

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

United States Courts  
Southern District of Texas  
FILED

JUN 24 2002

Michael N. Milby, Clerk

MARK NEWBY,

Plaintiff,

VS.

ENRON CORP., et al.,

Defendants.

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CIVIL ACTION NO. H-01-3624  
(Consolidated)

**DEFENDANT JOSEPH W. SUTTON'S  
REPLY IN SUPPORT OF HIS MOTION TO DISMISS**

Pursuant to Federal Rule of Civil Procedure ("FED. R. CIV. P." or "Rule") 12(b)(6), Defendant JOSEPH W. SUTTON ("Sutton") files this Reply in Support of his Motion to Dismiss all claims asserted against him in Plaintiffs' Consolidated Complaint for Violation of the Securities Laws (the "Complaint"), for failure to state a claim upon which relief can be granted.

**I. Introduction**

Plaintiffs' Response to Sutton's Motion to Dismiss ("Sutton's Motion") identifies each fact that the Complaint particularizes against Sutton in one paragraph. The Response then attempts to show how those facts adequately state a securities claim against Sutton. As shown below, Plaintiffs' Complaint establishes nothing more than that Sutton worked for Enron, received bonuses for that work, and traded Enron stock. These "particularized" facts are insufficient under the PSLRA's heightened pleading requirements. Plaintiffs' claims against Sutton must be dismissed with prejudice.

**II. Adoption and Incorporation of Other Reply Briefs**

Sutton's Motion adopted and incorporated the argument and authorities contained in other

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Defendants' motions. See SUTTON MOTION n. 1 and p.7. Sutton hereby adopts the reply briefs filed in support of those motions, including those filed by Rebecca Mark-Jusbashe, the Outside Directors, and Certain Officer Defendants. For this reason, this Reply will consider only those scienter allegations and arguments that are unique to Sutton and are therefore not considered in the other replies.

### **III. Scienter**

Plaintiffs' Response summarizes the facts particularized to Sutton that allegedly satisfy the PSLRA's heightened pleading requirements. See RESPONSE pp. 66-67. Those facts consume all of one paragraph and are totally void of any direct link between Sutton and the alleged conduct underlying Plaintiffs' Complaint. Plaintiffs' scienter "facts" consist only of (i) one vague allegation regarding Sutton's alleged attendance at an analyst meeting in 1999, (ii) various allegations attributing knowledge of Enron's alleged fraud to Sutton solely by way of his positions within Enron International, and (iii) allegations regarding Sutton's trading in Enron stock. As shown below, these allegations do not support Plaintiffs' claims, which the Court should therefore dismiss.

#### **A. Sutton's Position at Enron Does Not Strongly Infer Scienter.**

As detailed more extensively in other briefs currently before this Court, Fifth Circuit precedent does not allow securities plaintiffs to impute knowledge of a company's core operations or questionable accounting practices to an officer simply by virtue of his position with the company. See *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 424 (5<sup>th</sup> Cir. 2001) (core operations); *Abrams v. Baker Hughes, Inc.*, 2002 WL 1018944, \*6 (5<sup>th</sup> Cir. May 21, 2002) (questionable accounting practices). Instead, securities plaintiffs must plead additional facts that *strongly infer* that the officer knew of the wrongful conduct underlying the plaintiffs' claims. See *Abrams*, 2002 WL 1018944 at

\*6; *In re Tyco International, Ltd. Sec. Litig.*, 185 F.Supp.2d 102, 115 (“Absent specific factual allegations linking specific defendants with the preparation of AMP’s allegedly false financial statements prior to completion of the Tyco acquisition of AMP, defendants cannot be said to have necessarily participated in such activities simply because they were in positions of authority at Tyco.”)

