

JUN 24 2002 LF

Michael N. Milby, Clerk

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

MARK NEWBY,

Plaintiff,

vs.

ENRON CORPORATION, *et al.*,

Defendants.

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C.A. No. H-01-3624
AND CONSOLIDATED CASES

**JAMES V. DERRICK, JR.'S REPLY
TO PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION
TO MOTIONS TO DISMISS FILED BY ENRON DEFENDANTS BUY, ET AL.**

Plaintiffs address James V. Derrick, Jr.'s Motion to Dismiss Consolidated Complaint in a 161-page brief responding to many other motions, asserting mostly group-pleaded allegations, and discussing Derrick individually in 2½ total pages that confirm he should be dismissed.¹ In sum:

(1) Plaintiffs' only particularized "scienter" allegation against Derrick is his exercise of stock options. But Plaintiffs now concede that Derrick always exercised *only* stock options about to expire, a trading pattern negating scienter under the case law and deemed normal by Plaintiffs' "expert."

(2) SEC forms establish that Derrick's options exercises were only 12.95% of his holdings, a fact separately negating scienter. Plaintiffs do not contest that their higher calculation results from *excluding* extensive data from the forms, data that courts have held must be included.

(3) Plaintiffs admit Derrick did not speak or create a misleading statement. Even if non-speakers could be liable, the thin "facts" cited as to his role confirm he must be dismissed.

¹ James V. Derrick, Jr. will be referred to as "Derrick." "Derrick's Motion" refers to his Motion to Dismiss Consolidated Complaint. "Pl. Resp." or "Plaintiffs' Response" refers to Plaintiffs' Memorandum of Law in Opposition to Motions to Dismiss Filed by Enron Defendants Buy, Causey, Derrick, Fastow, Frevert, Hannon, Harrison, Hirko, Horton, Kean, Koenig, Lay, Mark-Jusbache, McMahon, Olson, Pai, Rice, Skilling, Sutton and Whalley. Plaintiffs' Consolidated Complaint for Violation of the Securities Laws is referred to as the "Complaint."

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I. Plaintiffs cannot raise even a weak inference of scienter as to Derrick.

A. Plaintiffs admit that Derrick's consistent trading pattern was to exercise, by simultaneously buying and reselling, only options about to expire.

The particularized "evidence" of Derrick's scienter that Plaintiffs cite is his options exercises. Yet Plaintiffs *do not contest* that Derrick's consistent trading pattern was to only exercise options on the verge of expiration, by buying and simultaneously reselling the shares.² That Derrick's trading pattern was consistent and usual for him refutes scienter (even without considering the additional fact that he exercised only a very minor percentage of his exercisable, profitable options, discussed below).³ Plaintiffs also do not refute that their Complaint and Hakala affidavit describe such a trading pattern as normal; indeed, though Plaintiffs' Response invokes Hakala's "study" in discussing other defendants' trades, it avoids any reference to Hakala with respect to Derrick.⁴

Plaintiffs irrelevantly note that an options exercise does not require Derrick to both purchase and resell the shares on the same date.⁵ But as Plaintiffs admit, required or not, simultaneous purchases and resales of options about to expire were Derrick's normal and consistent trading pattern. As such, his simultaneous purchases and resales are not "suspicious" in the least.⁶

Such simultaneous purchases and resales are, in fact, common in option exercises. Plaintiffs' bare assertion that they are not⁷ is not supported by case law, or averred in their Complaint, or endorsed anywhere by Hakala. To the contrary, the Complaint and Hakala treat the concepts of

² See Pl. Resp., pp. 120-21.

³ See *In re Securities Litigation BMC Software, Inc.*, 183 F.Supp.2d 860, 901 (S.D. Tex. 2001)(to be suspicious, defendant's trading must be "out of line with prior trading practices...")(emphasis added); see also *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 420-21 (5th Cir. 2001); *In Re Baker Hughes Sec. Litig.*, 136 F.Supp.2d 630, 646 (S.D.Tex. 2001); *Gaylinn v. 3COM Corp.*, 2000 U.S. Dist WL 33598337, *11 (N.D.Cal. 2000)(quoting *In Re Silicon Graphics Inc Sec. Litig.*, 183 F.3d 970, 986 (9th Cir.1999)("insider trading is suspicious only when it is 'dramatically out of line with prior trading practices...'").

⁴ See Pl. Resp., pp. 120-21.

⁵ Pl. Resp., pp. 119-20.

⁶ See, e.g., *Gaylinn v. 3Com Corp.*, 185 F.Supp. 2d 1054 (N.D.Cal. 2000); *In re Silicon Graphics, Inc. Sec Litig.*, 183 F.3d 970 (9th Cir. 1999).

⁷ Pl. Resp., p. 120.

options exercises and simultaneous sales as interchangeable.⁸ So does the case law. *See Gaylinn v. 3Com Corp.*, 185 F.Supp. 2d 1054 (N.D.Cal. 2000), where the court held scienter was not alleged where a former executive sold 100% of his shares on the verge of expiring:

...Manire, ... who had sold the highest percentage of shares, 100%, and the largest amount of stock, sold most of his holdings after he left 3Com in 1998; under his 3Com Executive Stock Option Plan, Manire had to *exercise* his stock options within ninety days of his departure or forfeit them. (Citation omitted). *These facts tend to negate any inference of scienter that may arise from Manire's stock sales.*

Id. at 1067 (emphasis added).⁹ Derrick, too, exercised options only to avoid forfeiture.

