not exclude other plausible explanations that would undercut a plaintiff's circumstantial inference of scienter, then that plaintiff's facts cannot be fairly said to raise a 'strong inference' that the defendant acted with the required state of mind."), *rev'd on other grounds*, 252 F.3d 1161 (11th Cir. 2001).[28] In these circumstances, the claims against Mr. Pai must therefore be dismissed.[29]

[28] *See also Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) ("[T]he 'strong inference' requirement means that plaintiffs are entitled only to the *most plausible* of competing inferences.") (emphasis added); *Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 910 (N.D. Ill. 2001) (the strong inference requirement "means that the *most reasonable* interpretation of the[] facts [must be] mischievous") (emphasis added); *First Union*, 128 F.Supp. 2d at 886, 898 (recognizing that to survive a motion to dismiss "[i]t is not sufficient for a plaintiff to plead facts that could plausibly be consistent with innocent conduct" and holding that news article in the record indicating that company Chairman had sold stock concurrent with his resignation rebutted plaintiffs' suggestion that his stock sale was suspicious).

[29] Plaintiffs halfheartedly suggest that whether particular stock sales were unusual is a question of fact "not appropriate for resolution at the pleading stage," and that the Court must therefore simply accept their characterization of the Enron Defendants' trading as unusual and suspicious. Pls.' Officer Opp'n at 108. To accept Plaintiffs' position, however, would be to turn the PSLRA on its head. The PSLRA places the burden squarely on plaintiffs to "provide a clear context from which [the court] can find a strong inference of fraud." *Vantive*, 283 F.3d at 1093. Plaintiffs cannot shirk their pleading burden when the defendant places before the Court information cognizable at the motion to dismiss stage. To the contrary, if the facts properly before the court—the averments in the Complaint and the documents to which it refers, the contents of SEC filings and other public records and any other items of which the court can take judicial notice—do not add up to the conclusion that the stock sales in question were suspicious or unusual, the trading activity is not even probative of scienter. *Abrams*, 2002 U.S. App. LEXIS 9565, at *12, *24. Nor do the cases cited by Plaintiffs, *In re Hi/fn, Inc. Sec. Litig.*, No. C 99-4531 SI, 2000 U.S. Dist. LEXIS 11631 (N.D. Cal. Aug. 9, 2000), and *Rubinstein v. Collins*, 20 F.3d 160 (5th Cir. 1994), suggest otherwise. *Rubinstein* was decided in 1994, before the enactment of the PSLRA, and the plaintiffs thus had no obligation to state with particularity facts giving rise to a *strong inference* of scienter. Moreover, unlike in this case, the alternative explanations proffered by the defendants in both *Rubinstein* and *Hi/fn* had no support in the record and thus were appropriately disregarded at the motion to dismiss stage.

1. Plaintiffs do not challenge the 1999 option exercises.

In January and April, 1999, Mr. Pai exercised options that were set to expire in 30 days or less and sold the shares acquired as a result. *See* Pai Mem. at 42; Pai App. Tab 1 (Jan. 1999 and Apr. 1999 Form 4s), Tab 2 (1/8/99 and 4/19/99 Form 144s, reflecting that options exercised would expire "in less than 30 day" and "in a few days," respectively). Plaintiffs do not dispute that these trades were driven by the fact that the options were about to expire, nor do they suggest that there was anything unusual or suspicious about this trading activity. In fact, their Opposition ignores it completely. *See* Pls.' Officer Opp'n at 129-30.

2. Based on the facts in the record, the most plausible explanation for the 2000 option exercises is Mr. Pai's ongoing divorce and division of marital assets.

Plaintiffs do not deny that Mr. Pai and his former wife were separated and filed for divorce in early 2000, and they concede that the close to 3 million options exercised in his name during the period January through May 2000 were marital assets in which the former Mrs. Pai had both a property interest and the right to a say in their disposition. Pls.' Officer Opp'n at 129-30. But instead of acknowledging the common sense notion that people getting divorced need to divide up their assets, satisfy outstanding joint financial obligations and revisit their investment and estate plans, Plaintiffs serve up a convoluted and self-contradictory theory that amounts to the contention that Mr. Pai used (unspecified) inside information to trade prematurely, missing the market's peak by as much as seven months and more than $25 per share, thereby exposing himself to a $48 million "dissolution of assets" claim by his former wife. Pls.' Officer Opp'n at 130.

Plaintiffs have it backwards. If missing the market's peak would have exposed him to a dissolution claim, Mr. Pai would not have exercised the options unless he knew that no such claim would be made because the option exercises were part of an agreed-upon plan for the division of marital assets. And, indeed, although exercising the options in January to May, rather than in August, cost the Pais as much as $48 million, there is no record that any such claim was asserted. As for Plaintiffs' effort to suggest that the timing was suspicious because "community property is normally divided at the time of the divorce, not at the time of separation,"[30] Pls.' Officer Opp'n at 130, the Pais had each represented to the court that they were working towards a division of their property, and they were unquestionably dividing some of their investment-related assets during the same period. As Mr. Pai disclosed in a Form 4 filing, he transferred 200,000 shares of Enron stock to his wife in April 2000, one month after filing his divorce petition. *See* Pai App. Tabs 1 (Apr. 2000 Form 4), 4 at 2, ¶ 8 (divorce petition filed by Lanna Pai), Tab 5 at 2, ¶ 9 (Lou Pai's divorce petition).[31]

Subsequent events give the lie to Plaintiffs' suggestion that Mr. Pai exercised his options in early 2000 because he "had inside information that Enron's stock would soon be declining."

[30] Of course, Mr. Pai's trading in 2000 did not occur merely "at the time of separation" because the Pais had originally filed for divorce in June 1999. Pai App. Tab 4.

[31] Moreover, inasmuch as the Enron stock options were marital property in which Mr. Pai's wife undeniably had an interest and the parties were then in the middle of divorce proceedings, there is no reason to assume, as Plaintiffs apparently do, that decisions regarding the disposition of the options were being made unilaterally by Mr. Pai.

Apparently hoping to suggest that Mr. Pai knew something about Enron that Mrs. Pai did not, Plaintiffs try to manufacture a non-existent conflict in the way that each of them traded during this period, attempting to contrast (what they assume to be) Mr. Pai's option exercises with Mrs. Pai's failure to dispose of the 200,000 securities transferred to her in April. Plaintiffs' comparison, however, depends on a misstatement of fact; they erroneously describe the securities transferred to Mrs. Pai as options and make much of the fact that she failed to exercise them. Pls.' Officer Opp'n at 130. However, the Form 4 clearly shows that the securities transferred to Mrs. Pai were "common stock," not options. *See* Pai App. Tab 1 (April 2000 Form 4). And if Mrs. Pai held on to her Enron stock for some period after April 2000, Mr. Pai did exactly the same. He sold not a single share of stock until more than one year later, by which time Enron had peaked and fallen to approximately $20 below its April 2000 price.

