

complied with the appropriate rules governing the disclosures. The First Amended Consolidated Complaint makes no claim that Fastow had that type of knowledge.

Absent allegations that Fastow possessed the know-how required to understand the alleged shortcomings of Enron's disclosures, the Consolidated Complaint does not raise a strong inference that he knew that any of Enron's disclosures were inadequate or that the accounting treatment of special purpose entities and/or affiliates was improper. Absent that strong inference, Plaintiffs' Consolidated Complaint does not adequately allege adequately scienter, a prima facie element of a securities fraud claim.

1. This Court should reject Plaintiffs' attempt to obfuscate the Fifth Circuit's straightforward pleading standards for securities fraud cases.

Notwithstanding Plaintiffs' references to notice pleading and Rule 8, the Fifth Circuit has articulated this pleading standard for securities fraud cases: a plaintiff must "specify the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 412-13 (5th Cir. 2001) (quoting *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997)). Furthermore, a plaintiff must allege scienter "by pleading facts giving rise to a strong inference of recklessness or conscious misconduct." *Nathenson*, 267 F.3d at 410 (citing *In re: Comshare, Inc. Sec. Litig.*, 180 F.3d 542, 548-49 (6th Cir. 1999)). Allegations of motive and opportunity to commit securities fraud will not suffice to satisfy Rule 9(b). *Id.*

Moreover, this Court has rejected the group pleading doctrine; plaintiffs must identify the individual speaker for alleged misstatements. *See In re: Sec. Litig. BMC Software, Inc.*, 183 F.Supp.2d 860, 913 n.50 (S.D. Tex. 2001). Plaintiffs misrepresent the content of this Court's decision in *BMC*. Nowhere in *BMC* did this Court suggest that the

group pleading doctrine survived as to persons who “significantly participated” in “transactions” as Plaintiffs contend. Rather, this Court decided that the group pleading doctrine did not survive passage of the PSLRA *in any form*.

2. Because of the reliance requirement, Plaintiffs must tie their claims under Rule 10b-5 to statements, not actions, by Fastow.

Plaintiffs cannot make their case against Fastow simply by alleging supposedly wrongful acts, no matter how specifically they describe those acts. Rule 10b-5 “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.” *Central Bank of Denver, N.A. v. First Interstate Bank Denver, N.A.*, 511 U.S. 164, 177 (1994).² Thus, Plaintiffs’ claims that Fastow assisted or participated in an undefined “fraudulent scheme” do not give rise to a cause of action under Rule 10b-5. As the Supreme Court explained in *Central Bank*, “A plaintiff must show reliance on the *defendants’* misstatements or omissions to recover under Rule 10b-5.” *Id.* (emphasis added). “Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.” *Id.* Thus, Fastow’s alleged *conduct* to which Plaintiffs’ refer in the Opposition (at pages 48-49) does not support their 10b-5 claims unless it is meaningfully tied to a particular false statement. In sum, the reliance requirement precludes Plaintiffs from alleging a litany of acts by Fastow having no connection to the information on the basis of which they purchased Enron stock and lumping those acts together as part of a “fraudulent scheme.”

² In this context, “[m]anipulation is virtually a term of art.” *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 467 (1977). “The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” *Id.* Thus, Plaintiffs’ vague allegations of a company plan to reduce debt or inflate earnings do not plead a “manipulative act.”

3. Plaintiffs have not stated a claim against Fastow under Rule 10b-5 with the particularity required by Rule 9(b) and PSLRA.

In light of *Central Bank*, this Motion turns upon whether Plaintiffs have alleged statements by Fastow with: (1) the particularity required by law; and, (2) if the particularity requirement is satisfied, whether Plaintiffs have alleged facts that give rise to scienter, that is a strong inference of reckless or intentional conduct on Fastow's part. The statements with which Plaintiffs seek to charge Fastow fall into two categories: (1) conference calls in which Plaintiffs fail to identify the particular speaker;³ and (2) SEC filings signed by Fastow.⁴ For the first of these two types of statements (conference calls), Plaintiffs have failed to satisfy Rule 9(b)'s particularity requirement, because they have not identified the particular speaker. As for the second category, while Plaintiffs have identified Fastow as the "speaker" of allegedly false statements made in SEC filings, they have failed to plead sufficient facts to satisfy the scienter requirements. Nowhere does Plaintiffs' First Amended Complaint offer any facts to suggest that, at the time Fastow signed those SEC filings, he believed the disclosures to be false, inadequate, or not in compliance with generally accepted accounting principles.⁵

3.1 Plaintiffs' pleading of statements on conference calls fails to satisfy Rule 9(b), regardless of whether the group pleading doctrine applies.