B. Derrick exercised only a minor percentage of his exercisable, profitable options, thus negating scienter.

Plaintiffs do not contest that Derrick's exercise of only 12.95% of his holdings would negate his scienter. Nor can they dispute the simple math behind his calculation: if he exercised 221,425 options (as shown on Ex. A to Derrick's Motion, summarizing information from SEC Forms), and if his holdings at the time were 1,709,449.94 (as shown on p. 2 of the same table), the resulting ratio of options exercised to holdings is uncontrovertibly 12.95%. Plaintiffs cite their alleged "ratio" of 73.8%,¹⁰ but as shown below, Plaintiffs' "ratio" is bogus as a matter of law, because it ignores data that courts have held *must* be considered, specifically, all of Derrick's 1.6 million exercisable options.

⁸ The Complaint, for example, says: "Premature *sales* of stock options are non-optimal,....In sum, executives will be generally hesitant to *exercise* an option well in advance of the expiration date of the option, since an early option *exercise* forfeits the time value of the option,...." Complaint, ¶ 408 (emphasis added). Yet an early option exercise could only forfeit "time value of the option" if accompanied by a simultaneous resale of the exercised purchases. Moreover, Hakala's discussion of those who "engaged in premature option exercises...." -- a group that in which he does *not* include Derrick -- is based on data on those individuals' *sales*. (Hakala Decl., ¶¶ 13, 14). Finally, it defies common sense to suggest that Derrick, who had 87% of his exercisable options remaining, would additionally retain part of the 12.95% exercised.

⁹ *See also In Re Silicon Graphics*, in which the court noted "virtually all of the shares sold by officers in this case, were originally vested stock options that were converted to shares and then immediately sold....[therefore], the district court did not err in treating the officer's stock options as shares of stock for purposes of evaluating the suspiciousness of their stock sales." 183 F.3d at n.16, 986-987.

¹⁰ Pl. Resp., p. 120.

1. As a matter of law, Derrick's unexercised options must be considered in calculating the percentage of shares he sold, in which case the ratio is 12.95%.

Courts hold, and Plaintiffs and Derrick both agree, that the relevant ratio is:

$$\frac{\text{OPTIONS EXERCISED}}{\text{TOTAL HOLDINGS}}$$

Derrick's calculation of total holdings includes all of his 1.6 million exercisable options, and thus follows the case law with respect to such a calculation. Plaintiffs' calculation of total holdings wrongly *excludes* most of that data. The vast difference in the parties' denominators of "total holdings" results in the huge disparity in the resulting percentages.

Courts have established that *Derrick's* method of calculating total holdings, by including all of his exercisable options, is correct as a matter of law. In *In re Silicon Graphics, Inc. Sec Litig.*, 183 F.3d 970 (9th Cir. 1999), the Ninth Circuit held that vested stock options are to be considered in determining the percentage of shares sold by an insider in the context of alleged insider trading:

[Appellant] argues that it was improper for the district court to consider the officer's vested stock options in evaluating the proper proportions of their stock sales. [Appellant] contends that because vested stock options are not shares, they should not be treated as such for the purpose of calculating the percentage of shares that each officer sold. *We disagree.*

Id. at 986 (emphasis added), *cited with approval by Ronconi v. Larkin*, 253 F.3d 423, 435 n.5 (9th Cir. 2001)("Stock options should be considered in calculating the percentage of shares sold unless the insider could not have exercised them."); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2nd Cir. 1995) ("The additional 30,000 shares that [appellee] sold in January represented less than 11% of his holdings; after the sale, [appellee] owned approximately 259,000 shares *and/or options* of IMCERA stock.")(emphasis added), *In re Splash Technology Holdings Inc. Securities Litigation*, 160 F.Supp.2d 1059, 1082 n. 21 (N.D. Cal. 2001) ("Plaintiffs ... offered no convincing reason to distinguish between vested stock options and shares..."); *Gaylinn*, 2000 WL 33598337 *11 n. 10

("[I]n considering the amount and percentages of stock sold during the class period, the Court considers defendants' stock holdings and vested options."); *Dularne Partners, Ltd. v. SYNC Research, Inc.*, 103 F.Supp.2d 1209, 1213 (C.D. Cal. 2000) ("[I]nsider's vested stock options should be included in calculating the percentage of the insider's total holdings that had been sold."). The *Silicon Graphics* Court reasoned that it was nonsensical to distinguish between vested stock options and shares, given their comparable liquidity and given that virtually all of the shares sold were vested stock options that were converted to shares and then immediately sold:

When evaluating stock sales, we have held that the proportion of shares actually sold by an insider to the volume of shares he could have sold is probative of whether the sale was unusual or suspicious....In this case, we see no reason to distinguish vested stock options from shares because vested stock options can be converted easily to shares and sold immediately. Actual stock shares plus exercisable stock options represent the owner's trading potential more accurately than the stock shares alone. Therefore, a sale involving a significant portion of an insider's actual shares, but only a small portion of his shares and options combined, is less suspicious than were the insider to hold no options.

Id. at 986-987 (internal citations omitted).

Similarly, this Court, in *In re Securities Litigation BMC Software, Inc.*, expressly applied the *Silicon Graphics* rationale. *In re Securities Litigation BMC Software, Inc.*, 183 F.Supp.2d 860, 898 (S.D. Tex. 2001)("In determining whether the sale was unusual or suspicious, [a court] should examine the proportion of shares actually sold by the insider to the volume of shares he could have sold.") (*citing Silicon Graphics*, 183 F.3d at 986). This Court, therefore, considered *both* vested options and shares in calculating the percentage of shares a defendant sold:

...[Defendant], who held 3,539,180 shares *and vested options* during the Class Period, sold only ten percent of his stock,...