Pls.' Officer Opp'n at 130. It was not until *seven months after Mr Pai began to exercise his options* in January 2000 that Enron's stock "soar[ed] to its all-time high of $90-3/4 on 8/23/00." NCC ¶ 15. Moreover, the stock traded at or above its first and second quarter 2000 prices for another five months, until February 2001. Further, Plaintiffs make no effort to explain *why, if Mr. Pai indeed possessed inside information that Enron's stock was about to decline, he stopped trading in May 2000 while still holding more than one million shares and options.* Pai App. Tab 1 (May 2000 Form 4). He held those shares and options for an entire year, as the stock climbed to its peak and then lost more than 40 percent of its value by the following May. Doing so "cost" him more than $20 million. "When insiders miss the boat this dramatically, their sales do not support an inference that they are preying on ribbon clerks who do not know what the insiders know." *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001); *see also In re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C99-00109 SBA, 2000 U.S. Dist. LEXIS 15369, *78 (N.D. Cal. Sept. 29, 2000) (insider sales not suspicious where stock "continued to rise to considerable new heights" for three months after defendants sold); *Thornton v. Micrografx, Inc.*, 878 F.Supp. 931, 938 (N.D. Tex. 1995) (no showing of scienter because it is "non-sensical" to allege that defendants committed fraud to inflate the price of their securities yet waited until price slid downward for *seven weeks* before selling their stock).[32]

[32] Plaintiffs urge the Court to follow *In re Secure Computing Corp., Sec. Litig.*, 184 F.Supp. 2d 980, 989 n.1 (N.D. Cal. 2001), in which a CEO's stock sales were found to be probative of scienter notwithstanding that the sales occurred during a period when he was separated from his wife. The trading at issue in *Secure Computing* involved a series of highly coordinated stock sales by five top corporate officers, none of whom had ever previously sold a share of stock. *Id.* at 989-90. The sales occurred during the same three-week period immediately after certain of the defendants, including the CEO, had made false statements about the company's expected financial performance, and almost immediately before the company released the adverse financial information that caused the company's stock to drop in price. *Id.* Although the court recognized that divorce can provide a satisfactory explanation for a large sale of assets, it concluded that the CEO's assertion that he had separated from his wife during the class period

Remarkably, *Plaintiffs' own expert* **confirms** *that Mr. Pai's trading during the first half of 2000—three-quarters of his trading during the class period, responsible for 80 percent of the proceeds—was economically rational and therefore not suspicious*. Under Hakala's model, it is economically rational to exercise a stock option prematurely (that is, in advance of its expiration date) if that option is "deep-in-the-money," *i.e.*, when the stock price is "at least three to four times greater than the exercise price." Hakala Decl. ¶ 13 & n.21. Premature exercise of such deep-in-the-money options is not suspicious and does not imply possession of inside information (or any consideration other than price). *See* Hakala Decl. ¶¶ 12-13 & n.21. *All* of Mr. Pai's option exercises in 2000 meet this standard, as Hakala acknowledges. *See* Hakala Decl. ¶ 25 n.27 ("The substantial increase in Enron's shares price meant that a lot of option exercises in early 2000 were deep-in-the-money and, therefore, could be explained by wealth diversification and risk aversion.").[33] In every one of Mr. Pai's option transactions between January and May 2000, the stock price was at least 3.4 times, and in some cases more than ten times, the exercise price. Pai App. Tab 1 (Form 4s). At the same time, he refrained from exercising options that were not "deep-in-the-money." *See* Pai App. Tab 1 (May 2001 Form 4 (showing that Mr. Pai waited until May 2001 to exercise options with a strike price of $38.50); June 2001 Form 4 (same)).

"*alone* does not *necessarily* explain the sales." *Id.* at 989 n.1 (emphasis added). In contrast, the record in this case reflects not just that Mr. Pai was separated from his wife at the time of his option exercises and corresponding stock sales in the first half of 2000, but that the parties were in fact dividing their marital estate during this period. Pai App. Tab 1 (April 2000 Form 4) (reflecting Mr. Pai's transfer of 200,000 Enron shares to his former wife); *see also* Pai App. Tab 4 at 2, ¶ 8, 5 at 2, ¶ 9, 6 at 2 ¶ 5.

[33] Hakala directs his purported conclusions of foreknowledge to Mr. Pai's exercise of options in May and June of 2001 and never criticizes his transactions in 2000. *See* Hakala Decl. ¶¶ 9(d) (challenging only "[c]ertain exercises of stock options by Pai *in May 2001* . . . [as] inconsistent with rational economic behavior") (emphasis added); 41 (identifying a high excess risk premium only with respect to Pai's May and June 2001 option exercises).

Mr. Pai's trading during the first half of 2000 accounts for 75 percent of his stock sales during the entire class period and 80 percent of the proceeds of his class period trading. Thus, the expert sponsored by Plaintiffs eliminates any inference that the overwhelming majority of the transactions challenged by Plaintiffs are the result of insider trading or are in any way indicative of scienter.[34]

3. Plaintiffs do not dispute that the 2001 option exercises and stock sales were in connection with Mr. Pai's departure from Enron shortly thereafter.

Plaintiffs concede that Mr. Pai's option exercises and stock sales in May and June 2001 were related to his departure from Enron shortly thereafter at the end of June 2001. Pls' Officer Opp'n at 130. They must also concede that such transactions are neither suspicious nor unusual, given the overwhelming judicial recognition that "[i]t is not unusual for individuals leaving a company . . . to sell shares." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 206 (1st Cir. 1999); *see also Kwalbrun v. Glenayre Tech., Inc.*, No. 99-7125, 1999 WL 1212491, *2 (2d Cir. 1999); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *First Union*, 128 F.Supp. 2d at 898; *Gaylinn v. 3Com Corp.*, No. C-99-2185 MMC, 2000 WL 33598337, *12 (N.D. Cal. June 9, 2000); *In re Read-Rite Corp. Sec. Litig.*, 115 F. Supp. 2d 1181, 1184 (N.D. Cal. 2000); *In re*

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[34] Hakala's only other observation about the 2000 option exercises is to note that Mr. Pai had previously neglected to exercise 6,400 options that were deep-in-the-money in 1999. Hakala Decl. ¶ 41. He overgeneralizes from this oversight because he ignores the fact that almost none of Mr. Pai's 3.6 million options were deep-in-the-money at that time. The fact that Mr. Pai overlooked the *less than one percent* of his options that were deep-in-the-money in 1999 is hardly a basis for concluding that his admittedly rational exercise of *more than 75 percent* of those options when they were deep-in-the-money the following year was in any way unusual.

Of course, Hakala has no information about Mr. Pai's trading history on which to base any valid conclusions. Although Hakala claims to have obtained all available SEC filings "associated with the exercise of stock options and trading of Enron shares between June 1996 and November 30, 2001," Hakala Decl. ¶ 17, Mr. Pai's position at Enron did not require him to report his securities transactions to the SEC until June 1998. Thus, Hakala has no information whatsoever concerning Mr. Pai's Enron transactions prior to that time.

Carter-Wallace, Inc. Sec. Litig., No. 94 CIV. 5704 (KTD), 1999 WL 1029713, *5 (S.D.N.Y. Nov. 10, 1999). Their rejoinder is the red herring that Mr. Pai's departure from Enron does not explain his trading "six months in advance of that date," Pls.' Officer Opp'n at 130, a period in which they do not even allege that he traded.

Unable to refute Mr. Pai's explanation for his trading activity during May and June 2001, Plaintiffs instead ignore it, arguing that abstract economic considerations suggest that Mr. Pai should have waited longer to trade, based on a claimed analysis of the purported "excess risk premium." Pls.' Officer Opp'n at 129; Hakala Decl. ¶ 41. Plaintiffs fail to mention, however, that even Hakala acknowledges that "[s]ome of these transactions *may have been in anticipation of his departure*." Hakala Decl. ¶ 41 n.33 (emphasis added). Moreover, while Hakala criticizes Mr. Pai for exercising his options immediately preceding his departure, Hakala Decl. ¶ 41, n.33, Plaintiffs seem to have a different view because they put forward as evidence of scienter another Defendant's having waited for several months after his retirement to exercise his options. Pls.' Officer Opp'n at 122.