In their allegations regarding statements made on investor/analyst conference calls, Plaintiffs fail to make even a minimal effort to identify the particular speaker who made the statements of which they complain. Rather, Plaintiffs simply generalize the

³ FAC, ¶¶119, 179, 224, 247, 263, 282, 309, 317, 329, 343.

⁴ FAC, ¶¶109, 110, 126, 134, 141, 292, 336.

⁵ Because Plaintiffs' pleading fails on the particularity and scienter prongs of Rule 9(b) and the PSLRA, Fastow does not address in this Reply whether or not Plaintiffs have adequately alleged falsity of the statements at the time they were made. However, to the extent the briefs of other Defendants address the issue of falsity, Fastow refers this Court to those briefs.

allegations, using the catch-all “they stated” (or listing the names of various individuals followed by the word “stated”) before a list of bulleted “statements.” *See, e.g.*, FAC, ¶¶119, 179, 224, 247. In fact, Plaintiffs do not even identify the actual statements; rather, they provide only their own paraphrasing of what Defendants supposedly said. Thus, this pleading fails on two counts.

First, because the First Amended Complaint uses vague paraphrasing, it fails to identify the “contents of false representations” as required by Fifth Circuit law. *Tel-Phonic Svcs., Inc. v. TBS Int’l, Inc.*, 975 F.2d 1134, 1139 (5th Cir. 1992). Plaintiffs’ vague statements – not defendants – such as “Enron’s news was extremely good”; “Enron had another excellent quarter”; and “Everything was going great with Enron,” fail to provide the defendants sufficient notice of falsehood with which Plaintiffs seek to charge them. Indeed, to the extent Plaintiffs have relied on analyst reports as the source for what was said, rather than a conference call itself, their pleading fails to satisfy Rule 9(b) altogether. *See BMC Software*, 183 F.Supp.2d at 914 n.51. Regardless, Plaintiffs have failed to describe the contents of false statements, as required.

Second, courts have held, even when applying the group pleading doctrine, that a plaintiff alleging false statement made *orally* must identify the particular speaker. *See BMC Software*, 183 F.Supp.2d at 915-16 (citing *Pegasus Holdings v. Veterinary Centers of America, Inc.*, 38 F.Supp.2d 1158, 1164 (C.D. Cal. 1998)). Under Rule 9(b), “plaintiffs must attribute particular misstatements, omissions, or otherwise manipulative conduct on the part of each and every defendant listed.” *Pegasus*, 38 F.Supp.2d at 1166.

The First Amended Complaint fails to discharge that burden as to the allegations regarding statements made on conference calls.⁶

3.2 Plaintiffs have not alleged sufficient facts to discharge their burden of pleading facts sufficient to support an inference of scienter.

As stated above, Plaintiffs must plead facts sufficient to allow an inference that Fastow acted intentionally or with severe recklessness when signing the SEC filings about which Plaintiffs complain. *See Nathenson*, 267 F.3d at 410. All of Plaintiffs' complaints against Fastow regarding the SEC filings he signed relate to the presentation of Enron's financial condition, as set forth by Plaintiffs in the section of their Opposition that argues the reasons why they have satisfied Rule 9(b):

- "The financial statements . . . inflated Enron's revenues, earnings, assets, and equity, and concealed . . . debt . . ." *Opp.*, at 50.⁷
- "Fastow . . . and the other Enron Defendants, caused the company to *violate GAAP [generally accepted accounting principles] and SEC rules* in specific and substantial ways." *Id.*
- "The [First Amended Complaint] specifies that Enron's failure to consolidate subsidiaries and special-purpose entities into its *financial statements violated GAAP.*" *Id.*
- "For Enron's accounting scheme to work, Fastow and the parties involved in his SPEs and subsidiaries had to be controlled by Enron and this control and affiliation had to be concealed, *in violation of FASB No. 57.*" *Id.*

(emphasis added in all). Plaintiffs do not contend that Fastow misled them as to particular facts other than the figures reported in the financial statements. Rather, as described in the excerpts above, all of Plaintiffs' allegations regarding the falsity of SEC

⁶ To the extent that this Court finds Plaintiffs have satisfied the particularity requirement regarding statements made on conference calls, they have nevertheless failed to make a legally sufficient pleading of scienter. As to statements on conference calls regarding the prospects or performance of Enron's various business units, such as Broadband, EES, etc., Plaintiffs have not alleged that Fastow had any particular knowledge about the supposed problems of those units. As to any statements regarding Enron's overall financial condition, *see* Part 3.2 *infra* regarding the inadequacy of Plaintiffs' pleading of scienter.