Plaintiffs’ Complaint identifies Sutton as an Enron International officer for the year 1997 (¶ 88 at p. 92) and then identifies alleged improprieties at that company several pages later, without any reference to Sutton or his alleged role therein. *See, e.g.*, COMPLAINT ¶ 155(h) at p. 126 (alleging the Dahbol “financial disaster” with no mention of Sutton). Only the Response, and not the Complaint, explicitly ties Sutton’s corporate positions at Enron International to recognizable scienter allegations.<sup>1</sup>

Plaintiffs allege that Sutton’s position at Enron International charges him with knowledge of the company’s accounting practice informally known as “snowballing.” See Response p. 67. With this practice, Enron was allegedly able to avoid over \$100 million in write downs for a period of several years.<sup>2</sup> *Id.* In order to charge Sutton with knowledge of “snowballing,” however, the Fifth Circuit requires that Plaintiffs particularize facts beyond Sutton’s corporate position that justify a strong inference of that knowledge. *See Abrams*, 2002 WL 1018944 at \*6. In *Abrams*, the Fifth Circuit stated that imputing knowledge of accounting errors to executives required detailed allegations of specific corporate reports, including the reports’ contents, authors, and recipients. In

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<sup>1</sup> Plaintiffs’ complaint identifies Sutton as an officer at Enron International in conjunction with its placing him on the Enron Management Committee for 1997. Elsewhere, the complaint alleges that Sutton was Enron Vice Chairman, a position not on the board of directors and wholly undefined in the complaint.

<sup>2</sup> “Snowballing” allegedly involved deferring start-up costs for failed project proposals.

this case, Plaintiffs must therefore plead the specific information provided to Sutton that alerted him to the alleged accounting improprieties. Plaintiffs should identify the person(s) from whom he received that information, as well as the form by which the information was transmitted. Anything less is insufficient under the PSLRA.

Plaintiffs do not particularize *one fact* beyond Sutton's corporate position that justifies imputing knowledge of Enron International's accounting practices to him personally. *See* RESPONSE p. 67. Plaintiffs further fail to particularize *one fact* that suggests that Sutton, who is not an accountant, was subjectively aware that such practices were improper or unusual. *Id.* Plaintiffs do not even allege that "snowballing" violated generally accepted accounting principles. Plaintiffs' simply allege that it is inconceivable that Sutton did not know about "snowballing" or other accounting practices. *Id.* Plaintiffs must allege scienter beyond negligence. Moreover, Plaintiffs' Complaint actually concedes that the \$100 million "snowballing" charge was taken, *i.e.*, it was disclosed, in Enron's 11-17-98 10-Q. *See* RESPONSE at 10, n. 11. Plaintiffs' "snowballing" allegations do not strongly infer that Sutton acted with the requisite scienter; therefore, they and cannot form the basis of a securities claim.

Plaintiffs further allege that Sutton's position at Enron International charges him with knowledge of the "financial disaster" associated with the Dabhol plant in India, as well as other projects that Plaintiffs allege to be Enron International's core businesses. *See Response* p. 67. As stated above, however, to charge Sutton with specific knowledge about these projects, the Fifth Circuit requires that Plaintiffs particularize facts beyond his corporate position that justify a strong inference of that knowledge. *See Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 424 (5<sup>th</sup> Cir. 2001). In *Nathenson*, the court found that scienter was sufficiently pled where, in addition to corporate

position, the plaintiffs pled that (i) the company was a one product company, (ii) the company's future profits were tied to that product, (iii) the alleged misrepresentations involved a patent for that product, (iv) the company was relatively small, and (v) the defendant was both CEO and maker of the alleged misrepresentations. *See Nathenson*, 267 F.3d at 425. Even under these facts, which are substantially more egregious than those particularized against Sutton, the Fifth Circuit held that the plaintiffs' scienter allegations "*only barely*" escaped dismissal. *Id.*