Having begun their scienter argument by asking the Court to consider whether all of the facts, taken together, support a strong inference that the defendants acted with fraudulent intent, Pls.' Officer Opp'n at 98, Plaintiffs conclude by asking the Court to believe that it is mere happenstance that Mr. Pai's trading coincided precisely with his divorce and his retirement from Enron, asking the Court instead to swallow a theory that he first rushed to use prematurely inside information because he knew that the stock would decline and then sat passively holding more than one million shares while the stock rose to nearly $91 and then dropped to $55 and below. Moreover, they claim to have carried their pleading burden without identifying a single item of information that Mr. Pai knew when he traded or a single false statement properly attributable to him. They simply hope that the Enron momentum will sweep him indiscriminately into this case, which is the very thing that the PSLRA is intended to prevent.

4. Plaintiffs ignore Mr. Pai's substantial investment in New Power, a key part of the context for Mr. Pai's trading during the class period.

After completing the option exercises in connection with his divorce during the first half of 2000, Mr. Pai invested more than $12 million in the Enron-related company New Power between July 2000 and February 2001. Jt. SEC App. Tab 61, at 55 (New Power IPO, filed Oct. 5, 2000); Pai App. Tab 3 (Form 4s). As we pointed out in the memorandum accompanying Mr. Pai's motion to dismiss, this substantial investment in a company alleged to have been part of the Enron "Ponzi scheme," NCC ¶ 42, directly contradicts Plaintiffs' scienter allegations, for if Mr. Pai knew of "the financial fraud and fraudulent course of business at Enron [that] permeated virtually all aspects of Enron's operations," including New Power, NCC ¶¶ 83(hh), 395, then he would have had no reason to make *any* investment in New Power, much less an investment of $12 million. In opposing Mr. Pai's motion to dismiss, however, Plaintiffs ignore his New Power investment altogether, unable to square it with their allegations about what he "must have known" but obviously did not know. If anything, Plaintiffs' flat assertion that "the New Power spin off was a sham and its securities worthless," Pls.' Mot. Strike at 6, only highlights the extent to which Mr. Pai's substantial investment in New Power, and his offer to invest still more by buying Enron's share of the company, *see* Section II B, *supra*, undercut the inference that any of Mr. Pai's investment decisions were driven by inside information.

B. <u>Mr. Pai's trading cannot support an inference of scienter because Plaintiffs fail to allege with particularity that Mr. Pai personally made any fraudulent statements or engaged in fraudulent conduct</u>.

Although, in our opening memorandum, we pointed out that allegations concerning Mr. Pai's trading during the class period cannot support a strong inference of scienter as a matter of law unless accompanied by particularized allegations that Mr. Pai personally made fraudulent statements or engaged in fraudulent conduct, Pai Mem. at 52-53, here again, Plaintiffs make no response. The law is clear, however, that absent such specific allegations of fraudulent conduct by a company insider, even allegations that the insider sold all or virtually all of his stock during the class period are inadequate. *E.g.*, *In re Ashworth, Inc. Sec. Litig.*, No. 99CV0121-L(JAH), 2000 WL 33176041, *11 (S.D. Cal. July 18, 2000) (insider's sale of 100% of her stock was not suspicious in the absence of "any specific allegations directly attributing misrepresentations to [insider] or particularized facts indicating that [insider] had specific knowledge of the fraudulent manipulation of accounting practices"); *Head v. Netmanage, Inc.*, No. C 97-4385 CRB, 1998 WL 917794, *5 (N.D. Cal. Dec. 30, 1998) (insiders' sales of 100%, 76% and 94% of their shares respectively were insufficient to create a strong inference of scienter absent "any specific allegations as to their fraudulent conduct, including the lack of any allegation that they personally made any of the allegedly fraudulent statements"); *see also In re Ciena Corp. Sec. Litig.*, 99 F.Supp. 2d 650, 663 (D. Md. May 15, 2000) (trades by nonspeaking defendants "simply are not 'suspicious'"). As set forth in Section I, *supra*, Plaintiffs fail to identify with the requisite particularity a single misstatement or fraudulent act properly attributable to Mr. Pai. In the absence of such a showing, Plaintiffs' allegations concerning Mr. Pai's trading are "irrelevant." *BMC*, 183 F.Supp. 2d at 902.

C. <u>In the absence of information concerning Mr. Pai's prior trading, Plaintiffs cannot allege that his trading during the class period was unusual or suspicious.</u>

Where, as here, Plaintiffs make no allegations concerning a defendant's trading practices prior to the proposed class period, they cannot establish that his class period trading was unusual or suspicious for scienter purposes. For where there is no trading history for comparison, there can be no basis on which to find a defendant's trading unusual. Even when an insider sells all or substantially all of her company stock, courts do not consider it a basis for scienter if plaintiffs present no facts regarding her pre-class period trading. *See, e.g., Ronconi*, 253 F.3d at 435-36 (sale of 98 percent of holdings by Executive Vice President and General Counsel did not support strong inference of scienter because absence of prior trading history precluded showing that this was dramatically out of line with prior trading practices). It is well established, in this Circuit and elsewhere, that in the absence of particularized allegations concerning an insider's past trading practices, "there is nothing precluding an inference that [the insider's] sales are consistent with his prior sales." *In re Baker Hughes Sec. Litig.*, 136 F.Supp. 2d 630, 647 (S.D. Tex. 2001), *aff'd*, 2002 U.S. App. LEXIS 9565 (5th Cir. May 21, 2002); *see also In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 987 (9th Cir. 1999) (insider's trading activity did not give rise to a strong inference of scienter where insider "had no significant trading history for purposes of comparison"); *BMC*, 183 F.Supp. 2d at 901-02 (CFO's trading during the class period did not give rise to an inference of intent to defraud because CFO's trading history was "too limited"); *In re Baan Co. Sec. Litig.*, 103 F.Supp. 2d 1, 19 (D.D.C. 2000) (stock sales by company insiders did not support a strong inference of scienter where plaintiffs failed to indicate "whether these sales were in keeping with the defendants' prior history of stock sales"); *In re Peritus Software Servs., Inc. Sec. Litig.*, 52 F.Supp. 2d 211, 224 (D. Mass. 1999) ("One fact *necessary* to a showing of unusualness is the amount of trading that the insider conducted before or after the class period.") (emphasis added). Thus, as Plaintiffs concede, to demonstrate that stock sales by company insiders are unusual, they must plead facts to show that the trading activity is "out of line with prior practices." Pls.' Officer Mem. at 113.[35]

[35] Plaintiffs claim to have met this standard based on their allegations regarding the number of shares sold by the Enron defendants *in the aggregate* before and during the class period. Pls.' Officer Mem. at 113-14. Even if accurate, such a comparison would shed no light on whether

Plaintiffs admit that they have alleged no facts concerning Mr. Pai's pre-class period trading. Pls.' Officer Mem. at 114. Such information is not publicly available because Mr. Pai did not become obligated to report his Enron transactions to the SEC until late June 1998, only months before the beginning of the class period. As a result, there is thus nothing to compare, and Plaintiffs cannot show Mr. Pai's trades to be unusual. *See* cases cited, *supra*. Plaintiffs appear to suggest that the unavailability of information regarding pre-class period trading by Mr. Pai somehow excuses them from having to demonstrate that his trading during the class period was out of line with his prior trading practices. In fact, the opposite is true: it *precludes* them from making the necessary showing. Indeed, faced with a similar situation in *BMC*, this Court disregarded allegations concerning a company CFO's trading during the class priod, finding that the CFO's trading history was "too limited to give rise to an inference of intent to defraud" where he had not acquired any vested options until the year before the class period began. 183 F.Supp. 2d at 901. The same result should obtain here.

D. Plaintiffs fail to relate particular stock sales by Mr. Pai to specific materially false and misleading statements or to identify specific nonpublic information that Mr. Pai used to trade.