⁷ Plaintiffs' Memorandum of Law in Opposition to Motions to Dismiss filed by Enron Defendants.

filings depend on accounting treatment: if the proper reporting conventions were followed, then Plaintiffs admittedly have made no allegation of a false statement by Fastow in an SEC filing. The Fifth Circuit has held that “the mere publication of inaccurate accounting figures or failure to follow GAAP without more, does not establish scienter.” Rather, “[t]he party must know that it is publishing materially false information, or must be severely reckless in publishing such information.” *Abrams v. Baker Hughes*, __ F.3d __, __, 2002 WL 1018944, *6 (5th Cir. May 21, 2002); *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1020-21 (5th Cir. 1996).

Thus, whether or not Plaintiffs have discharged their burden of pleading scienter depends on whether they have alleged any facts to suggest that Fastow knew the accounting treatment of the transactions complained of was wrong at the time he signed the SEC filings. They have not. Plaintiffs have not pled any facts suggesting that Fastow knew, at the time he signed Enron’s SEC filings, that the filings allegedly did not comply with GAAP or FASB No. 57. Plaintiffs do not allege any facts to suggest that Fastow understood the proper reporting of Enron’s financial information to be anything other than what the SEC filings reflected.

Furthermore, Plaintiffs offer no allegation that Fastow had any special expertise in GAAP or accounting which would have led him to be able to identify the alleged problems with the financial statements. As Plaintiffs hesitatingly acknowledge, GAAP sets forth special rules, which allow companies not to consolidate special purpose entities and/or affiliates in some circumstances. While they accuse Fastow of falsehoods by signing financial reports that improperly consolidated special purpose entities and/or affiliates, Plaintiffs fail to allege any facts to suggest that Fastow knew or believed that

GAAP's special rules were not being followed. "[P]laintiffs point to no specific internal or external report available [to Fastow] at the time of the alleged misstatements that would contradict them." *Abrams*, 2002 WL 1018944 at *6. Indeed, the First Amended Complaint offers no "allegations of actual knowledge or intentional or deliberate behavior" by Fastow in this case. *Id.*

Finally, Plaintiffs allegations of insider trading by Fastow also do not satisfy their burden of pleadings facts to support an inference of scienter. "Only insider trading in suspicious amounts or at suspicious times is probative of scienter." *Id.* (citing *In re: Silicon Graphics Sec. Litig.*, 183 F.3d 970, 975-77 (9th Cir. 1999)). As to Fastow, "Plaintiffs make no allegations that these sales are out of line with prior trading practices or at times calculated to maximize personal profit." *Id.* Aside from the self-serving, conclusory statements of their "expert" Scott Hakala, Plaintiffs make no allegation that suggests Fastow timed his sales of Enron stock to maximize personal profit, ignoring that his last sale occurred nearly a year before the company's collapse and that in the interim, apparently alone among Enron officers, Fastow actually bought Enron stock. Indeed, they make no effort to compare the amount of his sales against his total holdings in Enron stock, a comparison that would be a necessary step in any such evaluation. Plaintiffs offer no pleading regarding Fastow's pre-class period trading, also a necessary step in evaluating whether his trading pattern during the class period differed from his pattern of trading Enron stock prior to the class period. Indeed, the best Mr. Hakala can offer is that Fastow's sales were "more likely than not" made while in possession of material, non-public information. Unfortunately for Plaintiffs, that statement offers no factual allegation that either the timing or amount of Fastow's sales was "suspicious." Mr.

Hakala's analysis impliedly concedes the weakness of the insider trading allegations against Fastow, because it admits that Fastow is the *least likely* of all defendants to have engaged in insider trading.

4. Because Plaintiffs have failed to allege a violation of Rule 10b-5, their claims of control person liability under Section 20(a) and insider trading liability under Section 20A of the 1934 Act fail as well.

The requirement that a plaintiff plead facts to support an inference of scienter applies with the same force to claims under Sections 20(a) and 20A as it does to Rule 10b-5 claims. As one court has explained,

Scienter is an essential element of a § 10(b) or Rule 10b-5 claim. . . . And to prevail on their claims for violations of § 20(a) and § 20A, plaintiffs must first allege a violation of § 10(b) or Rule 10b-5. . . . Absent pleading scienter with particularity, there can be no liability in this case.

Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1035 n.15 (9th Cir. 2002) (citations omitted). Thus, for the reasons stated in Part 3.2 above, Plaintiffs failure to plead scienter adequately dooms their claims for both control person and insider trading liability.

5. Plaintiffs' Section 11 claim fails as a matter of law because they do not plead purchases in Enron's initial offerings of the relevant securities.

