UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re:

LEHMAN BROTHERS SECURITIES AND ERISA LITIGATION

This Document Applies To:

In re Lehman Brothers Equity/ Debt Securities Litigation, 08 Civ. 5523 (LAK)

Civil Action 09 MD 2017 (LAK)

MEMORANDUM OF LAW IN SUPPORT OF THE EXECUTIVE DEFENDANTS' MOTION TO DISMISS THE EXCHANGE ACT CLAIMS OF THE SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT

SIMPSON THACHER & BARTLETT LLP
425 Lexington Avenue
New York, New York 10017
(212) 455-2000
Attorneys for Defendants Joseph M. Gregory, Ian Lowitt and Christopher M. O'Meara

ALLEN & OVERY LLP
1221 Avenue of the Americas
New York, NY 10010
(212) 610-6323
Attorneys for Defendant Richard S. Fuld, Jr.

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP
One New York Plaza
New York, New York 10004
(212) 859-8218
Co-Counsel for Defendant Joseph M. Gregory

PROSKAUER ROSE LLP
1585 Broadway
New York, NY 10036
(212) 610-6323
Attorneys for Defendant Erin Callan

Dated: April 27, 2009

TABLE OF CONTENTS

Page

PRELIMINARY STATEMENT 1

FACTUAL BACKGROUND 6

A. Plaintiffs' Claims 6

B. Lehman's Growth And The Concomitant And Disclosed Risks 8

C. Lehman's Mortgage Business And Real Estate Asset Concentration 10

D. The Inherent – And Disclosed – Limitations Of Risk Mitigation Techniques 14

E. The Onset Of The Credit Crisis 16

F. Lehman Is Destroyed By A Classic Run On The Bank 22

ARGUMENT 26

I. THE EXCHANGE ACT CLAIMS SHOULD BE DISMISSED (COUNTS IV, V & VI) 26

A. The Legal Standard 26

B. The SAC Does Not Adequately Allege Any Material Misstatements Or Omissions 27

1. The Heightened Standard Of The Reform Act 27

2. The Exchange Act Claims Against Defendant Gregory Who Made None Of The Challenged Statements Should Be Dismissed 27

C. The SAC Does Not Adequately Allege Scienter 28

1. Plaintiffs Cannot Meet Their Burden Under Rule 9(b) And The Reform Act 28

2. The SAC Fails To Allege Motive Through "Insider Trading" 31

3. There Is No Circumstantial Evidence Of Scienter 37

a. The SAC Improperly Alleges Fraud Or Reckless Conduct By Hindsight 37

b. The SAC Fails To Plead That The Executive Defendants Received Facts Contradicting Their Public Statements 41

(1) Allegations Of Scienter Based On The Executive Defendants' Respective Positions At Lehman Are Insufficient 42

(2) Vague Allegations Of Internal Reports That Do Not Contradict The Executive Defendants' Statements Do Not Plead Scienter 42

(3) Allegations By Employees With No Contact With Executive Defendants Cannot Impute Scienter 44

(4) Plaintiffs' Allegations Regarding Valuations And Accounting Methods Fail To Plead Scienter 50

4. The Most Logical Inference Is That The Executive Defendants Were Merely Responding To Unforeseen Market Conditions 54

D. Plaintiffs Do Not Plead Loss Causation 55

1. The Decline In Lehman's Stock Price Did Not Follow Any Corrective Disclosure 56

2. Plaintiffs' Losses Were Caused By Unforeseen And Uncontrollable Market Forces, Not Alleged Misstatements Or Omissions 59

3. The SAC Fails To Apportion Losses Between The Disclosed And Allegedly Concealed Information 60

E. Plaintiffs' §§ 20(a) And 20A Claims Should Be Dismissed 63

CONCLUSION 64

TABLE OF AUTHORITIES

Cases

Acito v. IMCERA Group, 47 F.3d 47 (2d Cir. 1995) 32, 34, 35

Atl. Gypsum Co., Inc. v. Lloyds Int'l Corp., 753 F. Supp. 505 (S.D.N.Y. 1990) 30

ATSI Commc'ns Inc. v. Shaar Fund, Ltd., 493 F.3d 87 (2d Cir. 2007) 28, 63

Bastian v. Petren Res. Corp., 892 F.2d 680 (7th Cir. 1990) 59

Beck v. Mfrs. Hanover Trust Co., 820 F.2d 46 (2d Cir. 1987) 37

Caiafa v. Sea Containers Ltd., 525 F. Supp. 2d 398 (S.D.N.Y. 2007) 51, 52

Chill v. Gen. Elec. Co., 101 F.3d 263 (2d Cir. 1996) 45

Ciresi v. Citicorp., 782 F. Supp. 819 (S.D.N.Y. 1991) 31, 38

City of Brockton Ret. Sys. v. Shaw Group Inc., 540 F. Supp. 2d 464 (S.D.N.Y. 2008) 28, 33

Coronel v. Quanta Capital Holdings Ltd., No. 07 Civ. 1405 (RPP), 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009) 38

Cozzarelli v. Inspire Pharms., Inc., 549 F.3d 618, 628 n.2 (4th Cir. 2008) 53

Davidoff v. Farina, No. 04 Civ. 7617, 2005 WL 2030501 (S.D.N.Y. Aug. 22, 2005) 30, 51

Decker v. Massey-Ferguson, Ltd., 681 F.2d 111 (2d Cir. 1982) 52

Denny v. Barber, 576 F.2d 465 (2d Cir. 1978) 5, 39, 55

Druskin v. Answerthink, Inc., 299 F. Supp. 2d 1307 (S.D. Fl. 2004) 47

Dura Pharm., Inc. v. Broudo, 127 S.Ct. 1627, 544 U.S. 336 (2005) 26, 55, 56, 58

ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187 (2d Cir. 2009) 29, 63

Fadem v. Ford Motor Co., 352 F. Supp. 2d 501 (S.D.N.Y. 2005), *aff'd*, 157 Fed. App'x 398 (2d Cir. 2005) 30, 53

First Nat'l Bank v. Gelt Funding Corp., 27 F.3d 763 (2d Cir. 1994) 59

Fraternity Fund Ltd. v. Beacon Hill Asset Mgm't LLC, 376 F. Supp. 2d 385 (S.D.N.Y. 2005) (Kaplan, J.) 52

Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736 (9th Cir. 2008) 54

Hershfang v. Citicorp, 767 F. Supp. 1251 (S.D.N.Y. 1991) 38

Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753 (7th Cir. 2007) 49

In re 2007 Novastar Financial, Inc. Sec. Litig., No. 07-0139-CV-W-ODS, 2008 WL 2354367 (W.D. Mo. June 4, 2008) 2, 39, 41, 42

In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999) 37

In re Aegon N.V. Sec. Litig., No. 03 Civ. 0603 (RWS), 2004 WL 1415973 (S.D.N.Y. June 23, 2004)... 39, 55

In re Am. Express Co. Sec. Litig., No. 02 Civ. 5533, 2008 WL 4501928 (WHP) (S.D.N.Y. Sept. 26, 2008) 45, 52

In re Astea Int'l Inc. Sec. Litig., No. 06-1467, 2007 WL 2306586 (E.D. Pa. Aug. 9, 2007) 32

In re Bausch & Lomb, Inc. Sec. Litig., 529 F. Supp. 2d 323 (W.D.N.Y. 2008) 33

In re Bisys Sec. Litig., 397 F. Supp. 2d 430 (S.D.N.Y. 2005) 33, 51

In re Bristol-Myers Squibb Sec. Litig., 312 F. Supp. 2d 549 (S.D.N.Y. 2004) 34

In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009) 40

In re Citigroup, Inc. Sec. Litig., 330 F. Supp. 2d 367 (S.D.N.Y. 2004)....................................... 42

In re Comshare Inc. Sec. Litig., No. 96-73711-DT, 1997 WL 1091468 (Sept. 18, 1997 E.D. Mich.) 35

In re Corning Inc. Sec. Litig., No. 04-2845-CV, 2005 WL 714352 (2d Cir. Mar. 30, 2005) 30

In re Credit Acceptance Corp. Sec. Litig., 50 F. Supp. 2d 662 (E.D. Mich. 1999) 33, 35

In re Diebold Sec. Litig., No. 5:05CV2873, 2008 WL 3927467 (N.D. Ohio Aug. 22, 2008) 46

In re Downey Sec. Litig., No. CV 08-3261-JFW, 2009 WL 736802 (C. D. Cal. Mar. 18, 2009) 57

In re Dura Pharm., Inc. Sec. Litig., No. 99CV0151-L(NLLS), 2000 WL 33176043 (S.D. Cal. July 11, 2000) 32

In re Elan Corp. Sec. Litig., 543 F. Supp. 2d 187 (S.D.N.Y. 2008) 36, 46

In re Health Mgmt. Sys., Inc. Sec. Litig., 97 Civ. 1865, 1998 WL 283286 (S.D.N.Y. June 1, 1998) 42

In re Initial Pub. Offering Sec. Litig., 399 F. Supp. 2d 298 (S.D.N.Y. 2005) 62

In re Initial Pub. Offering Sec. Litig., 544 F. Supp. 2d 277 (S.D.N.Y. 2008) 60

In re KeySpan Corp. Sec. Litig., 383 F. Supp. 2d 358 (E.D.N.Y. 2003) 32, 35

In re LaBranche Sec. Litig., 405 F. Supp. 2d 333 (S.D.N.Y. 2005) 42

In re Merrill Lynch & Co., Research Reports Sec. Litig., 272 F. Supp. 2d 243, 263 (S.D.N.Y. 2003) 30

In re Merrill Lynch & Co. Research Reports Sec. Litig., No. 02 CIV 9690, 2008 WL 2324111 (S.D.N.Y. June 4, 2008) 59

In re Merrill Lynch & Co., Inc., 273 F. Supp. 2d 351 (S.D.N.Y. 2003) 2

In re Nokia Oyj (Nokia Corp.) Sec. Litig., 423 F. Supp. 2d 364 (S.D.N.Y. 2006) 44

In re NVE Corp. Sec. Litig., 551 F. Supp. 2d 871 (D. Minn. 2007) 34

In re Omnicom Group, Inc. Sec. Litig., 541 F. Supp. 2d 546 (S.D.N.Y. Jan. 29, 2008) 56

In re Pfizer, Inc. Sec. Litig., 538 F. Supp. 2d 621 (S.D.N.Y. 2008) 28

In re Polaroid Corp. Sec. Litig., 134 F. Supp. 2d 176 (D. Mass. 2001) 52

In re PXRE Group Ltd., No. 06 Civ. 3410 (RJS), 2009 WL 539864 (S.D.N.Y. Mar. 4, 2009) 51

In re Radian Secs. Litig., No. 07-3375, 2009 WL 974324 (E.D. Pa. Apr. 9, 2009) 40

In re Rhodia S.A. Sec. Litig., 531 F. Supp. 2d 527 (S.D.N.Y. 2007) 55, 56, 57

In Re Scholastic Corp. Sec. Litig., 252 F.3d 63 (2d Cir. 2001) 31

In re Sina Corp. Sec. Litig., No. 05 Civ. 2154, 2006 WL 2742048 (S.D.N.Y. Sept. 26, 2006) 2, 34

In re Sotheby's Holdings, Inc., No. 00 Civ. 1041(DLC), 2000 WL 1234601 (S.D.N.Y. Aug. 31, 2000) 42

In re Take-Two Interactive Sec. Litig., 551 F. Supp. 2d 247 (S.D.N.Y. 2008) 63

In re The Warnaco Group, Inc. Sec. Litig., 388 F. Supp. 2d 307 (S.D.N.Y. 2005) 62

In re Time Warner Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993) 28

In re Vantive Corp. Sec. Litig., 283 F.3d 1079 (9th Cir. 2002) 32

In re Winstar Communications, No. 01 CV 3014, 2006 WL 473885 (S.D.N.Y. Feb. 27, 2006)... 56

In re WorldCom, Inc. Sec. Litig., No. 02 CV 3288, 2005 WL 375314 (S.D.N.Y. Feb. 17, 2005)... 56

Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527 (5th Cir. 2008)...49, 52, 54

Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., 32 F.3d 697 (2d Cir. 1994 63

Kalnit v. Eichler, 264 F.3d 131 (2d Cir. 2001) 29, 36, 37

Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147 (2d Cir. 2007) 58, 62

Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005)..55, 56, 62

Leykin v. AT&T Corp., 423 F. Supp. 2d 229 (S.D.N.Y. 2006) 58

Malin v. XL Capital, Ltd., 499 F. Supp. 2d 117 (D. Conn. 2007) *aff'd*, 2009 WL 481897.. 47