Because trading by company insiders is only helpful in demonstrating that "certain statements were misleading and made with knowledge or deliberate recklessness *when those sales are able to be related to the challenged statements*," plaintiffs seeking to rely on trading activity to support a strong inference of scienter must tie particular stock sales by particular defendants to specific false and misleading statements. *Vantive*, 283 F.3d at 1093 (emphasis

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Mr. Pai's trading during the class period was out of line with his pre-class period sales, and thus would have no bearing on whether *Mr. Pai's* trades were unusual or suspicious. However, Plaintiffs' group allegations are not even accurate, as Plaintiffs admit that, for 28 of the 38 Enron Defendants, including Mr. Pai, "pre-Class Period sales data was either unavailable or absent." Pls.' Officer Mem. at 114.

added). Plaintiffs claim to have met this burden based on their "Enron Timeline," a graph showing Enron's stock price during the class period, interspersed with what appear to be snippets of statements challenged elsewhere in the Complaint[36] and with information concerning the trading of the Enron Defendants *as a group* during various one- to five-months periods. Pls.' Officer Opp'n at 115-16. That effort, however, falls far short of the mark.

Displaying only information concerning the Enron Defendants' stock sales *in the aggregate*, Plaintiffs' timeline does not even identify Mr. Pai's stock sales. NCC ¶ 74. Accordingly, Plaintiffs patently have made no effort to tie *Mr. Pai's* stock sales to any of the purported statements they excerpt. Moreover, Plaintiffs ask this Court to find that they can call a statement into question merely by alleging that an executive—and not necessarily the speaker—traded within the next five months. Almost every company would meet this standard, even in the absence of fraud. Since publicly traded companies are required to file public reports on a quarterly basis, any sale by an executive will by law occur within three months of a company public statement, and merely by pointing to that executive's transaction, an opportunistic plaintiff could cast doubt on any positive statement in the company's quarterly report. Plaintiffs' methodology assumes the flawed premise, long rejected by the courts, that securities transactions by insiders are inherently badges of fraud, and accepting it would be an invitation to a flood of fraud by hindsight claims.

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[36] Plaintiffs provide no identifying information whatsoever with respect to the "statements" appearing in the timeline. For example, Plaintiffs do not identify the maker of the statement or whether it appeared in an analyst report or an SEC filing. Plaintiffs provide only the month in which the statement was made, not the particular day. Indeed, Plaintiffs do not even identify the paragraph in the Complaint in which the statement is discussed.

Likewise, Plaintiffs have failed to plead with particularity the material nonpublic information that Mr. Pai supposedly used at the time of his trades, alleging only that "[d]uring the Class Period, while in possession of adverse undisclosed information about the Company, Pai sold 3,912,205 shares of his Enron stock." NCC ¶ 83(j). Conclusory allegations such as these are insufficient to support a strong inference of scienter or to give rise to liability for insider trading under Section 20A. *See, e.g., BMC*, 183 F.Supp. 2d at 916 (agreeing with defendants that plaintiffs' "generalized allegation of insider trading fail[ed] to satisfy the PSLRA's heightened pleading requirements" in the absence of any "specific allegation of what nonpublic information was used by Defendants to trade and how 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"); *In re 3Com Sec. Litig.*, No. C-97-21083 JW, 1999 WL 1039715, *8 (N.D. Cal. July 8, 1999) (allegation that "individual defendants had the 'material adverse non-public information about USR and 3Com complained of herein when they sold their shares of stock" was "too conclusory to give rise to liability for insider trading under Section 20A"); *In re Oak Tech. Sec. Litig.*, No. 96-20552SW, 1997 WL 448168, *12 (N.D. Cal. Aug. 1, 1997) (dismissing insider trading claims where plaintiffs "fail[ed] to specify what material information . . . Defendants possessed").

E. Plaintiffs' trading allegations do not suggest a strong inference of scienter even when combined with their speculation about what Mr. Pai "must have known."

In their Opposition, Plaintiffs criticize the Enron Officer Defendants for "attempting to parse the allegations of the [Complaint] into discreet bits," suggesting that the correct approach to analyzing their scienter allegations is to "consider whether all facts and circumstances 'taken together' are sufficient to support the necessary strong inference of scienter on the part of the plaintiffs." Pls.' Officer Opp'n at 98 (*quoting Abrams*, 2002 U.S. App. LEXIS 9565, at *12); *see also id.* at 105. But when presented with a case that does precisely what Plaintiffs claim this Court should do, on strikingly similar facts, Plaintiffs all but ignore it.

The totality of the Plaintiffs' scienter allegations as to Mr. Pai bear a close resemblance to the scienter allegations at issue in *In re Vantive Corp. Sec. Litig,* as we pointed out in our original Memorandum. Pai Mem. at 4-6. In *Vantive*, as in this case, plaintiffs asserted claims for securities fraud against an insider defendant who had sold a large percentage of his holdings, but who was not alleged to have made any of the false and misleading statements underlying plaintiffs' claims. 283 F.3d at 1084, 1093-94. There, as here, to establish the defendant's scienter, plaintiffs relied heavily on generalized allegations concerning the officers and directors as a group, including their "'hands-on' management style, their 'interaction with other corporate officers and employees, their attendance at management and board meetings, and reports generated on a weekly and monthly basis in the Finance Department.'" *Id.* at 1087. And there, as here, most of the defendant's sales had occurred well before the stock peaked, and plaintiffs had failed to relate his sales to any particular misleading statements in any event. *Id.* at 1093-94. Based on the totality of these circumstances, the court in *Vantive* concluded that plaintiffs' allegations did not amount to a strong inference of scienter. *Id.*

Notwithstanding the similarity of the totality of the scienter allegations rejected in *Vantive* to Plaintiffs' own scienter allegations in this case, Plaintiffs' only response to *Vantive* is to point out that the case was decided by the Ninth Circuit. Pls.' Officer Opp'n at 108 & n.27. But as we have demonstrated in our opening memorandum and in this brief, the same principles applied by the *Vantive* court apply here, and those allegations are equally defective under the law applicable in this Circuit. Even cumulatively, the bases relied upon by Plaintiffs here are simply too flimsy to establish an inference of scienter on the part of Mr. Pai, let alone a strong inference. Plaintiffs' claims against Mr. Pai should fare no better than the claims dismissed by the Court in that case.

IV. PLAINTIFFS' "SCHEME" ALLEGATIONS DO NOT OVERCOME THE LIMITATIONS ON SECTION 10(b) LIABILITY IMPOSED IN *CENTRAL BANK*, AND THEIR CLAIMS AGAINST MR. PAI MUST BE DISMISSED.

We have argued that the allegations against Mr. Pai do not state a Section 10(b) claim because, even if proven, they fail to demonstrate a primary violation of the statute, as required in *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994). Plaintiffs' main response to this argument is the unremarkable assertion that one can, in general, be liable under Section 10(b) for actions other than misstatements, including actions that are part of a fraudulent "scheme." Plaintiffs then point to assertions in their Complaint that Mr. Pai was part of such a scheme, as though the mere incantation of the word "scheme" states a claim for primary liability that transcends *Central Bank*. It does not.

The word "scheme" does not appear in Section 10(b), which prohibits "manipulative or deceptive" *conduct*. *See Central Bank*, 511 U.S. at 191 (holding that an individual is not liable under Section 10(b) unless he "commit[ted] a manipulative or deceptive *act* within the meaning of [the statute]") (emphasis added). And it is clear that allegations of particular acts of misconduct by a defendant, and not generalized claims that the defendant was part of a fraudulent scheme, are required to create Section 10(b) liability.[37] Plaintiffs' allegations that Mr. Pai was part of a scheme do not absolve them of the responsibility under *Central Bank* to allege

[37] *E.g.*, *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997) (alleged schemers liable under Section 10(b) only where each made misleading statements); *Lemmer v. Nu-Kote Holding, Inc.*, No. 398CV0161L, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001) (no liability under Section 10(b) where allegations did not identify particular acts of manipulation or deception engaged in by alleged schemers).

specific conduct by Mr. Pai that makes him a primary violator of Section 10(b). Thus, the task confronting this Court is to evaluate whether, apart from Plaintiffs' conclusory invocations of the word "scheme," the factual allegations against Mr. Pai can in fact sustain a claim of a primary Section 10(b) violation. A careful review of those allegations demonstrates that they cannot.