...[D]uring the Class Period [Defendant] held 730,180 BMC shares *and more than 2,000,000 vested options* with an exercise price substantially below market price....

...During the Class Period, [Defendant] sold only twenty-two percent of his stock *and vested options*,...

Id. at 901-02 (emphasis added).

Applying this law to the numbers from the SEC forms, as a matter of simple math, yields a ratio of 12.95%. The key reason for the disparity in Derrick's and Plaintiffs' ratios is that Plaintiffs' denominator *did not* include all of Derrick's 1,612,839 exercisable options, in contravention of the authorities cited above. Instead, Plaintiffs used a very small denominator of "total holdings" -- 312,533 -- that ignored almost all of Derrick's exercisable options (including those not yet exercised) as shown on SEC forms.¹¹ Including all of Derrick's exercisable options results in a much larger denominator of 1,709,449.94, as shown on Table A attached to Derrick's Motion. Obviously, comparing 221,425 exercised options to 312,533 total holdings yields a vastly higher "percentage" than comparing 221,425 exercised options to 1,709,449.94 total holdings. As the case law holds, however, Derrick's calculation of "total holdings," and thus the resulting ratio of 12.95%, is correct.¹²

2. Plaintiffs Misrepresent the SEC Forms.¹³

Finally, Plaintiffs desperately resort to *outright mischaracterization* of one of the SEC Forms attached to Derrick's Motion -- a Form 4 filed on July 3, 2001 (covering June, 2001), which they falsely claim shows Derrick's entire holdings at the end of June, 2001 to be 14,727 shares in his ESOP Plan and his remaining exercisable options to be zero. Plaintiffs completely misrepresent the form.

¹¹ Plaintiffs' denominator came from merely adding part of Derrick's common stock to the options he actually exercised. (Plaintiffs made other mistakes, as shown by the SEC Forms: (i) they omitted from their calculation of common stock holdings 14,727.52 shares held in an ESOP and 401(k); and (ii) they overstated Derrick's options exercises by 9,235. The most important reason their calculation is so inflated, however, is their failure to include all of his 1.6 million in exercisable options.)

¹² Plaintiffs' wishful thinking that their mere pleading of 73.8% raises a fact issue is also disputed by the authorities cited *supra*, where courts determined that exercisable options should be included as a matter of law.

¹³ Forms 3, 4, and 5 are filed with the SEC to reflect any changes in certain officers' (including Derrick's) beneficial ownership of Enron securities. Form 3 records initial acquisitions of beneficially owned securities, including grants of options. Form 4 records any changes in beneficial ownership, including options exercises. Form 5 is simply an annual statement of changes in beneficial ownership. All three forms are comprised of two Tables. Table I records changes relating to "non-derivative" securities (such as shares of common stock directly owned or held though an ESOP or 401[k]). Table II records changes relating to options and other "derivative" securities.

First, they wrongly suggest that the number "0.0" in Column 9 of Table II means Derrick had no exercisable options left as of the end of June, 2001. That is a flat misreading. Table II, Column 9 of a given Form-4 does *not* set forth a cumulative total of all options remaining. *See* Romeo, Peter J. & Dye, Allen L., SECTION 16 FORMS AND FILING HANDBOOK, Model Form 84 Reporting Principle (15) (2000). Rather, it sets forth only the total remaining of the specific *grant* of options whose exercise is recorded on that particular Form 4. *Id.*¹⁴ Because separate grants of options have different grant dates (and thus different expiration dates), and because Derrick's consistent pattern was to exercise all of a given grant that was about to expire, that number in Table II, Column 9 on the Form 4s was always "0.0" as to Derrick. (*See also* March 2, 1999, February 7, 2000 and January 5, 2001 Form 4s, attached as part of Ex. A-1 to Derrick's Motion). Obviously, if the "0.0" in Table II, Column 9 had the meaning ascribed by Plaintiffs, Derrick would have had no options left to exercise after March 2, 1999! Thus, the "0.0" is merely further evidence of Derrick's consistent trading pattern, *not* a cumulative total of options left. (Of course, such a total of options left is easily calculated from the options grants and exercises shown on multiple SEC Forms, which are carefully summarized on Ex. A to Derrick's Motion.)

Second, Plaintiffs also misstate Table I of the July 3, 2001 Form. They assert that Table I -- which does include a cumulative total of all shares Derrick owned as of the end of June, 2001 in the classes recorded on Table I -- "explicitly states that his entire share holdings (after huge sales in June) consisted solely of 14,727 shares in his ESOP plan."¹⁵ But Table I does *not* include unexercised, but exercisable options. *See* Romeo, Peter J. & Dye, Allen L., SECTION 16 FORMS AND

¹⁴ "Only securities of the same class or classes as those involved in the transactions being reported need be included in the end-of-period holdings shown on a report. Since options that have different exercise prices or expiration dates are not considered to be of the same class, [the filer] need not include in his end-of-period holdings of derivative securities his options to purchase...shares of common stock." Romeo, Peter J. & Dye, Allen L., SECTION 16 FORMS AND FILING HANDBOOK, Model Form 84 Reporting Principle (15), (2000).

¹⁵ Pl. Resp., p. 120.