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S.Ct. 1503, 547 U.S. 71 (2006) 26

Mills v. Polar Molecular Corp., 12 F.3d 1170 (2d Cir. 1993).. 27

Mills v. Polar Molecular Corp., Nos. 91 Civ. 0249, 91 Civ. 0902, 1992 WL 309592 (S.D.N.Y. Oct. 14, 1992)... 48

Mizzaro v. Home Depot Inc., 544 F.3d 1230 (11th Cir. 2008) 46

Patel v. Parnes, No. CV 07-05364 MMM, 2008 WL 2803076 (C.D. Cal. May 19, 2008) 44

Pittleman v. Impac Mortgage Holdings, Inc., No. SACV 07-0970 AG, 2009 WL 648983 (C.D. Cal. Mar. 9, 2009)... 40, 48

Powers v. British Vita. P.L.C., 57 F.3d 176 (2d Cir. 1995).. 59

Ressler v. Liz Claiborne Inc., 75 F. Supp. 2d 43 (E.D.N.Y. 1999) 34

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978)... 37

Rombach v. Chang, 355 F.3d 164 (2d Cir. 2004) 27, 33

Ronconi v. Larkin, 253 F.3d 423 (9th Cir. 2001) 48

Rothman v. Gregor, 220 F.3d 81 (2d Cir. 2000) 31, 37

San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801 (2d Cir. 1996) 34

Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 97 S.Ct. 1292 (1977) 30

SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996) 63

SEC v. Price Waterhouse, 797 F. Supp. 1217 (S.D.N.Y. 1992) 53

Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124 (2d Cir. 1994) ..... passim

Shufkin v. Golden State Vintners, Inc., 471 F. Supp. 2d 998 (N.D. Cal. 2006) 46

Steinberg v. Ericsson LM Tel. Co., No. 07 CV 9615 (RPP), 2008 WL 5170640 (S.D.N.Y. Dec. 10, 2008) 44, 45, 51

Stevelman v. Alias Research, Inc., 174 F.3d 79 (2d Cir. 1999) 51

Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190 (2d Cir. 2008) 41

Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S. Ct. 2499 (2007) 6, 26, 28, 49

Tripp v. IndyMac Financial Inc. 39

Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981 (9th Cir. 2009) 48, 53

Statutes and Rules

Securities and Exchange Act of 1934 § 20A 7, 63

Securities and Exchange Act of 1934 § 10(b) ..... *passim*

Securities and Exchange Act of 1934 § 20(a) ..... *passim*

Private Securities Litigation Reform Act 26, 28

Fed. R. Civ. P. 9(b) 26, 27

SEC Regulation S-K, Item 305, Quantitative and Qualitative Disclosures About Market Risk, 17 C.F.R. § 229.305 (2008) 15

SEC Rule 10b-5 of the Exchange Act 6, 26, 27, 63

Securities Act of 1933 § 11 7

Securities Act of 1933 § 12(a)(2) 7

Securities Act of 1933 § 15 7

Other Authorities

Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rules: Differences in Hindsight Bias*, 73 Or. L. Rev. 587 (1994) 38

ABBREVIATIONS & DEFINED TERMS

ABBREVIATION	DESCRIPTION	EXHIBIT
	Lehman Brothers Holdings Inc. Exchange Act Filings	
2006 10-K	Lehman Brothers Holdings Inc. Annual Report on Form 10-K for the fiscal year ending November 30, 2006 (filed with the SEC on February 13, 2007)	17
2007 Proxy St.	Lehman Brothers Holdings Inc. 2007 Proxy Statement on Form DEF 14A (filed with the SEC on February 26, 2007)	64
2007 1Q Report	Lehman Brothers Holdings Inc. Quarterly Report on Form 10-Q for the quarter ending February 28, 2007 (filed with the SEC on April 9, 2007)	21
2007 2Q Report	Lehman Brothers Holdings Inc. Quarterly Report on Form 10-Q for the quarter ending May 31, 2007 (filed with the SEC on July 10, 2007)	19
2007 3Q Report	Lehman Brothers Holdings Inc. Quarterly Report on Form 10-Q for the quarter ending August 31, 2007 (filed with the SEC on October 10, 2007)	32
8/22/07 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on August 22, 2007)	39
9/6/07 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on September 6, 2007)	40
2007 10-K	Lehman Brothers Holdings Inc. Annual Report on Form 10-K for the fiscal year ending November 30, 2007 (filed with the SEC on January 29, 2008)	18
1/17/08 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on January 17, 2008)	41
2008 Proxy St.	Lehman Brothers Holdings Inc. 2008 Proxy Statement on Form DEF 14A (filed with the SEC on March 5, 2008)	65
3/18/08 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on March 18, 2008)	23
2008 1Q Report	Lehman Brothers Holdings Inc. Quarterly Report on Form 10-Q for the quarter ending February 29, 2008 (filed with the SEC on April 9, 2008)	33

6/9/08 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on June 9, 2008)	73
6/16/08 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on June 16, 2008)	27
2008 2Q Report	Lehman Brothers Holdings Inc. Quarterly Report on Form 10-Q for the quarter ending May 31, 2008 (filed with the SEC on July 10, 2008)	34
9/10/08 8-K	Lehman Brothers Holdings Inc. Current Report on Form 8-K (filed with the SEC on September 10, 2008)	74
Conference Call Transcripts		
2007 1Q Call	Transcript of Lehman Brothers Holdings Inc. First Quarter 2007 Earnings Conference Call (March 14, 2007)	24
2007 2Q Call	Transcript of Lehman Brothers Holdings Inc. Second Quarter 2007 Earnings Conference Call (June 12, 2007)	25
2007 3Q Call	Transcript of Lehman Brothers Holdings Inc. Third Quarter 2007 Earnings Conference Call (September 18, 2007)	42
2007 4Q Call	Transcript of Lehman Brothers Holdings Inc. Fourth Quarter 2007 Earnings Conference Call (December 13, 2007)	31
2008 1Q Call	Transcript of Lehman Brothers Holdings Inc. First Quarter 2008 Earnings Conference Call (March 18, 2008)	35
2008 Pr. 2Q Call	Transcript of Lehman Brothers Holdings Inc. Preliminary Second Quarter 2008 Earnings Conference Call (June 9, 2008)	51
2008 2Q Call	Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Conference Call (June 16, 2008)	36
2008 Pr. 3Q Call	Transcript of Lehman Brothers Holdings Inc. Preliminary Third Quarter 2008 Earnings Conference Call (September 10, 2008)	50
Forms 3 & 4		
Fuld Forms 4	Richard S. Fuld, Jr. SEC Forms 4 (filed with the SEC on September 18, 2006); Richard S. Fuld, Jr. SEC Forms 4 (filed with the SEC on July 26, 2006); Richard S. Fuld, Jr. SEC Form 4 (filed with the SEC on July 24, 2006); Richard S. Fuld, Jr. SEC Form 4 (filed with the SEC on March 20, 2006)	67