A. In general, 10(b) liability can only be imposed when *all* elements of a 10(b) violation, including the element of reliance, are met.

Central Bank holds that conduct gives rise to liability under Section 10(b) only if "*all* of the requirements for primary liability under Rule 10b-5 [are] met." 511 U.S. at 191 (emphasis in original). The *Central Bank* Court rejected the concept of aiding and abetting liability under Section 10(b) precisely because that theory of liability, if recognized, would have resulted in liability even where plaintiffs failed to satisfy one of the "element[s] critical for recovery under 10b-5" – the element of reliance. *Id.* at 179.[38] This reasoning has required courts to reject *conspiracy* liability under Section 10(b)[39] and, by analogy, claims based on mere allegations of

[38] The elements of a Section 10(b)/Rule 10b-5 violation are (1) a misrepresentation, omission, or other fraudulent device; (2) a purchase or sale of securities in connection with the fraudulent device; (3) scienter; (4) materiality of the fraudulent statement/device; (5) justifiable reliance by the plaintiff; and (6) resulting damages. *Fine v. American Solar King Corp.*, 919 F.2d 290, 294 (5th Cir. 1990). By contrast, the elements of a cause of action for aiding and abetting were (1) the existence of a primary violation; (2) the aider/abettor's "general awareness" of his role in the violation; and (3) the aider/abettor's substantial assistance in furtherance of the violation. *Abbott v. The Equity Group, Inc.*, 2 F.3d 613, 621 (5th Cir. 1993). The Supreme Court recognized in *Central Bank* that it is clearly possible to prove "general awareness" and "substantial assistance" without being able to prove reliance or causation.

[39] *E.g., Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837 (2d Cir. 1998) (rejecting Section 10(b) conspiracy claims as inconsistent with *Central Bank* and noting that "[j]ust as an aiding and abetting cause of action would have impermissibly permitted liability to be imposed in the absence of any showing of reliance . . . a conspiracy cause of action would similarly render irrelevant the question whether the plaintiffs relied on any misstatements or omissions by the defendant being sued"). *See also Basic Capital Mgmt., Inc. v. Gotham Partners, LP*, No. 3:01-CV-0942-P, 2002 U.S. Dist. LEXIS 7227, *6 (N.D. Tex. Apr. 23, 2002)

participation in a "scheme."[40] Thus, in order for Mr. Pai's conduct to constitute a primary violation under Section 10(b) and *Central Bank,* Plaintiffs must allege conduct that satisfies *all* the elements of a 10(b) violation – including the element of reliance. *See also Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359 (5th Cir. 1987) (noting that "[r]eliance is one of the cornerstones of a Rule 10b-5 claim"). In other words, Plaintiffs must be able to show that Mr. Pai's alleged conduct, *standing alone*, meets all the elements of a 10(b) violation. This Plaintiffs cannot do.

B. Plaintiffs' allegations that Mr. Pai was involved in setting up some of the "bad deals" relating to EES cannot provide the elements of a Section 10(b) violation.

Plaintiffs claim that Mr. Pai "participated in and authorized the signing of contracts that EES knew would lose hundreds of millions of dollars for Enron, but which were accounted for as profitable endeavors to inflate Enron's stock price." Pls.' Officer Opp'n at 59; NCC ¶ 83(j) (alleging merely that Mr. Pai "was involved in setting up some of the bad deals"). Plaintiffs' efforts to impose Section 10(b) liability on Mr. Pai for this conduct cannot be squared with

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(noting that conspiracy allegations do not give rise to Section 10(b) liability, citing *Central Bank*)

[40] *E.g., In Re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2001 U.S. Dist. LEXIS 16252, *29 (N.D. Cal. Aug. 27, 2001) (rejecting scheme claims as "in essence . . . conspiracy claim[s]"); *Erickson v. Horing,* No. 99-1468, 2001 WL 1640142, *12 n.12 (D. Minn. Sept. 21, 2001) (allegations of "a common scheme," like conspiracy claims, are foreclosed by *Central Bank*); *Hi/Fn,* 2000 U.S. Dist. LEXIS 11631, at *35 (rejecting scheme allegations as "inconsistent with Central Bank's prohibition of conspiracy pleading").

Plaintiffs insist that *Central Bank* is a narrow decision addressing only aiding and abetting liability under Section 10(b). Pls.' Officer Opp'n. at 74. But even a cursory reading of the decision and the lower court cases that followed it reveal that the Supreme Court's holding in fact established important limits on 10(b) liability in *all* cases brought under that Section, whether denominated "aiding and abetting" cases, "conspiracy" cases, "scheme" cases, or otherwise. *Central Bank* stands squarely for the proposition that 10(b) liability cannot be predicated on actions that are not prohibited by the statute. And allegations of mere participation in a scheme, without allegations of specific manipulative or deceptive conduct, do not satisfy this criterion any more than do allegations of aiding and abetting or participation in a conspiracy.

Central Bank. This is so principally because Plaintiffs here – like the *Central Bank* plaintiffs -- cannot be said to have *relied* on Mr. Pai's alleged "setting up" of "bad deals," nor can such misconduct be said to have *caused* the harm they allege. Indeed, Mr. Pai's conduct, standing alone, cannot even be said to have occurred "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b). Thus, Mr. Pai's conduct, even if true as alleged, does not satisfy the elements of a Section 10(b) claim, as *Central Bank* requires.

Any effort on Plaintiffs' part to show that their claims against Mr. Pai satisfy the 10(b) elements is betrayed by their own theory of the case, which is that the Enron Defendants committed a "fraud on the market" by causing investors to pay "artificially inflated prices in connection with their purchase of Enron securities." NCC ¶ 997. In *Finkel v. Docutel/Olivetti Corp.*, the Fifth Circuit explained that:

> The fraud on the market theory is premised on the hypothesis that the market price of a security, in an open market environment as opposed to a private transaction between seller and buyer, accurately reflects the value of that security if all relevant information has been disclosed in the marketplace. When *one fails to disclose or misrepresents material information about a security*, the market's efficient pricing mechanism is skewed and the price of the security is distorted.

817 F.2d at 360 (footnote omitted) (emphasis added).[41] Thus, in a "fraud on the market case," the reliance-inducing act is *by definition* the statement or omission that skews the market's efficient operation and distorts the price of the relevant security. Likewise, it is the statement or

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[41] *See also Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1120 (5th Cir. 1988) ("[A] fraud on the market is any deceit that successfully disseminates false or misleading information into the securities market or withholds vital information from that market.").

omission that satisfies the causation prong of Section 10(b)/Rule 10b-5.[42] It is *only* when such statements are made and then relied upon that the harm to the market occurs. Statements or any other acts – like the setting up of "bad" deals -- that do not induce reliance or do not reach or affect the market do not violate Section 10(b) in a fraud on the market case. *See Nathenson.,* 267 F.3d at 415 ("[A] fraud on the market theory may not be the basis for recovery in respect to an alleged misrepresentation which does not affect the market price of the security in question."). *Cf. United States v. O'Hagan*, 521 U.S. 642, 655-56 (1997) (the elements of a claim for insider trading are met not when the faithless fiduciary takes his principal's confidential information with wrongful intent, "but when, without disclosure to his principal, he uses the information to purchase or sell securities").