In the present case, Plaintiffs do not particularize *one fact* beyond Sutton's corporate position that justifies imputing knowledge of the "financial disaster" of Dabhol or other projects to him personally. Plaintiffs do not particularize *one fact* that suggests that Sutton was subjectively aware that Dabhol or any other project was improperly accounted for on Enron International's books. Without such allegations, Plaintiffs' Complaint fails to meet the "bare minimum" pleading standard described in *Nathenson*. Moreover, although Plaintiffs' Response indicates that the allegations in paragraphs 155(h), (i), and (j) concern events at Enron International that occurred during Sutton's tenure as that company's President and Chief Operating Officer, Plaintiffs' Complaint simply lists those paragraphs as evidence of the "true but concealed facts" for 10/21/98 through 7/6/99. This is problematic because the Complaint places Sutton at Enron International for the year 1997. The Complaint does not specify the extent, if any, to which any of these "financial disasters" were apparent to Sutton or anyone else at Enron International while Sutton was actually at the company. For these reasons, Plaintiffs' core business operations allegations do not strongly infer that Sutton acted with scienter.

**B. The Alleged Analyst Meeting Statements Do Not Strongly Infer Scienter.**

Plaintiffs' Complaint makes only one allegation regarding allegedly fraudulent affirmative

statements generally attributed to Sutton as one of four Enron insiders who, between July 13 and 16, 1999, appeared at analyst meetings in three different cities to discuss Enron's Second Quarter 1999 results and business:

On 7/13/99, Enron held a conference call for analysts and investors to discuss Enron's 2Q 99 results and its business. On 7/14-16/99, Enron executives Skilling, Sutton, Koenig and Causey also appeared at Enron's 2ndQ analyst meetings in New York, Boston, and Houston. In the conference call and in follow-up conversations with analysts and in formal presentations and break-out sessions at the analysts meetings, they stated:

- EPS in the 2ndQ increased 29% to \$.27 per share compared to \$.21 in the 2ndQ of last year. Net income in the 2ndQ increased 53% to \$222 million up from \$145 million last year.
- Enron had a great quarter. Enron was hitting on all eight cylinders. Enron was very pleased with the results for the quarter and very optimistic about the outlook for the future. Enron was very optimistic about how the business was playing out.
- Overall, Enron's businesses had been performing well. Enron was well positioned for significant continued growth.<sup>3</sup>

Complaint ¶ 157. The extent to which these allegation constitute impermissible group pleading, forward-looking statements, or "puffing" is presented in other motions. *See, e.g., CERTAIN OFFICER DEFENDANTS REPLY*, pp. 10-12. As evidence of Sutton's scienter, these allegations are insufficient for other reasons. Specifically, the allegations consist of Plaintiffs' summary of allegedly fraudulent statements made during an "Enron" conference call on 7/13/99, in one of three subsequent analyst meetings, or in "break-out" sessions or follow-up conversations. Plaintiffs' allegations, however, place Sutton *only* at the analyst meetings. Therefore, Sutton cannot be liable for statements made

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<sup>3</sup> *Id.* (emphasis added).

in the conference call, the break-out sessions, or the follow up conversations. Without knowing who said what and where, and whether Sutton spoke or was even present when these statements were allegedly made, this allegation cannot establish – or help to establish – that Sutton made any material misrepresentation or that he stood by while someone else did.

Plaintiffs do not particularize *one fact* beyond Sutton’s corporate position that strongly infers that Sutton knew that these alleged statements were false when made. As stated above, his corporate position does not charge him with knowledge of Enron’s core businesses or accounting practices. To the extent that the statements referencing Enron’s corporate earnings were false, Plaintiffs must particularize facts *to Sutton* as to why he knew that they were false. Otherwise, Plaintiffs’ allegation that Sutton made material misrepresentations or stood by while others did so is of no legal consequence and certainly does not strongly infer that Sutton acted with scienter.

**C. Sutton’s Trading Does Not Strongly Infer Scienter.**

The paragraph designated in Plaintiffs’ Response as containing the factual basis for Plaintiffs’ claims against Sutton generically states that Sutton engaged in illegal insider trading. Plaintiffs believe that this allegation strongly infers scienter based upon the conclusion of their “statistician,” Dr. Scott Hakala. With Dr. Hakala’s declaration, Plaintiffs attempt to bootstrap scienter over the PSLRA’s heightened pleading requirements.