Lowitt Form 4	Ian Lowitt SEC Form 4 (filed with the SEC on December 4, 2007)	69
O'Meara Form 4	Christopher O'Meara SEC Form 4 (filed with the SEC on December 4, 2007)	68
Callan Form 3	Erin Callan SEC Form 3 (filed with the SEC on December 1, 2007)	70
Callan Forms 4	Erin Callan SEC Form 4 (filed with the SEC on December 7, 2007); Erin Callan SEC Form 4 (filed with the SEC on February 9, 2008)	71
Prospectus & Prospectus Supplements		
11/13/06 Pro.	Structured Asset Securities Corporation, Greenpoint Mortgage Funding Trust 2006-AR7, Free Writing Prospectus to September 13, 2006 Prospectus (filed with the SEC on November 13, 2006)	30
1/24/07 FWP	Structured Asset Securities Corporation Free Writing Prospectus to November 13, 2006 Prospectus (filed with the SEC on January 25, 2007)	28
7/2/07 Pro. Supp.	Structured Asset Securities Corporation Prospectus Supplement to May 22, 2007 Prospectus (filed with the SEC on July 2, 2007)	29
4/4/08 Pro. Supp.	Lehman Brothers Holdings Inc. Prospectus Supplement to May 30, 2006 Prospectus (filed with the SEC on April 4, 2008)	47
6/9/08 Preferred Pro. Supp.	Lehman Brothers Holdings Inc. Preferred Prospectus Supplement to May 30, 2006 Prospectus (filed with the SEC on June 9, 2008)	48
6/9/08 Common Pro. Supp.	Lehman Brothers Holdings Inc. Common Prospectus Supplement to May 30, 2006 Prospectus (filed with the SEC on June 9, 2008)	49
Defined Terms		
Am. Nat'l Compl.	Complaint filed in *Am. Nat'l Ins. Co., et al. v. Fuld, et al.*, No. 09-CV-00020 (S.D. Tex.)	
CW	Confidential Witness	

Class Period	Between February 13, 2007 and September 15, 2008	
Defendants	Individual Defendants and Underwriter Defendants	
Director Defendants	Michael L. Ainslie, John F. Akers, Roger S. Berlind, Thomas H. Cruikshank, Marsha Johnson Evans, Sir Christopher Gent, Roland A. Hernandez, Henry Kaufman and John D. Macomber	
Exchange Act	Securities Exchange Act of 1934	
Exchange Act Period	Between June 12, 2007 and September 15, 2008	
Executive Defendants	Former Chairman and Chief Executive Officer Richard S. Fuld, Jr., former President and Chief Operating Officer Joseph Gregory and former Chief Financial Officers Erin Callan, Ian Lowitt and Christopher O'Meara	
Rule 9(b)	Federal Rule of Civil Procedure 9(b)	
Fremont Compl.	Complaint filed in *City of Fremont v. Citigroup Global Markets, Inc., et al.*, No. 09-cv-00926 (N.D. Cal. filed Feb. 24, 2009)	
Individual Defendants	Michael L. Ainslie, John F. Akers, Roger S. Berlind, Erin Callan, Thomas H. Cruikshank, Marsha Johnson Evans, Richard S. Fuld, Jr., Sir Christopher Gent, Joseph M. Gregory, Roland A. Hernandez, Henry Kaufman, Ian Lowitt, John D. Macomber and Christopher O'Meara	
Initial Compl.	Initial Amended Class Action Complaint in *In re Lehman Brothers Equity/ Debt Securities Litigation*, No. 08 Civ. 5523 (LAK)	
Lehman	Lehman Brothers Holdings Inc.	
Reform Act	Private Securities Litigation Reform Act	
SAC	Second Amended Consolidated Class Action Complaint dated February 23, 2009	
SEC	U.S. Securities & Exchange Commission	
Securities Act	Securities Act of 1933	

Securities Act Motion	Memorandum of Law in Support of Defendants' Motion to Dismiss Plaintiffs' Securities Act Claims in the Second Amended Consolidated Class Action Complaint	
Solton Compl.	Complaint filed in *Solton v. Fuld, et. al.*, No. 08-CV-5617 (N.D. Cal. filed Dec. 1, 2008)	
Underwriter Defendants	All Defendants other than the Individual Defendants	

"I think that every regulator wishes that he or she had been able to predict the unprecedented meltdown of the entire US mortgage market."

– Christopher Cox
Chairman, SEC, Oct. 24, 2008[1]

"By any measure, this downturn represents by far the deepest global recession since the Great Depression."

- International Monetary Fund
April 2009[2]

"There was no playbook for responding to a once or twice in a hundred year event."

- Henry M. Paulson, Jr.
Nov. 20, 2008[3]

PRELIMINARY STATEMENT

In 2007, despite some signs of trouble in the subprime sector of the residential mortgage market, the consensus of then-Treasury Secretary Henry M. Paulson, Jr., Federal Reserve Chairman Ben S. Bernanke, the International Monetary Fund and many others was that the problems in the subprime market were "containable."[4] In 2008, however, a series of unexpected events unfolded: Bear Stearns, Merrill Lynch and Wachovia were sold for prices unimaginable

---

1 Michael Rowland, *Greenspan Grilled Over Credit Crisis*, Lateline, Oct. 24, 2008, *transcript available at* http://www.abc.net.au/lateline/content/2008/s2400968.htm (Ex. 4). All exhibit references herein are to exhibits accompanying the Declaration of Michael J. Chepiga in Support of the Executive Defendants' Motion to Dismiss the Exchange Act Claims of the Second Consolidated Class Action Complaint.

2 International Monetary Fund, *World Economic Outlook: Crisis and Recovery*, April 2009 (Ex. 5) at 9.

3 Press Release, U.S. Treasury, Remarks by Secretary Henry M. Paulson, Jr. at The Ronald Reagan Presidential Library (Nov. 20, 2008), http://www.treas.gov/press/releases/hp1285.htm (last visited April 25, 2009) (Ex. 77).