The lesson of *Central Bank* is that each alleged violation of Section 10(b) must stand on its own. And setting up "bad deals," standing alone, does not create a fraud on the market. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (declining to extend Section 10(b) liability to cover areas of corporate misconduct within the province of state law). Had Plaintiffs alleged a Section 10(b) violation against Mr. Pai alone, and against no other Enron defendant, their allegations of "bad deals" would clearly not satisfy the elements of reliance or causation, or connect the alleged misconduct to the purchase or sale of securities. The fact that these deals later became the subject of alleged misrepresentations by others does not change the equation as to Mr. Pai's liability. In short, if Plaintiffs want the benefit of establishing reliance on a class-

[42] *See McNamara v. Bre-X Minerals*, Ltd., 57 F.Supp. 2d 396, 403 (E.D. Tex. 1999) ("To satisfy their pleading burden on causation [in a fraud on the market case], the Plaintiffs need only allege facts which show that *Defendants' omissions and misrepresentations* caused the market price of the stock to be artificially inflated, and therefore to appear to be a good risk for investment, so that when the truth came out about the company's condition, the stock lost value and Plaintiffs suffered a loss.") (citation, internal quotations omitted) (emphasis added).

wide basis through a fraud on the market theory, a consequence of that benefit is that only those defendants whose actions affected the market directly can be liable. Mr. Pai is not among those defendants in this case.

Plaintiffs cannot avoid their burden of proving reliance and causation by positing that Mr. Pai's liability is founded not on statements he made or helped prepare (Rule 10b-5(b)), but rather on his conduct as a "schemer" (Rules 10b-5(a) and (c)). First, this *is* a statements case, whatever Plaintiffs choose to call it; the core allegation is that Defendants committed a "fraud on the market" by a variety of material misrepresentations and omissions that were relied on by, and harmed, the plaintiff class. Plaintiffs cannot run away from the core allegations of their 500-page, 1000-paragraph Complaint. Second, *Central Bank* is clear that the elements of reliance and causation must be proven with respect to *every* 10(b) violation, and Plaintiffs cannot escape this burden by simply christening their case a "conduct" as opposed to a "misstatements" case. Third, the law has always treated the primary violator in fraud claims as the *maker* of the statement on which the victim has relied. *Trenholm v. Ratcliff*, 646 S.W.2d 927, 930 (Tex. 1983) (proof of fraud requires, *inter alia*, proof of a false, material representation). The "schemer" whose predicate conduct made the statement possible has always been liable *only* through the application of accessorial liability, either as an aider and abettor or as a conspirator. This body of law predates *Central Bank* and informs its analysis.

Thus, it is not surprising that Plaintiffs have not identified, and cannot identify, a single fraud on the market case where an individual was held liable for securities fraud merely for participating in business deals that were later touted by others to the market. To be sure, the courts are divided as to the proper standard for primary liability in fraud on the market cases after *Central Bank.* Some require that the defendant make misstatements (or that the defendant make misstatements *and* that such misstatements be attributed to him) for Section 10(b) liability to attach.[43] And others require only that the defendant play a significant role in the misstatements' preparation – *e.g.*, by drafting sections of the misleading materials or furnishing misleading materials for others to disseminate.[44] The Court need not choose between these standards in order to resolve Mr. Pai's Motion to Dismiss. The Complaint in this case contains no allegations that Mr. Pai either made misleading statements or helped prepare any such statements. And allegations that Mr. Pai participated in setting up "bad" EES deals are insufficient under any test for 10(b) liability articulated by any court.

The cases cited by Plaintiffs are not to the contrary; in fact, they support the distinction drawn here. For example, in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), the Fifth Circuit upheld liability for participation in Section 10(b) scheme on the basis of a lawyer's *drafting* of a fraudulent offering circular upon which the market relied. Similarly, in *McNamara v. Bre-X Minerals, Ltd.*, 57 F.Supp. 2d 396 (E.D. Tex. 1999), the court, citing *Central Bank*, held that a 10(b) claim could lie against defendants who had themselves prepared misleading written reports that were disseminated by others to the market. By contrast, in *In re Netsolve, Inc. Sec. Litig.*, 185 F.Supp. 2d 684, 699 (W.D. Tex. 2001), the district court rejected a 10(b) claim against a defendant who was not alleged to have had "a direct hand in at least one of the allegedly misleading statements." These cases *support* Mr. Pai's position that an individual who

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[43] *E.g., Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194 (11th Cir. 2001); *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (2d Cir. 1998); *Lemmer v. Nu-Kote Holding, Inc.,* 2001 WL 1112577.

[44] *In re Software Toolworks Sec. Litig.*, 50 F.3d 615 (9th Cir. 1995); *Cashman v. Coopers & Lybrand*, 877 F.Supp. 425, 432 (N.D. Ill. 1995) (sustaining Section 10(b) claim where accountant drafted sections incorporated into allegedly misleading prospectus); *In re ZZZZ Best Sec. Litig.*, 864 F.Supp. 960, 970 (C.D. Cal. 1994) (sustaining Section 10(b) claim where accounting firm was "intricately involved" in the preparation of misleading statements).

did not directly prepare or play a major role in the preparation of the statements that were relied on by, and that caused harm to, the market is not liable under Section 10(b).[45]

A non-fraud on the market case, *Primavera Familienstiftung v. Askin*, No. 95 Civ. 8905, 1996 U.S. Dist. LEXIS 12683 (S.D.N.Y. Aug. 22, 1996), helps answer the question whether involvement in predicate bad business acts can serve as the basis for Section 10(b) liability. There, plaintiffs alleged that the defendants participated in a fraudulent scheme to induce plaintiff class members to purchase a certain fund of securities – specifically, by leading plaintiffs to believe that the securities they were considering purchasing were "risk balanced" or "market neutral" when in fact they were "speculative, high-yielding, exotic classes of risky market-sensitive mortgage derivatives." *Id.* at *5. Among those sued under Section 10(b) were the brokers who had created the securities at issue, who had financed their purchase by the defendant sellers, and who had 'set' the prices of the 'toxic' securities in the Funds' accounts," *id.* at *6 – in short, the individuals who, like Mr. Pai is alleged to have done, established a "bad" business vehicle that later became the subject of misrepresentations by others. The court rejected the plaintiffs' scheme allegations against the broker defendants, holding that "while a substantial, integral role [in the scheme] is necessary to primary liability under Section 10(b) and Rule 10b-5, it is not sufficient," and that the allegations "at their core" amounted to claims that the broker defendants merely aided and abetted the violations of the misrepresenting defendants. *Id.* at *19-*20

Central Bank compels the result in *Primavera* and dismissal of the claims against Mr. Pai here. The limitations on Section 10(b) liability imposed in that case would be rendered

[45] *See also Robbins v. Hometown Buffet, Inc.*, No. 94-1655-J, 1995 U.S. Dist. LEXIS 17870, *19 (S.D. Cal. Mar. 15, 1995) (rejecting scheme theory in fraud on the market case in the absence of

absolutely meaningless if a plaintiff could artfully plead a fraud on the market case as a "scheme" and thereby attach Section 10(b) liability to *any* individual who participated in *any* business transaction that later became the subject of a misrepresentation or nondisclosure to the market. Liability on that basis is indistinguishable from aiding and abetting or conspiracy liability and would turn almost every act of business fraud into a 10(b) violation, which is precisely what *Central Bank* sought to avoid. *See In re Kendall Square Research Corp. Sec. Litig.*, 868 F.Supp. 26, 28 (D. Mass. 1994) ("The Supreme Court's decision in *Central Bank* makes clear that the policy undergirding it is to constrict the ambit of private actions under Section 10(b) and to thereby reduce the number of parties implicated by that statute.") *See also Santa Fe Indus.*, 430 U.S. at 478-79 (interpreting Section 10(b) so as to avoid the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5").