Dr. Hakala’s qualifications and the propriety of his statistical model, to the extent that they can be deciphered from his declaration, are sufficiently covered in other briefs. Sutton’s Motion, however, made several arguments against the Hakala model that were unique to that motion, and one of those requires special attention here.

Sutton’s Motion argues that Dr. Hakala’s model is not reliable because it assumes that

efficient market hypothesis is fact. *See* SUTTON MOTION pp. 25-27. As explained in the motion, the Hakala model, even if flawlessly executed, can show only that a trader subjectively valued stock differently than the market valued it on the day of a particular trade. What the model cannot show is whether that valuation difference arose from the trader's independent assessment of publicly disclosed information or from his use of non-public, inside information.

In response, Plaintiffs state simply that Sutton's argument "ignores the legal presumption that there is an efficient market for publicly traded stock." *See* RESPONSE p. 133. This is simply not true. Sutton's argument explicitly acknowledges that presumption and then demonstrates that when one assumes that the facts alleged by Plaintiffs are true, there could not have been an efficient market when Sutton traded Enron stock. *See* SUTTON MOTION pp 25-26. This latter point has been totally ignored in Plaintiffs' Response. Moreover, the legal presumption to which Plaintiffs refer is simply a pleading device that allows securities purchasers to allege reliance without the necessity of pleading "direct" reliance on misrepresentations actually heard and digested by that purchaser. The efficient market presumption allows investors to reasonably rely on the market's integrity when buying widely traded securities. The presumption does not support Plaintiffs' argument that the market is actually efficient and certainly does not support the Hakala model's assumption that the market's "efficient" valuation of a particular security is the only reasonable valuation.

Simply stated, the Hakala model assumes that market efficiency is a measurable fact. It is not. The model assumes that *every single individual* trader with access to only public information will value a stock exactly as the "market" will. He will not. To argue otherwise would be ridiculous.

Plaintiffs also ignore Sutton's argument that efficient market hypothesis is especially inapplicable to Enron at the time Sutton sold his shares. As described throughout Plaintiffs'

Complaint, at that time, the Enron business plan had absorbed countless new businesses, and Enron had evolved into something very different from its beginnings as a “stodgy regulated natural gas company.” Enron was touted in the press as a corporate pioneer, a free market trailblazer whose “asset-lite” profit model was to define the way companies would do business in the twenty-first century. Clearly, there can be no consensus regarding the valuation of such a company, and thus there can be no efficient market for its stock. Yet this is exactly what the Hakala model assumes as fact. For this reason, that model proves absolutely nothing and is not credible evidence that Sutton for that matter, or anyone, acted with scienter.

#### **IV. Conclusion**

Plaintiffs’ allegations against Sutton are blatantly defective and are inadequate as a matter of law, and must therefore be dismissed.

Respectfully submitted,



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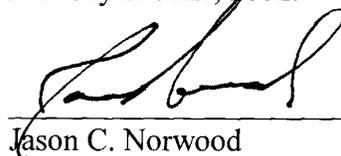
Jack O’Neill  
Attorney-In-Charge for  
Defendant Joseph W. Sutton  
State Bar No. 15288500  
Federal ID No. 3696  
Wells Fargo Plaza  
1000 Louisiana Street, Suite 1800  
Houston, Texas 77002-5009  
Telephone: (713) 654-7607  
Telecopier: (713) 654-7690

OF COUNSEL:

Jason C. Norwood  
State Bar No. 24027579  
Federal ID No. 28825  
CLEMENTS, O'NEILL, PIERCE,  
WILSON & FULKERSON, L.L.P.  
Wells Fargo Plaza  
1000 Louisiana Street, Suite 1800  
Houston, Texas 77002-5009  
Telephone: (713) 654-7664  
Telecopier: (713) 654-7690

**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that a true and correct copy of the foregoing document was forwarded to each counsel listed on the attached Exhibit A Service List by e-mail or by facsimile or by United States Mail or by Federal Express on this 24th day of June, 2002.

  
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Jason C. Norwood

The Service List  
Attached  
to this document  
may be viewed at  
the  
Clerk's Office