Plaintiffs make a claim against Fastow for violation of Section 11 of the Securities Act of 1933. That section provides for liability against certain individuals and entities that sign a registration statement accompanying an initial public offering of securities. To sue under Section 11, Plaintiffs must have purchased their stock in the initial public offering to which the registration statement applied. Plaintiffs do not plead, in the Consolidated Complaint, and do not argue in their Opposition to dismissal, that

they purchased stock in the Company's initial public offering. Accordingly, their Complaint under Section 11 against Fastow must be dismissed.

Section 11 permits "any person acquiring" a security issued pursuant to a registration statement that contains material misstatements to sue certain enumerated defendants, including individuals who signed the registration statement. 15 U.S.C. § 77k(a). As the Court noted in *Irving Rosenzweig v. Azurix Corporation*, 2002 WL 562819 at 58, 59 (and cases cited therein), case law "has limited the term 'any person acquiring such security' to purchasers of shares issued and sold pursuant to the challenged registration statement."

In the Consolidated Complaint, Plaintiffs do not allege they purchased common stock in the initial public offering. Instead, at Paragraph 1014, Plaintiffs claim that "[e]ach of the plaintiffs listed herein and the members of the Offering Subclasses purchased the Enron securities detailed in [the Consolidated Complaint], traceable to a false and misleading Registration Statement." This allegation is not sufficient to bring Plaintiffs within the ambit of persons permitted to sue for a violation of Section 11.

In their Opposition, Plaintiffs do not claim that they purchased common stock in an initial public offering. Rather, Plaintiffs argue the legal point that they are entitled to make a Section 11 claim even though they purchased in the open market. Plaintiffs' arguments run afoul of the Court's decision on this point in *Rosenzweig*.

While this Court wrote in *U. S. Liquids Sec. Litig.*, No. H-99-2785 (S.D. Tex. Apr. 30, 2002) that "all federal courts of appeals that have addressed the question have concluded that a secondary market purchaser who can trace his securities to a registered offering has standing to sue under § 11," Plaintiffs have expanded that holding to mean

that so long as a person buys a security and a company has at one time issued a registration statement that could apply to the security, the purchaser has standing. If that reading of §11 were correct, no difference would exist between a §11 and a Rule §10-b(5) claim, as virtually all securities are issued pursuant to a registration statement at some point in the past. For §11 to apply, the purchaser must trace the security to a registration statement, a hurdle impossible to jump for a purchaser of common stock in the aftermarket. For this reason, plaintiffs' §11 claims with respect to purchase of Enron common stock must be dismissed.

In their Opposition, Plaintiffs seek to amend the Consolidated Complaint by adding and dropping registration statements upon which they sue. They may not do this. *See In re BMC Software*, 183 F.Supp.2d 860, 915 (S.D.Tex. 2001) (“[I]t is axiomatic that the Complaint cannot be amended by the briefs in opposition to a motion to dismiss.”). In the Consolidated Complaint, at Paragraph 1006, Plaintiffs list four registration statements upon which they base their claim. In the Opposition, at page 140, they try to add a fifth registration statement (an offering of 27.6 million shares of common stock with an offering date of 2/11/99), add another claim based on an 11/24/98 offering of \$250 million of 6.95% notes underwritten by CS First Boston, and drop a claim with respect to the 7% Exchangeable Notes. Because Plaintiffs have not pled these claims in any complaint, the Court should not consider them. In addition, the §11 claim against Fastow should be dismissed for the reasons stated in other Defendants' briefs, including that filed on behalf of the Outside Directors.

6. Conclusion

With respect to Plaintiffs' Texas Securities Act claim Fastow requests that the Court dismiss those claims for the reasons stated in the briefs of Kenneth Lay, Jeffrey Skilling, and the Outside Directors. For of the reasons stated in the Reply, in Fastow's Motion to Dismiss, and in the briefs of other Defendants (to the extent they support dismissal against Fastow), Fastow respectfully requests that this Court dismiss Plaintiffs' First Amended Complaint against him.

Respectfully submitted,

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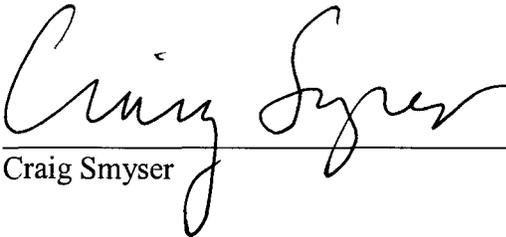
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CERTIFICATE OF SERVICE

This is to certify that on **June 24, 2002**, a true and correct copy of the above and foregoing instrument was served on all counsel listed below in accordance with the Federal Rules of Civil Procedure:

[See attached Service List]


Craig Smyser