C. Plaintiffs' insider trading allegations against Mr. Pai also cannot give rise to Section 10(b) liability in this case.

Plaintiffs' claim that Mr. Pai's alleged insider trading gives rise to Section 10(b) liability also fails. In a fraud on the market case, proof of insider trading alone, like proof of participation in "bad deals," cannot satisfy the Section 10(b) elements of reliance and causation.[46]

In re Splash Tech. Holdings, Inc. Sec. Litig., No. C 99-00109 SBA, 2000 U.S. Dist. LEXIS 15369 (N.D. Cal. Sept. 29, 2000), is directly on point. There, non-speaking defendants were alleged to have participated in a fraud on the market scheme, in violation of Section 10(b),

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"specific allegations that several plaintiffs *participated in producing misrepresentations*" and citing *Central Bank*) (emphasis added).

[46] At Section III, *supra*, we discuss why allegations of insider trading are also insufficient as a basis for proving that Mr. Pai acted with scienter.

solely on the basis of their alleged insider trading activities. The court, however, dismissed the 10(b) claims on the grounds that fraud on the market cannot be proved on the basis of allegations of insider trading. In reaching this conclusion, the court found that the theories of "fraud on the market" and insider trading are analytically distinct – "the market" does not rely on, and is not harmed by, the deceptive act of insider trading, which harms only those who traded contemporaneously with the insider. *Id.* at *64-*65 ("the focus in a fraud on the market case is to compensate market participants for 'artificial boosts or deflations in stock prices caused by material representations,' [whereas] the focus in an [insider trading] case is to compensate investors who were exploited by insider traders as a result of an informational disadvantage") (*quoting Simon v. American Power Conversion Corp.*, 945 F.Supp. 416 (D.R.I. 1996)). *See also In re Aldus Sec. Litig.*, No. C92-885C, 1993 U.S. Dist. LEXIS 5008, *20-*21 (W.D. Wash. Mar. 1, 1993). ("In contrast to a fraud-on-the-market scheme, insider trading does not artificially boost or deflate the market price of a stock aside from typically negligible supply and demand adjustments."). In short, proof of insider trading, the *Splash* court found, cannot as a matter of law satisfy the elements of a Section 10(b) claim that is based on a different set of injuries and a different theory of reliance and causation.

The courts have also recognized that allowing claims of insider trading to serve as the basis for an implied fraud on the market Section 10(b) claim would conflict with the express private right of action created by Congress in Section 20A of the Exchange Act, 15 U.S.C. § 78t-1, for those trading contemporaneously with the insider. Aware of the limited impact that insider trading has on the price of a stock, Congress limited the relief available under Section 20A to disgorgement of trading profits and made such relief available only to a limited class of contemporaneous investors. 15 U.S.C. § 78t-1(b)(1). *See also In re Aldus*, 1993 U.S. Dist.

LEXIS, at *21 & n.5 (noting legal standard and listing cases defining "contemporaneous").[47] The courts have recognized that to allow recovery by market participants who traded outside the contemporaneous trading period would undermine congressional intent by "mak[ing] the insider liable to all the world."[48] This is, of course, precisely the result that would obtain here if Plaintiffs' insider trading allegations were permitted to serve as the basis of 10(b) claims brought against Mr. Pai on behalf of a class that is not limited to those who traded contemporaneously with Mr. Pai.[49]

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[47] In this lawsuit, for example, Count I of the Complaint asserts a 10(b) claim on behalf of all those who purchased Enron stock during the class period (10/19/98-11/27/01), NCC ¶¶ 992-995, while Count II asserts a 20A claim again, *inter alia*, Mr. Pai, on behalf of those who traded contemporaneously him, a much smaller subclass. NCC ¶¶ 998-1004.

[48] *Colby v. Hologic*, 817 F.Supp. 204, 216 (D. Mass. 1993). *Accord In re Seagate Tech. II Sec. Litig.*, 843 F.Supp. 1341, 1370 (N.D. Cal. 1994).

[49] If the intent of Congress in limiting liability for insider trading were not already clear, well-established principles of statutory construction make it manifest and preclude the use of insider trading as a basis for Plaintiffs' Section 10(b) claims against Mr. Pai. Three such principles are important here. First, two statutory provisions that address the same subject matter should, wherever possible, be read so as to avoid conflict between them. *Cash v. Conn Appliances,* 2 F.Supp. 2d 884, 905 (E.D. Tex. 1997). Reading Section 10(b) to broaden the remedial scheme for insider trading in Section 20A would put the former provision in direct conflict with the latter provision – a result which can and should be avoided by foreclosing reliance on insider trading allegations in 10(b) fraud on the market cases. Second, where conflict between two statutory provisions is unavoidable, the more specific provision governs the more general provision. *Crawford Fitting Co. v. J.T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987). The limited remedial scheme of Section 20A, which specifically addresses insider trading, prevails over the more general remedial scheme of Section 10(b) and therefore precludes making an inside trader liable to "all the world" in fraud on the market cases brought under the latter provision. Finally, "it is an elementary canon of statutory construction that where a statute expressly provides a remedy, courts must be especially reluctant to provide additional remedies." *Chair King, Inc. v. Houston Cellular Corp.*, 131 F.3d 507, 512 (5th Cir. 1997). This Court, as others have, should therefore decline Plaintiffs' invitation to interpret Section 10(b) to provide additional remedies for insider trading other than those expressly set forth in Section 20A.

D. Plaintiffs' allegations that Mr. Pai participated in the alleged fraudulent scheme by virtue of his involvement in the Enron Management Committee cannot give rise to Section 10(b) liability under *Central Bank*.

Plaintiffs also urge that Mr. Pai is liable under Section 10(b) by virtue of his membership on Enron's Management Committee, which "[was] provided with copies of the filings, reports and releases alleged herein to be misleading prior to or shortly after their issuance and had the ability and opportunity to prevent their issuance or cause them to be corrected." NCC ¶ 397.

That these allegations fail to meet the particularity requirements of Rule 9(b) and rely on group pleading, which the PSLRA now precludes, is discussed, *supra,* at Sections I C & II A. Of importance here is that even if these allegations were pled with sufficient particularity and implicated Mr. Pai specifically, and not just the Management Committee in general, they would still furnish an insufficient basis for Section 10(b) liability.

The allegations in this case regarding the Management Committee are that it tacitly approved the Enron fraud – that it was aware of and received access to allegedly fraudulent misstatements but did nothing to interfere with their dissemination in the market. These allegations of passive conduct are simply insufficient to make out a Section 10(b) claim after *Central Bank.* In fact, at best, they are tantamount to claims that the Management Committee "substantially assisted" in the fraud – which are exactly the kinds of claims the Supreme Court rejected in *Central Bank* when it did away with aiding and abetting liability under Section 10(b).

Plaintiffs have not identified a single fraud on the market case in which Section 10(b) liability was imposed for passive conduct. Rather, as discussed above, in such cases, the possibility of Section 10(b) liability is sustained only for the making of a misstatement or omission or for active involvement in preparing such misstatements or omissions.[50] The decisions in this area that do address Section 10(b) claims based on allegations of passive conduct are clear that such claims are precisely what *Central Bank* sought to foreclose. For example, in *In re Splash Tech. Holdings Inc. Sec. Litig.*, the court dismissed Section 10(b) claims against certain non-speaking individuals in the defendant company. These claims were based on the non-speaking defendants' participation in a fraudulent scheme but alleged only that the non-speaking defendants "knew about, and agreed to, a fraudulent scheme." The court held that such claims were tantamount to conspiracy claims and did not survive *Central Bank.* 2001 U.S. Dist. LEXIS 16252, at *28-*29.