FILING HANDBOOK, Model Form 84 Reporting Principle (4). Moreover, Plaintiffs make an additional obvious mistake: the 14,727 shares they say are Derrick's "entire share holdings" are recorded on page "1 of 2" of Table I; Plaintiffs ignore page "2 of 2," which additionally records 81,873 shares of directly owned common stock plus 10.34 shares in Derrick's 401(k)!¹⁶ Plaintiffs' characterizations of the Forms have no credibility whatsoever.

Finally, Plaintiffs do not even attempt to refute that, according to cases previously cited by this Court, even a very high ratio does not show scienter by a non-speaker like Derrick.¹⁷

3. Plaintiffs' global assertions raise no inference of scienter by Derrick

Plaintiffs' Response *nowhere even mentions Derrick* in its group-pleaded section containing generalized allegations of scienter.¹⁸ Thus, those allegations raise no inference of Derrick's scienter, because it is axiomatic that: (1) group pleading has not survived the PSLRA;¹⁹ (2) scienter must be pleaded with particularity as to a given defendant;²⁰ (3) conclusory allegations based on executive positions and involvement in management -- including assertions that a defendant knew or had access to information by virtue of board or managerial positions -- are insufficient to plead scienter;²¹ (4) instead, Plaintiffs must allege "with particularity...how..the individual Defendants knew facts sufficient to determine...statements were false..."²²

¹⁶ Further undermining Plaintiffs' credibility, the table *in their Complaint* purporting to compute the 73.8% figure referenced, from Table I, *only* the 81,873 shares that they ignored in their Response, and utterly disregarded not only the 14,727 shares they now cite in their Response as the "entire" holdings, but also the 10.34 401(k) shares appearing on the same page "2 of 2" from which they drew the 81,873 figure.

¹⁷ See Derrick's Motion, p. 8, referencing *BMC Software*, 183 F.Supp.2d at 902, and cases cited therein.

¹⁸ See Pl. Resp., pp. 97-119.

¹⁹ *BMC Software*, 183 F.Supp.2d at 866 n.14.

²⁰ 15 U.S.C. § 78u-4(b)(2); *Nathenson*, 267 F.3d at 407.

²¹ *BMC Software*, 183 F.Supp.2d at 887; see also *Azurix Corporation Sec. Litig.*, 198 F.Supp.2d 862, 890 (S.D. Tex. 2002)("Merely alleging that the defendants knew or had access to information by virtue of their board or managerial positions is not sufficient to plead scienter.")

²² *Greebel v. FTP Software, Inc.* 182 F.R.D. 370, 374 (D. Mass. 1998) ("Plaintiffs must allege "with particularity... how ... the individual Defendants knew facts sufficient to determine that such statements were false...")

Again, Derrick is nowhere mentioned in these conclusory allegations. Asserting that "factors affecting Enron's contracts and core business" and alleged financial manipulations "would have been "obvious" falls far short of Plaintiffs' burden to plead facts demonstrating *how* these matters, and any alleged fraud connected to them, were known by each individual defendant.²³ With respect to "internal complaints...." allegedly "ignored," names are mentioned here, but Derrick's is not.²⁴ Nor is Derrick among those identified in a footnote as the "specific Insiders" who made "optimistic portrayals."²⁵ Plaintiffs nowhere attempt to tie alleged GAAP violations and the magnitude of the ultimate Restatement²⁶ to any knowledge or action by Derrick, who Plaintiffs would surely concede is not an accountant and did not, in his position, participate in any way in the accounting treatment.²⁷ Finally, Plaintiffs' generalized discussion of insiders' "trading"²⁸ is irrelevant to Derrick, whose own trading pattern refutes his scienter.²⁹

²³ See Pl. Resp., pp. 98-101. Plaintiffs cite alleged omissions relating to an Indian power plant, projects at Enron International, Azurix earnings, Enron's VOD/Blockbuster venture, projects with special purpose entities, Enron Broadband Services, commodities trades and swaps, and Enron's use of risk management and hedging. See Pl. Resp., pp. 100-01. None of the cited allegations offer any details as to when, how and what any defendant knew, much less which defendant knew it or how he learned it. Of course, Plaintiffs nowhere mention Derrick in this section; it bears noting that Derrick was General Counsel of Enron Corp., not of its business divisions, which had their own legal staffs. Moreover, Plaintiffs do not contend Derrick was involved with the accounting.

Plaintiffs' assertion that the transactions allegedly "requir[ed] the personal attention of top Insiders....," is also too conclusory to pass muster. What specific "top Insiders"? What was the nature of the "personal attention"? Did the "personal attention" yield evidence of fraudulent activity? Much more particularity is needed to plead scienter. Again, Derrick is not mentioned in connection with this statement. (See *id.*, p. 101).

²⁴ Pl. Resp., p. 47. Plaintiffs do not contend that Derrick was a direct recipient of any of the letters Plaintiffs mention, and the one that he ultimately did see -- Ms. Watkins' August 15, 2001 initial letter to Ken Lay -- was hardly "ignored;" an investigation was almost immediately begun, and the Raptors (a main subject of Ms. Watkins' concerns) were unwound not long thereafter. (See Complaint, ¶ 495).

²⁵ Pl. Resp., pp. 102-03 and n. 24 and 25.

²⁶ Pl. Resp., pp. 103-05.