4 *See*, *e.g.*, Ex. 2 at Tab 16 (Paulson stating on July 23, 2007, "I don't deny there's a problem with subprime mortgages, but I really do believe that's containable."); *id*. at Tab 8 (Bernanke stating on March 28, 2007 that the "impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."); *id*. at Tab 9 (IMF reporting in April 2007 that "most investors with exposure to subprime mortgages through securitized structures will not face losses").

just weeks earlier;[5] two of the country's biggest banks, IndyMac and Washington Mutual, failed;[6] and Fannie Mae and Freddie Mac were placed into government conservatorship.[7] But even as late as mid-June 2008, former Federal Reserve Chairman Alan Greenspan believed that "[t]he worst is over in the financial crisis or will be very soon," and one month **later** Paulson stated that he "expect[ed] our economy to continue growing this year although at a moderate pace."[8] Financial leaders around the world failed to foresee the depth and breadth of the financial crisis. *See* Exhibit 2 (collecting statements, e.g., Paulson stating one month before Fannie Mae and Freddie Mac were placed into government conservatorship, "We have no plans to insert money into either of those two institutions.").[9]

---

5 J.P. Morgan Chase & Co., Current Report (Form 8-K) (Mar. 24, 2008) (Ex. 6) at 1; Bank of America Corp., Current Report (Form 8-K) (Sept. 15, 2008) Ex. 99.1 (Ex. 7) at 1; Wells Fargo & Co., Current Report (Form 8-K) (Oct. 3, 2008) Ex. 2.1 (Ex. 8) at 1.

6 Press Release, FDIC, FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California (July 11, 2008), http://www.fdic.gov/news/news/press/2008/pr08056.html (last visited Apr. 24, 2009) (Ex. 9); J.P. Morgan Chase & Co., Current Report (Form 8-K) (Sept. 25, 2008) (Ex. 10) at 1.

7 Statement of Federal Housing Finance Agency Director James B. Lockhart, Federal Housing Finance Agency Release, Sept. 7, 2008 *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf (Ex. 11).

8 Ex. 2 at Tab 27; *id*. at Tab 31. These statements and others like them by financial leaders are presented for the fact that they were made, not for their truth. *See*, *e.g.*, *In re Merrill Lynch & Co.,* 273 F. Supp. 2d 351, 383 n.3 (S.D.N.Y. 2003) (stating that on a motion to dismiss a court may take judicial notice of newspaper articles for "the fact of their publication"). Market phenomena such as the collapse of the mortgage industry and related economic events and stock price movements are appropriate subjects for judicial notice. *See*, *e.g*, *id*. at 421 n.6 (taking judicial notice of crash of internet bubble); *In re 2007 Novastar Financial, Inc. Sec. Litig.*, No. 07-0139-CV-W-ODS, 2008 WL 2354367 (W.D. Mo. June 4, 2008) (taking judicial notice of events in current financial crises); *In re Sina Corp. Sec. Litig.*, No. 05 Civ. 2154, 2006 WL 2742048, at *13 n.16 (S.D.N.Y. Sept. 26, 2006) (stating court may take judicial notice on motion to dismiss of stock prices).

9 *See also id*. at Tab 29 (Chairman Bernanke stating on July 16, 2008, "The GSEs [Fannie Mae and Freddie Mac] are adequately capitalized. They are in no danger of failing.").

Within weeks of Lehman's demise on September 15, 2008, the extent of the crisis began to be realized. In October 2008, Congress enacted a $700 billion bailout of the financial industry, and over the last six months the federal government has promised $170 billion in rescue funds to one of the world's largest financial institutions, AIG.[10] As Greenspan observed shortly after Lehman's bankruptcy, "We are in the midst of a once-in-a century credit tsunami. . . . This crisis, however, has turned out to be much broader than anything I could have imagined."[11]

A natural result of the crisis has been losses to investors and others, with inevitable finger-pointing. In response to the ongoing financial meltdown, literally hundreds of securities actions have been filed to date across the country, and more are filed every day. *See* Exhibit 1 (collecting over **520** similar cases). The sheer volume of these actions is telling, as is the similarity of their allegations – some variation on the theme that defendants failed to disclose their subprime or credit risk exposure and/or react quickly enough to rapidly unfolding events. *Id.* It defies common sense that scores of banks, mortgage lenders, insurance companies and other financial institutions in the United States and abroad intentionally (but independently) committed the same fraud at the same time. In reality, the more cogent explanation is that the mortgage and financial markets unexpectedly collapsed and these companies were caught in – to use the words of Chairman Greenspan – something "much broader than anything I could have imagined."

Among the casualties of the financial meltdown was Lehman. Due to events beyond its control, counterparties and other firms pulled back within a few days from doing business with

---

[10] Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. Times, Oct. 23, 2008 (cited by SAC ¶ 315) (Ex. 12).

[11] *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Congress (Oct. 23, 2008) (testimony of Dr. Alan Greenspan) (Ex. 13) at 1.

Lehman, causing the proverbial "run on the bank." And while the federal government had before, and has since, come to the rescue of similarly situated financial institutions, it did not provide assistance to Lehman at the critical moment it was needed. As a result, Lehman filed for bankruptcy. Four days later, Bankruptcy Judge James M. Peck observed at the close of a late-night hearing, "Lehman Brothers became a victim. In effect, the only true icon to fall in the tsunami that has befallen the credit markets. And it saddens me."[12]

With the benefit of hindsight, Plaintiffs cry fraud. But Plaintiffs plead no cognizable claims. The SAC does not satisfy the rigorous requirements for securities fraud pleadings set forth in Rule 9(b) and the Reform Act.[13] At most, Plaintiffs have simply alleged that, like virtually every other major financial institution, Lehman and the Defendants failed to foresee what Bernanke and others also did not foresee and have deemed the worst financial crisis since the Great Depression. Courts have already rejected similar efforts to convert substantial securities price declines following market dislocations into securities fraud claims. These decisions have recognized that the inability of defendants (like those here) to shield themselves as effectively as they had anticipated from drastic changes in the mortgage and capital markets does not constitute fraud.

The SAC fails to plead any material misstatement or omission. It fails to satisfy the stringent pleading standard that requires it to identify the speaker, where and when the statements were made and why they were fraudulent. Critically, the SAC does not allege facts to create a strong inference that each separate Executive Defendant acted with the required state of

---

[12] Transcript of Hearing, *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 19, 2008) (Ex. 14) at 248.