Similarly, in *Pegasus Holdings v. Veterinary Centers of America*, 38 F.Supp. 2d 1158 (N.D. Cal. 1998), the court addressed Section 10(b) scheme claims against various non-speaking defendants that were premised on the notion that these defendants "willfully consented" to the alleged fraud. The court noted that such claims of willful consent "could be leveled against any officer or director of a publicly traded company" and deemed them insufficient to state a claim after *Central Bank. Id.* at 1164-65. The plaintiffs in this case, too, have made "willful consent" allegations against the Management Committee and, by association, Mr. Pai that could be levelled against any high-level official at a publicly traded company – *i.e.*, that the Management Committee's members, by virtue of their positions in the company, were aware of the alleged fraud and yet failed to speak up against it, though by acting they might have stopped it. There is

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[50] *E.g., Netsolve*, 185 F.Supp. 2d at 699 (rejecting 10(b) liability where plaintiffs did not allege that the defendant "contributed in any manner to the allegedly misleading statements" or "had a direct hand in at least one of the allegedly misleading statements"); *ZZZZ Best,* 864 F.Supp at 970 (sustaining 10(b) claim where accounting firm "was intricately involved" in preparation of misleading statements); *Robbins,* 1995 U.S. Dist. LEXIS 17870, at *19 (Section 10(b) liability requires defendant to have participated in producing misprepresentations); *Cashman*, 887 F.Supp. at 432 (sustaining Section 10(b) claim where accountant drafted sections incorporated into allegedly misleading prospectus).

no escaping the fact that these are classic conspiracy and aiding and abetting claims that did not survive the *Central Bank* decision.

*   *   *   *   *

In deciding whether Plaintiffs' allegations against Mr. Pai are sufficient under Section 10(b), this Court need not, and should not, attempt to identify each and every act that might conceivably give rise to liability under that statute. There is no disputing that Section 10(b) contemplates liability for a wide range of fraudulent activity. At the same time, however, it is equally clear that Section 10(b) is also not designed to cover *every* fraudulent act, or, critically, *even every act relating to a scheme to perpetrate a fraud on the securities market*. The lesson of *Central Bank* is that the courts must make careful distinctions between defendants and measure each set of factual allegations against the legal theories set forth in a 10(b) case. In the case of Mr. Pai, Plaintiffs would have this Court set aside its critical line-drawing duties in favor of a rubber stamp the minute the Plaintiffs intone the word "scheme." But the claims against Mr. Pai are not availing of such casual treatment, and a careful review of those claims can only yield the conclusion that they must be dismissed.

V. PLAINTIFFS HAVE COMPLETELY FAILED TO MAKE OUT A CONTROL PERSON CLAIM AGAINST MR. PAI.

Plaintffs' control person claims against Mr. Pai fare no better than their claims that he is primarily liable under Section 10(b).

Plaintiffs' entire rebuttal to the claim that Mr. Pai and other Enron defendants are not control persons consists of a one-page restatement of the legal standard governing control person liability and a conclusory statement that the Enron insiders "had the power – and exercised it -- to control the activities of another" (presumably Enron). Pls.' Officer Opp'n at 153-154.

In their Complaint and once again in their Opposition, Plaintiffs thoroughly ignore several fatal shortcomings in their control person argument as to Mr. Pai:

1. Plaintiffs never confront the fact that mere allegations of an individual's position within a controlled entity are an insufficient basis for the imposition of control person liability against that person, and that it is *only* because of Mr. Pai's position on the Management Committee that they claim he was a control person under Section 20(a). *E.g., Lane Hartman, Ltd. v. P.R.O. Missions, Inc.,* No. 3:95-CV-0869-P, 1997 U.S. Dist. LEXIS 23067 (N.D. Tex. Aug. 4, 1997); *Dartley v. Ergobilt, Inc.,* No. 3:98-CV-1442-M, 2001 U.S. Dist. LEXIS 4154 (N.D. Tex. Mar. 29, 2001); *Feldman v. Motorola, Inc.,* No. 90 C 5887, 1993 U.S. Dist. LEXIS 14631 (N.D. Ill. Oct. 14, 1993). The absence of individualized control person allegations against Mr. Pai dooms Plaintiffs' efforts to impose Section 20(a) liability upon him.

2. Plaintiffs also ignore the fact that even if mere status could furnish a basis for liability under Section 20(a), control person claims, no less than claims of primary violations, must be pled with particularity as to each individual and that Plaintiffs' control person claims against Mr. Pai have not been so pled. *E.g., Splash Tech.,* 2000 U.S. Dist. LEXIS 15370, at *50; *Feldman, supra.* In their complaint, Plaintiffs merely state that the Management Committee controlled the day to day activities of Enron and therefore had the power to control the fraud alleged in this case. These allegations are nothing more than a restatement of the legal standard for control person liability, and provide no insight into *how* the Committee exercised control over Enron's operations, or how the Committee had the ability to control the specific transactions and statements alleged by the Plaintiffs to have been fraudulent. *In re Deutsche Telekom AG Sec. Litig.,* No. 00 Civ. 9475, 2002 U.S. Dist. LEXIS 2627, *20 (S.D.N.Y. Feb. 20, 2002).

3. Plaintiffs' claims against Mr. Pai, even more so than their claims against other members of the Management Committee, lack particularity because Plaintiffs have never even attempted to explain how it is that Mr. Pai, *an officer of one of Enron's subsidiaries*, had the capacity to control the statements or actions of various Enron Defendants who were, in fact, his superiors. Allegations that the Management Committee, in general, had the ability to control the actions and statements of Enron does not provide any insight whatsoever into how a particular member of the Committee, especially one with a reporting relationship to those alleged to have actually engaged in the fraud, could exercise such control. *BMC*, 183 F.Supp. 2d at 915 ("Nor have Plaintiffs specifically alleged how the individual nonspeaking Defendants . . . could have controlled misstatements by other named Defendants. . . *who were their superiors at BMC.*") (emphasis added); *Kurtzman v. Compaq Computer Corp.*, No. H-99-779, slip. op at 61-62, 128-29 (S.D. Tex. Dec. 12, 2000) (no control person liability for subordinates when complaint fails to allege with particularity how they could control misstatements of superiors).

4. Finally, Plaintiffs thoroughly fail to address the implications of their control person theory on the pleading requirements established by Congress in the PSLRA and on the Supreme Court's holding in *Central Bank*. As this Court has recognized, allegations that are insufficient to sustain a claim of *primary* liability under Section 10(b) cannot as a matter of law sustain claims of *derivative* liability under Section 20(a). *BMC*, 183 F.Supp. 2d at 915. But failure to dismiss the 20(a) claims against Mr. Pai would essentially permit Section 20(a) claims to proceed where Rule 9(b) and *Central Bank* would bar primary claims under 10(b). Indeed, claims that Mr. Pai, solely because of his unspecified role in the undefined operations of the Management Committee, is liable as a control person would effectively reinstate the notion of

aiding and abetting liability that the Supreme Court rejected in *Central Bank*. Plaintiffs have never even attempted to grapple with this fundamental flaw in their theory.

For all these reasons, Plaintiffs' control person claims against Mr. Pai must fail.

CONCLUSION

For the foregoing reasons and the reasons stated in the Memorandum of Law previously submitted in support of Mr. Pai's Motion to Dismiss, Defendant Lou L. Pai respectfully requests that all claims against him be dismissed, with prejudice.

Respectfully submitted,

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Attached

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