²⁷ The case law Plaintiffs cite proves this point: the defendants in each cited case were not general or corporate counsel, but held positions typically responsible for calculating and releasing financial information, unlike Derrick. See *In re Triton Energy Ltd. Sec. Litig.*, 2001 U.S. Dist. LEXIS 5920, *33 (E.D. Tex. Mar. 30, 2001); *In Re Microstrategy Inc. Sec. Litig.*, 115 F.Supp.2d 620, 637 (E.D. Va. 2000); *Rothman v. Gregor*, 220 F.3d 81, 84 (2d. Cir. 2000); *Gelfer v. Pegasystems, Inc.*, 96 F.Supp.2d 10,11(D.Mass. 2000); *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1248, (N.D. Ill. 1997).

²⁸ Pl. Resp., pp. 105-19.

²⁹ Plaintiffs assert that "[w]hen evaluating scienter, courts are required to consider the sales of all defendants and not view an individual's sales in isolation...." (Pl. Resp., p. 105, citing *Nathenson*, 267 F.3d at 421 (5th Cir.)). But this is not to say that the Court may infer scienter on the part of Derrick based upon the trades of the other Defendants. Plaintiff must plead scienter as to each individual defendant. *Coates v. Heartland Wireless Communications*, 26

(continued...)

II. Plaintiffs fail to state any claims against Derrick with particularity.

Challenged by Derrick's Motion to cite facts pleaded against him with the required particularity, Plaintiffs offer barely more than one page of conclusory contentions,³⁰ *half of which appear nowhere in the Complaint*, several of which are *refuted* by their own purported "sources," and none of which supports a claim against Derrick under any theory of liability (including "scheme"), or under any interpretation of *Central Bank*³¹ urged by parties or *amici*.

A. Facts Plaintiffs do not assert as to Derrick.

At the outset, it bears noting what Plaintiffs do *not* specifically plead against Derrick. They do not claim he made any public statements³² or signed any publicly filed documents.³³ They do not assert that he personally wrote, created, or "made" behind-the-scenes any misleading statements or

²⁹ (...continued)

F.Supp.2d 910, 916 (N.D.Tex. 1998)(PSLRA interpreted "to require that a plaintiff allege facts regarding scienter as to each defendant.") In fact, the Fifth Circuit's holding in *Nathenson* was based on the plaintiffs' failure to plead scienter against an individual defendant. 267 F.3d at 420-421. Thus, a defendant without unusual trades cannot be "guilty by association" with other defendants who had unusual trades. Instead, courts looking at sales of other defendants typically do so to determine whether there are defendants who did not sell shares during the class period, undermining the inference of scienter as to all defendants. *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (5th Cir. 1995); *Abrams v. Baker Hughes*, 2002 WL 1018944 *8 (5th Cir. 2002); *Nathenson*, 267 F.3d at 421; *In re The Vantive Corporation Securities Litigation*, 283 F.3d 1079, 1093-94 (9th Cir. 2002); *Ronconi v. Larkin*, 253 F.3d 423, 436 (9th Cir. 2001); *In re Baker Hughes Securities Litigation*, 136 F.Supp.2d 630, 647 (S.D. Tex. 2001).

Plaintiffs are also legally incorrect in claiming that whether a trading pattern is "unusual" is a fact question precluding dismissal. (Pl. Resp., p. 108). Many courts considering motions to dismiss have held as a matter of law that trading patterns were not unusual. *Feasby v. Industri-Matematik Intern. Corp.*, 2000 WL 977673 *4 n 5 (S.D.N.Y. 2000) ("As a matter of law, insider stock sales must be 'unusual' to satisfy the scienter requirement.") (citing *Acito v. Imcera Group*, 47 F.3d 47, 54 (2d Cir.1995)). *In re Stratosphere Corp. Securities Litigation*, 1 F.Supp.2d 1096, 1117 (D.Nev. 1998) ("[A]s a matter of law ... Plaintiffs ... failed to allege facts showing that the trades were unusual or suspicious, in terms of amount or the timing of the sales.") Indeed, plaintiffs bear the burden to plead facts showing an unusual pattern, using all the proper elements of any calculation. *In re Securities Litigation BMC Software, Inc.* 183 F.Supp.2d 860, 898 (S.D. Tex 2001) ("In determining whether the sale was unusual or suspicious, [a court] should examine the proportion of shares actually sold by the insider to the volume of shares he could have sold.") (citation omitted).

³⁰ See Pl. Resp., pp. 46-48.

³¹ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (herein referred to as "*Central Bank*").

³² See Pl. Resp., p. 33, listing the defendants Plaintiffs claim made public statements.

³³ See Pl. Resp., p. 35, listing the defendants Plaintiffs claim signed public filings.

financials disseminated to the public. They do not allege how he played any role in crafting or structuring any of the transactions that they describe as "manipulative devices."³⁴

B. Plaintiffs' "scheme liability" theory as to Derrick

Instead, they seem to hope to entangle Derrick, with 70 other individuals or entities, in their "scheme" liability theory.

1. The legal parameters and pleading requirements of "scheme" liability as applied to Derrick.

Various parties have argued that scheme liability is not a colorable separate theory under § 10b.³⁵ Because this legal argument has been thoroughly briefed elsewhere, Derrick simply requests that a favorable ruling by this Court be applied to dismiss Plaintiffs' claims against Derrick.