[13] The SAC is attached as Ex. 15.

mind. Moreover, the SAC ignores the voluminous disclosures that Lehman and the Defendants made throughout the Exchange Act Period.

As detailed in the Securities Act Motion, which is incorporated by reference herein, Lehman and the Executive Defendants disclosed the extent of Lehman's exposure to real estate and mortgage investment holdings, the risk of originating subprime loans and the methodology behind the Company's valuations and writedowns of its assets.[14] In the midst of unprecedented turmoil and illiquid markets, Lehman made judgments about how to value assets and take writedowns – facts that were fully disclosed to the market. The Company also informed investors of its risk management and hedging strategies – and the possibility that they might not work – as well as the risks of illiquidity and insolvency. Lehman's public filings made clear that the Company's hedging strategies were subject to judgments about timing and duration of their application, and that it would be impossible for Lehman to anticipate every event that might impact their effectiveness or for its risk strategies to be completely effective forever. Lehman consistently updated its disclosures and risks with the information available as time moved on. At its core, the SAC simply alleges a disagreement, with the benefit of hindsight, with Lehman's handling of an unprecedented real estate and credit meltdown.

The SAC fails to plead scienter because, among other things, it fails to account for the stunning scale of the mortgage and larger financial crisis. It is not fraud to fail to foresee the unforeseeable. *See Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978) (finding defendant's lack of "clairvoyance" to anticipate economic crisis of the 1970s is "fraud by hindsight," not securities fraud). In addition, that the Executive Defendants actually **held or increased** their

[14] *See, e.g.*, Securities Act Motion's discussion of the valuation of Lehman's mortgages and mortgage-related assets, amount of mortgage-related assets, Lehman's concentration of credit risks, the quality of underlying mortgages and loan applications, Lehman's risk management and the sufficiency of Lehman's capital and liquidity.

Lehman stock holdings during the period relevant to the claims affirmatively disproves scienter. Increasing stock ownership would have made no sense if those officers believed the stock's price was artificially inflated or the Company was in a precarious financial condition. The only "compelling" inference is that Lehman and the Executive Defendants – like so many others – were swept up in a market-wide downturn that was simply not understood at the time. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 2504-05 (2007).

The SAC also fails to plead loss causation. The decline in the stock price occurred amid a broad real estate and credit crisis, with many other financial firms' market capitalization experiencing similar erosion. The stock price of firms included in the S&P 500 Financial Sector Index dropped nearly 50% during the relevant period.[15] Moreover, the SAC fails to link the declines in price of Lehman's securities with any corrective disclosures. The statements that Plaintiffs allege caused those declines simply disclosed the advent of financial hardship for the Company and the world. Stock price declines in response to the disclosure of bad news do not suffice to show that an investor's losses were caused by securities fraud.

FACTUAL BACKGROUND

A. Plaintiffs' Claims

Plaintiffs assert claims in this action on behalf of themselves and a putative class of investors who purchased Lehman debt and equity securities between February 13, 2007 and September 15, 2008 (the "Class Period"). Their claims under §§ 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5, however, are asserted only on behalf of those who purchased Lehman common stock and call options and/or sold put options between June 12, 2007 and September 15, 2008 (the "Exchange Act Period"), and only against former Chairman

[15] Chart of S&P 500 Financial Sector Index from June 12, 2007 to September 15, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on April 27, 2009) (Ex. 16).

and CEO Richard S. Fuld, Jr., former President and COO Joseph Gregory, and former CFOs Christopher O'Meara, Erin Callan and Ian Lowitt (the "Executive Defendants").[16] Plaintiffs also bring a claim against Fuld under § 20A. Plaintiffs allege that the Defendants issued misleading disclosures concerning (i) the high-risk nature of Lehman's mortgage business; (ii) the concentration of its real estate-related assets in risky assets; (iii) the value of its real estate-related assets (by failing to make timely and adequate writedowns of those assets); (iv) its risk management and hedging capabilities; and (v) its capitalization, liquidity and risk of insolvency. The core theme of the SAC is that the purpose of these misleading disclosures was to enable Lehman to continue raising capital through securities offerings and the Underwriter Defendants to continue earning fees and commissions from those offerings. None of these allegations is sustainable.

Investors knew that Lehman had substantial exposure to mortgage-related assets and securitizations. Investors also knew that Lehman relied in part on hedging strategies to mitigate potential losses in these asset areas and others. Indeed, Lehman disclosed its leadership position in the mortgage securitization business, its large and increasing portfolio of real estate assets, how its valuations worked, its hedging strategies and their limitations and the growing impact of the real estate and credit crises. Moreover, as economic conditions grew more turbulent, Lehman consistently updated its investors with the information available to it at the time and reported the actions the Company was taking to address these evolving conditions. Such

[16] Plaintiffs also allege that Fuld, O'Meara and Callan, as well as the Director Defendants and Underwriter Defendants, violated Section 11 of the Securities Act in connection with public offerings of Lehman preferred and common stock and bonds during the Class Period, that Fuld, O'Meara, Gregory, Callan and Lowitt violated Section 15 of the Securities Act, and that the Underwriter Defendants violated Section 12(a)(2) of that Act. These claims are addressed in the Securities Act Motion. To the extent any of the arguments in that Motion bear on this motion to dismiss, those arguments are hereby incorporated by reference.

disclosures included the impact of the rapidly changing real estate and credit markets on the effectiveness of Lehman's hedging strategies, which had initially cushioned the Company from the economic downturn, but by the Company's second quarter 2008, no longer served to offset losses. These disclosures also included any changes in the valuation of Lehman's assets, how much Lehman was taking in writedowns and why. Against this backdrop, Plaintiffs cannot identify any statement regarding Lehman's exposure to mortgage related assets or securitizations that was untrue at the time it was made or any basis for claiming that additional disclosures were required.