Similarly, the issue of whether a defendant must "speak" to be liable under any § 10b theory, including "scheme to defraud," has also been thoroughly briefed, as has the related issue of whether "speaking" requires making a misstatement to the public³⁶ or "creating" a misstatement made to the public by others.³⁷ Plaintiffs do not contend that Derrick did either, so Derrick will not burden the Court with further discussion of this issue. Indeed, Plaintiffs do not even plead facts in their Complaint indicating Derrick played a "significant role" in preparing a false statement actually uttered by another, the standard urged by Plaintiffs for a misrepresentation.³⁸

³⁴ See Complaint, ¶¶ 20, 33, 70.

³⁵ See, e.g., Defendant Merrill Lynch & Co., Inc.'s Motion to Dismiss Plaintiffs' Consolidated Complaint, pp. 34-39; Defendant Bank of America Corporation's Motion to Dismiss the Consolidated Complaint, pp. 29-31; Defendant Credit Suisse first Boston Corporation's Motion to Dismiss Plaintiff's Consolidated Complaint, pp. 11-13. So as to avoid burdening the Court with additional briefing, in his Motion Derrick adopted any grounds asserted in other motions that would warrant his dismissal as well. See Derrick's Motion, pp. 1-2.

³⁶ See, e.g., Derrick's Motion, pp. 15-17; other motions have discussed this issue as well.

³⁷ See Motion of Securities and Exchange Commission for Leave as *Amicus Curiae*, to Submit Briefs Pertinent to Certain Legal Issues Raised by Motions to Dismiss, Attachment 1 at 21.

³⁸ See Pl. Resp., pp. 78-80.

This Response will focus on whether -- even assuming *arguendo* both that "scheme liability" is a viable theory and that non-speakers can be liable -- Plaintiffs have pleaded any facts as to Derrick sufficient to show his "participation" in a "scheme to defraud." They have not.

Since *Central Bank* applies to *any* § 10b violation, 511 U.S. at 191, participation that would amount to "aiding and abetting" is not enough; to the contrary, any pleaded facts as to participation by a normally secondary actor, such as a lawyer, must meet "*all* of the requirements for primary liability under Rule 10b-5..." *Id.* Calling claims "schemes" does not obviate these requirements. *See Lemmer v. Nu-Kote Holding, Inc.*, 2001 WL 1112577, at *8 (N.D.Tex. Sept. 6, 2001)(any pleaded acts of participation in an alleged scheme must clearly be of a nature to give rise to primary liability). Even according to Plaintiffs, each defendant must individually commit "*a manipulative or deceptive act in furtherance of the scheme.*"³⁹

Nor does "scheme liability" obviate Plaintiffs' burden to plead *with particularity* facts showing *each individual's* precise role, and how it rises to the level of primary liability. *BMC Software*, 183 F.Supp.2d at 915-16 (citing *Pegasus Holdings v. Veterinary Centers of America*, 38 F.Supp2d 1158, 1164,1166 [C.D.Cal. 1998]); *Lemmer*, 2001 WL 1112577, at *8.⁴⁰

2. Plaintiffs plead no actionable facts with particularity as to Derrick.

³⁹ Pl. Resp.at 73 (emphasis added), quoting *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997).

⁴⁰ As this Court stated in *BMC Software*, in considering a "scheme to defraud" claim asserted against nonspeaking defendants such as Derrick:

Nor have plaintiffs specifically alleged how the individual nonspeaking Defendants have participated in the alleged scheme to defraud or how they could have controlled misstatements by other named Defendants.....The amended complaint does not show how the non-speaking Defendants "had knowledge of the fraud" sufficient to give rise to a strong inference of scienter, or allege what information they knew, or when and how they learned it. It generally attributes to them knowledge of the alleged fraud to their high positions in BMC and their day-to-day involvement in the business or from unidentified internal corporate documents and conversations. Defendants correctly state that this Court has previously rejected just such vague pleading as insufficient to give rise to a strong inference of scienter under the PSLRA.

183 F.Supp.2d at 915-16.

The "facts" about Derrick cited in Plaintiffs' Response⁴¹ confirm that their Complaint does not even begin to meet the legal standard for surviving dismissal. Indeed, half of the allegations stated in their Response *are not even contained in their Complaint* (and thus cannot be considered) and/or are *refuted by the "source" they cite!*⁴² Each purported "fact" is considered below in the order set forth in the Response.

Derrick's executive positions and service on the Management Committee⁴³ have been held insufficient to show participation in a fraudulent "scheme."⁴⁴ Moreover, even assuming to be true Plaintiffs' flatly false assertion that "[t]he Management Committee approved all significant business transactions, including the Fastow-controlled partnership/SPE deals....,"⁴⁵ Plaintiffs nowhere plead facts showing (i) that Derrick was present when any given deal was "approved;" or (ii) that his "approval" occurred with any knowledge or any awareness of any alleged misuse of the deals for a fraudulent purpose. (Plaintiffs do not even specify the exact "deals" to which they are referring).

Derrick's stock trades⁴⁶ hardly show participation in a fraudulent "scheme"; to the contrary, his trading pattern compels his dismissal.⁴⁷ Nor, as a matter of law, does receipt of bonus payments⁴⁸ provide evidence of participation in a fraud or constitute a "manipulative or deceptive act."⁴⁹

⁴¹ See Response, pp. 46-48.