B. Lehman's Growth And The Concomitant And Disclosed Risks

Lehman was founded in 1850. With 28,000 employees working across 68 offices in over 28 countries by 2007, Lehman was well established as a premier global financial institution providing "a full array of equity and fixed income sales, trading and research, investment banking services and investment management and advisory services." 2006 10-K (Ex. 17) at 3.[17] Because Lehman was a global investment bank, "risk [was] an inherent part of [its] business." 2007 10-K (Ex. 18) at 14. And, like other financial institutions, Lehman was vulnerable to changes in worldwide economic conditions. Both before and during the relevant period, Lehman's public filings discussed its vulnerability to deterioration in one or more markets, including real estate.[18]

---

17 Lehman's fiscal year ends on November 30.

18 *E.g.*, 2007 2Q Report (Ex. 19) at 70 ("unexpected large or rapid movements or disruptions in one or more markets or other unforeseen developments could have an adverse effect on the results of our operations and on our financial condition."); 2007 10-K (Ex. 18) at 15 ("[f]urther declines in real estate values in the U.S. or elsewhere and continuing credit and liquidity concerns could further reduce our level of mortgage loan originations and securitizations and increase our mortgage inventory while adversely affecting its value").

In the four years leading up to the Class Period, Lehman's assets under management grew from $120 billion to $282 billion, net revenues more than doubled from $8.65 billion to $19.25 billion, and net assets increased from $163 billion to $373 billion. This growth was fueled by the use of leverage to fund these activities.[19] Lehman's shareholders benefited in the years leading up to the Class Period as the Company's stock price soared from $32 on January 2, 2001 to $78 on December 29, 2006.[20]

Throughout 2007, Lehman's disclosures emphasized its reliance on leverage and outside financing.[21] Lehman explained that it "rel[ied] on external sources to finance a significant portion of [its] day-to-day operations" and "utilize[d] cash capital to provide financing for [its] long-term funding needs," and that its "policy [was] to operate with an excess of long-term funding sources. . . [and] to maintain a cash capital surplus" of at least several billion dollars. 2007 10-K (Ex. 18) at 57-58, 60. Lehman also disclosed that, as a regulated entity, it was subject to minimum capital requirements that obligated it to raise and maintain significant capital reserves. *See* 2006 10-K (Ex. 17) at 13, 16 and 106–07.

---

[19] 10-K (Ex. 18) at 29 (stating that from 2003 to 2007 Lehman's leverage ratio rose from 23.7 to 30.7, assets under management grew from $120 billion to $282 billion, net revenues grew from $8.65 billion to $19.25 billion and net assets increased from $163 billion to $373 billion).

[20] Lehman Brothers Holdings, Inc. Closing Share Price, Jan. 2, 2001 & Dec. 29, 2006, Bloomberg L.P. (accessed via Bloomberg Terminal on Mar. 20, 2009) (Ex. 20). This increase occurred even with a two-for-one stock split on April 28, 2006. 2006 10-K (Ex. 17) at 67-68.

[21] 2007 10-K (Ex. 18) at 60, 63-64; 2007 1Q Report (Ex. 21) at 62.

This approach carried risks.[22] Those risks were fully disclosed, including the very "run on the bank" scenario that proved to be Lehman's demise. Lehman's 2006 and 2007 Annual Reports stated that "we depend on continuous access to secured financing in the repurchase and securities lending markets" and warned that in the event of a prolonged market liquidity shortage, "our ability to repay maturing indebtedness and fund operations could be significantly impaired." 2006 10-K (Ex. 17) at 16; 2007 10-K (Ex. 18) at 17. In the short space of a few days in September 2008, other institutions, traders and investors refused to extend credit to, enter into transactions with, or invest through Lehman. These investors pulled out their funds, or refused to deal with Lehman unless the Company posted greater cash collateral, which it could not muster in such an environment. *See infra* Section F. As was the case with Bear Stearns, once others lost confidence in Lehman's ability to survive, its demise became a self-fulfilling prophecy.

C. Lehman's Mortgage Business And Real Estate Asset Concentration

Lehman clearly disclosed to investors the composition of its real estate portfolio, its growth in mortgage- and asset-backed securities positions and its business strategy and concomitant risks.

Lehman was "a leading underwriter of and market-maker in residential and commercial mortgage- and asset-backed securities" and "active in all areas of secured lending, structured finance and securitized products" in the real estate sector. 2007 10-K (Ex. 18) at 5; *see also* SAC

[22] *See* Standard & Poor's, *Why Was Lehman Brothers Rated 'A'?*, Sept. 24, 2008 (Ex. 22) at 2 ("[T]here are cases where negative market sentiment – whether or not grounded in fundamentals – can create significant difficulties for a company, and can even precipitate a failure. Companies that operate in particularly confidence-sensitive businesses and/or place heavy reliance on short-term borrowings are especially vulnerable to this phenomenon. This can give rise to a potential 'credit cliff,' where credit quality can deteriorate precipitously in a short period.").

¶ 2. Lehman originated, securitized and sold mortgages that were rated below "prime."[23] Lehman's BNC Mortgage LLC ("BNC") subsidiary originated predominately residential subprime loans, and its Aurora Loan Services LLC ("Aurora") subsidiary originated predominantly residential Alt-A loans.[24] SAC ¶ 97; 2007 10-K (Ex. 18) at 105 n.1. Offering documents disclosed that these subsidiaries, as well as other originators of loans that it securitized, followed less stringent guidelines than those of Fannie Mae and Freddie Mac.[25]

Lehman's disclosed strategy was to originate real estate loans, earn fees on those loans and then sell them to other investors in a securitization. *See*, *e.g.*, 2007 10-K (Ex. 18) at 47.[26] Under this model, as long as there was a market for real estate securities, Lehman profited from

---

[23] *See*, *e.g.*, 3/18/08 8-K (Ex. 23) at 14; 2007 1Q Call (Ex. 24) at 6, 8, 16-17; 2007 2Q Call (Ex. 25) at 9-10.

[24] The prime rate is the "base rate that banks use in pricing commercial loans to their best and most creditworthy customers." Barron's Dictionary of Finance and Investment Terms 538 (7th ed. 2006) (Ex. 26). A mortgage categorized as "prime" is made to those "creditworthy" customers. Lehman defined "Alt-A" residential mortgage loans "as those associated with borrowers who may have creditworthiness of 'prime' quality but may have traits that prevent the loans from qualifying as 'prime,'" including "documentation deficiencies related to the borrowers' income disclosure, referred to as partial or no documentation; or the underlying property may not be owner occupied despite full or lower documentation of the borrowers' income levels." 6/16/08 8-K Ex. 99.2 (Ex. 27) at Attachment III. Lehman defined "subprime" mortgages as "those associated with borrowers having a credit score in the range of 620 or lower using the Fair Isaac Corporation's statistical model, or having other negative factors within their credit profiles." 2007 10-K (Ex. 18) at 105 n.1.