⁴² This Court should disregard allegations appearing for the first time in a Response. See, e.g., *In re Baker Hughes Sec. Litig.*, 136 F.Supp.2d 630, 646-47 (S.D. Tex. 2001) ("It is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss"). See also *Schneider v. California Department of Corrections*, 151 F.3d 1194, 1197 n.1 (9th Cir. 1998) ("In determining the propriety of a Rule 12(b)(6) dismissal, a court *may not* look beyond the complaint to a plaintiff's moving papers, such as a memorandum in opposition to a defendant's motion to dismiss."), citing *Harrell v. United States*, 13 F. 3d 232, 236 (7th Cir. 1993), *Moore's Federal Practice*, § 12.34[2] (Matthew Bender 3d ed.) ("The court may not ... take into account additional facts asserted in a memorandum opposing the motion to dismiss, because such memoranda do not constitute pleadings under Rule 7(a)").

⁴³ Pl. Resp., p. 46.

⁴⁴ See, e.g., *In re Sunbeam Sec. Litig.*, 89 F.Supp. 2d 1326, 1341 (S.D. Fla. 1999) (allegations that defendant Executive Vice President and General Counsel was member of Operating Committee, desired to see Sunbeam succeed, and had incentive-based compensation failed to allege sufficient facts to assert 10b-5 scheme liability).

⁴⁵ Pl. Resp., pp. 47-48.

⁴⁶ Pl. Resp., p. 47.

⁴⁷ See pp. 2-3, *supra*.

⁴⁸ Pl. Resp., p. 47.

⁴⁹ See *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068-69 (5th Cir. 1994); *Baker Hughes*, 136 (continued...)

Derrick's service as an officer or director of New Power⁵⁰ similarly provides no evidence of participation in a "scheme." Again, mere executive positions or positions on a Board are not enough.⁵¹ No facts whatsoever are pleaded as to what would have made Derrick "aware" that any business transactions occurring between New Power and Enron were "fraudulent" or being improperly accounted for by Enron (the essence of Plaintiffs' allegation).⁵²

Plaintiffs' next allegations – that Derrick was involved in hiring Vinson & Elkins to investigate Sherron Watkins' allegations, and was the addressee of their October 15, 2001 letter report -- are hardly "manipulative and deceptive" acts giving rise to primary securities fraud liability. No facts are cited in the Complaint, or even in the slightly embellished Response, suggesting Derrick had any manipulative or deceptive intent in hiring a world-class law firm to conduct the preliminary investigation. Plaintiffs themselves concede Derrick thought the choice was "logical,"⁵³ given the need to complete the preliminary investigation quickly so as to see if a full-scale forensic investigation was needed. Moreover, the very page of the Powers Report Plaintiffs cite makes clear that Derrick first requested V&E to opine as to whether it could conduct the investigation, consistent with the legal ethics rules.⁵⁴

Plaintiffs next make a brand-new allegation in their Response:

Derrick also helped V&E prepare Enron's deceptive related-party transactions disclosures and he gave substantial advice and reviewed disclosures made in Enron's financial statements. *See id.* [Powers Report] at 183.⁵⁵

⁴⁹ (...continued)

F.Supp.2d at 64; *In re Sunbeam Sec. Litig.*, 89 F.Supp.2d at 1341. Indeed, here Plaintiffs cannot even plead in good faith that any bonus payments were actually received, when it is well known many such payments were deferred into deferral accounts and thus lost in the bankruptcy.

⁵⁰ Pl. Resp., p. 47.

⁵¹ *See, e.g., Azurix Corporation Sec. Litig.*, 198 F.Supp.2d at 890.

⁵² Pl. Resp., p. 47.

⁵³ *See Powers Report*, p. 173 (the very page Plaintiffs cite).

⁵⁴ *See Powers Report*, p. 173.

⁵⁵ Pl. Resp., p 47

Elsewhere in their Response, Plaintiffs say Derrick "was involved in drafting Enron's press releases, SEC filings and shareholder reports;...." without specifying his involvement.⁵⁶

First, again, *these allegations are nowhere specifically pleaded against Derrick in the Complaint*, and appear to be an attempt by Plaintiffs to belatedly shore up their claims against Derrick by exaggerating his actual role.

Dispositively, though, Plaintiffs refute their own contention, by crediting it to the Powers Report, which said the exact opposite:

James Derrick, Enron's General Counsel, reviewed the final drafts [of the proxies] to look for obvious errors, but otherwise had *little involvement* with the related-party proxy statement disclosures. He said that he relied on his staff, Vinson & Elkins, and Andersen to make sure the disclosures were correct and complied with the rules.

See Powers Report at 183 (emphasis added). Indeed, the Powers Report also makes clear, on p. 182, that "[A]ccountants took the lead in preparing the financial statement footnote disclosures,...."

Where Plaintiffs reference a source in a Complaint, the Court, in evaluating a motion to dismiss by defendant, must rely on what the source *actually* stated. *See BMC Software*, 183 F.SUPP. 2d at 883 (rejecting Plaintiffs' argument that Court was prohibited from referring to relevant documents upon which the allegations were based to test Plaintiffs' allegations), citing *Sturm v. Marriott Marquis Corp.*, 85 F. Supp. 2d 1356, 1366 (N.D. Ga. 2000) ("The district courts cannot fulfill their gatekeeping role if plaintiffs are free to quote selectively or out of context from documents that they rely upon, and avoid further examination of the documents by not attaching them to the complaint..") *Bryant v. Avado Brands*, 187 F. 3d 1271, 1278 (11th Cir. 1999); *In re Burlington Coat Factory*, 114 F. 3d 1410, 1426 (3d Cir. 1997)(consideration of relevant documents precludes plaintiffs from "maintain[ing] a claim of fraud by extracting an isolated statement from

⁵⁶ Pl. Resp., p. 35.

a document"; "Plaintiffs cannot prevent a court from looking at the texts of documents on which its claim is based by failing to attach or explicitly cite them.")

Thus, when considered *with* what their source actually said, Plaintiffs' belated allegations outright *refute* that Derrick had a significant role in the disclosures (even if "significant role" is the test adopted by this Court).⁵⁷ Moreover, even accepting the allegations as wrongly stated without considering the actual Powers Report, they could not obviate dismissal, as the specifics of Derrick's role or supposed advice or "help" are not discussed, nor do Plaintiffs allege that Derrick provided to V&E any false material information, or that he knew of any material misstatements or omissions that needed to be disclosed to V&E.

Plaintiffs next claim Derrick was part of "a consensus" not to disclose "the substance" of the related-party transactions, "although he knew the truth."⁵⁸ First, that Derrick himself made decisions about the disclosures, individually or as part of a "consensus," is refuted by the very page of the Powers Report Plaintiffs reference, as shown above. Second, Plaintiffs offer no facts showing what "truth" he supposedly knew and how he knew it, or that he knew that "truth" was required to be disclosed and was not. *See BMC Software*, 183 F.Supp. 2d at 860 ("The amended complaint does not show how the non-speaking Defendants 'had knowledge of the fraud' ...or allege what information they knew, or when and how they learned it.").

⁵⁷ Again, Derrick supports the view that *Central Bank* imposes a higher standard, as set forth in his Motion at pp. 15-17. But even the "significant role" standard requires much more than Plaintiffs have pleaded. Plaintiffs cite *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) as supporting their view that a defendant may be liable for participation in a misrepresentation or omission without "speaking" *See* Pl. Resp. at 71-72. But *Shores* actually undermines, not supports, any liability as to Derrick. Though Plaintiffs describe the defendant lawyer Sklar as someone who was simply "involved in the documentation of the underlying industrial transaction and participated in drafting the Offering Circular, which contained false statements about the underlying project and audited financial statements that were false because of the deficiencies in the underlying project..." *id.* at 72 (emphasis added), in truth Sklar's participation amounted to *drafting* the very documents that allegedly contained false representations. *Shores*, 647 F. 2d at 465-466 (Sklar "drafted the lease, indenture of trust, mortgage, authorizing resolution, guarantee, and closing papers....." and "also drafted the Offering Circular" that allegedly contained false representations.)

⁵⁸ Pl. Resp., p. 47.

Finally, Plaintiffs again misstate their own "record" -- this time, a set of belatedly proffered "exhibits" that they filed along with their responses to motions to dismiss. They assert that Derrick was present at a number of "critical Board meetings, including 10/11-12/99, when the Board approved Chewco. *See* Exs. 21, 24, 25, 26...." and that he "reported to the board on legal matters disclosed in Enron's financial statements. *See* Ex. 28."⁵⁹

First, none of these allegations -- or the exhibits -- appear in or are attached to the Complaint, and thus cannot be considered.⁶⁰ In any event, again Plaintiffs' alleged "facts" are contradicted by their referenced source material. Ex. 24, the minutes of the October 11-12, 1999 Board meeting shows Derrick was *not* present.⁶¹ Ex. 26, the minutes of a May 1, 2000 Finance Committee meeting, also show Derrick was not present.⁶² Ex. 21, the minutes of a November 5, 1997 Executive Committee meeting, show Derrick in attendance, and evidence a discussion of Chewco, but describe Chewco as "a special purpose vehicle *not affiliated with the Company*...."⁶³ There is no indication that anyone present could have known facts about Chewco that ultimately came to light. Plaintiffs do not even bother to explain how Ex. 25 -- the minutes of the May 1, 2000 audit committee -- relates to anything or evidences any fraud by anyone present. Finally, Ex. 28 makes clear that Derrick's reports to the audit committee were *not* about any matters at issue in the Complaint, but related to the financial statement footnote "litigation and other contingencies" (i.e., unasserted potential litigation claims).⁶⁴

⁵⁹ *Id.*

⁶⁰ *See* n. 42, *supra*.

⁶¹ *See* Pl.'s Ex. 24, p. 1, listing attendees, who do not include Derrick.

⁶² Ex. 26, p. 1.

⁶³ Pl. Ex. 21, p. E 61431.

⁶⁴ Pl. Ex. 28, p. 3.

III. Plaintiffs abandon any claim of Derrick as a control person.

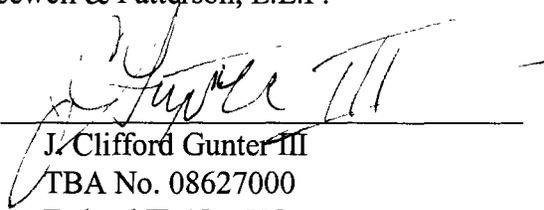
Plaintiffs' Response fails to rejoin to Derrick's specific grounds for dismissal from any § 20(a) "control person" claim (*see* Derrick's Motion, pp. 18-21), effectively conceding his points.

IV. Prayer

Defendant James V. Derrick, Jr. respectfully requests that his Motion to Dismiss be granted with prejudice, and further requests such other and further relief to which he may be justly entitled.

Respectfully submitted,

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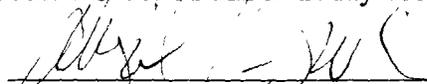
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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document has been forwarded to all known counsel of record pursuant to this Court's Order on this 24th day of June, 2002.



Abigail K. Sullivan