[25] *See, e.g.,* 1/24/07 FWP (Ex. 28) at S-19, S-68; 7/2/07 Pro. Supp. (Ex. 29) at S-62. Investors were informed that these relaxed guidelines permitted borrowers to secure a mortgage with no more than their word. Specifically, Lehman's subsidiaries originated and securitized mortgage loans under the "Stated Income" and "No Asset" guidelines as well as loans subject to "underwriting exceptions." *See, e.g.*, 11/13/06 Pro. (Ex. 30) at 7-8. Although it does not provide any attribution for its data, the SAC itself uses these prospectuses and prospectus supplements such as these to compile data purporting to show delinquencies, foreclosures and bankruptcies for Aurora's Alt-A loan servicing portfolio. *See* SAC ¶ 105.

[26] *Id*. ("We make markets in and trade . . . mortgage-related securities and loan products. . . . We also originate mortgages . . . .").

the spread between the cost of originating a mortgage and the price at which it was sold in a securitization. *See* SAC ¶ 328. As Lehman warned, however, this strategy rendered it vulnerable to market risks, which included "adverse conditions in the U.S. housing market" and "dislocations in the credit markets." 2007 10-K (Ex. 18) at 15.

Lehman told investors that its mortgage- and asset-backed securities positions grew from $57.7 billion as of 2006 year-end to $89.1 billion as of 2007 year-end (SAC ¶¶ 3, 170, 197), and that the value of its held-for-sale real estate assets grew from $9.4 billion at 2006 year-end to $21.9 billion at 2007 year-end. 2006 10-K (Ex. 17) at 66; 2007 10-K (Ex. 18) at 61. In its 2007 Annual Report, Lehman warned that, "Holding Large and Concentrated Positions May Expose Us to Losses. Concentration of risk may reduce revenues or result in losses. . . . Concentration of risk will increase as we expand our proprietary trading and principal investing activities or commit additional capital to facilitate client-driven business." 2007 10-K (Ex. 18) at 16. In that same report, Lehman said that downward market trends in real estate caused Lehman to have expanded its holdings of real estate, mortgages and asset-backed securities portfolios. 2007 4Q Call (Ex. 31) at 16–17. Lehman also disclosed risks associated with mortgage-backed securities, e.g.: "The U.S. subprime mortgage business remained challenged during our second quarter. We anticipate that this part of the U.S. mortgage market, as well as certain aspects of the leveraged finance origination market, will face challenges in the second half of 2007." 2007 2Q Report (Ex. 19) at 47.

As early as its September 18, 2007 earnings call, Lehman told investors that its mortgage assets were growing while its securitized product revenues were declining because it was selling

fewer mortgage-related securities and making less money on the sales it was able to make.[27] Additionally, in its Annual Report for the fiscal year ended November 30, 2007, Lehman warned that client revenues may decline because the "U.S. has experienced a significant downturn due to *declining real estate prices, substantially reducing mortgage loan originations and securitizations*. . . [which were] precipitating more generalized credit market dislocations and a significant contraction in available liquidity globally. . . [and] negatively impact[ing] [Lehman's] revenues." 2007 10-K (Ex. 18) at 15 (emphasis added). Lehman updated investors in 2008 as global economic conditions further declined.[28]

Lehman also disclosed the composition of its real estate asset portfolio in greater detail than was required by GAAP. Beginning with its December 13, 2007 earnings call and continuing through subsequent disclosures, Lehman gave the market additional information

---

[27] *E.g.*, 2007 3Q Report (Ex. 32) at 47-48 (disclosing origination and securitization volumes impacted by "significant re-pricing of credit risk and a liquidity squeeze" in capital markets and it would "take a three to six month period for the markets to return to a more normal environment with tighter credit spreads and more available liquidity").

[28] *See*, *e.g.*, 2008 1Q Report (Ex. 33) at 45-46 ("The stress experienced by global financial markets that began during the second half of 2007 continued and increased throughout the first quarter of the 2008 fiscal year. The operating environment during the period continued to be affected by the turmoil in the broader credit markets and general lack of liquidity, reflecting the migration of disruption in certain credit and fixed-income assets to virtually every asset class regardless of fundamentals or underlying quality. . . . Global equity markets during the three month period exhibited high volatility as the U.S. economy showed weakness and credit related concerns continued to weigh on investor sentiment."); 2008 2Q Report (Ex. 34) at 57 ("During the second quarter of 2008, the Company operated in an unfavorable global business environment. Conditions were characterized by a continued lack of liquidity in the credit markets, significantly depressed volumes in most equity markets, a widening in certain fixed income credit spreads compared to the end of the 2007 fiscal year and declining asset values. . . . These global economic conditions, in aggregate, depressed both the valuations of the Company's inventory positions as well as transactional volumes and market activity levels in which the Company's Capital Markets and Investment Banking business segments operated during the fiscal quarter.")

about the composition of its portfolio of real estate assets.[29] This occurred months before the SEC advised in March 2008 that corporations ***"may"*** want to do a breakdown of assets. SEC Division of Corporation Finance Letter dated March 27, 2008 (Ex. 37) (emphasis added). Thus, Plaintiffs' argument that Lehman made insufficient disclosure of its exposure to the real estate market and the composition of its holdings is spurious.

D. The Inherent – And Disclosed – Limitations Of Risk Mitigation Techniques

Lehman, of course, sought to protect itself from market forces, as well as real estate, credit, liquidity and operational risks, but fully disclosed the limitations of the systems it could employ to do so. Lehman warned investors that "no risk management procedure can anticipate every market event, and our hedging strategies and other risk management techniques may not be fully effective in mitigating our risk exposure in all market environments or against all types of risk, *including risks that are unidentified or unanticipated*." 2007 10-K (Ex. 18) at 22 (emphasis added); *see also* 2006 10-K (Ex. 17) at 19.

Even risk management strategies that had proved successful historically could be compromised by unusual market events or behavior. Lehman's disclosures were explicit (and accurate) that, although its hedges had in the past been beneficial, they too could be affected by deteriorating market conditions and could lead to "significant losses." *See, e.g.*, 2007 10-K (Ex.

---

[29] *See, e.g.*, 2007 4Q Call (Ex. 31) at 6 (breaking out numerically residential and asset backed, commercial and subprime mortgage assets into categories such as whole loans, servicing and securities); 2007 10-K (Ex. 18) at 104-105 (same); 3/18/08 8-K (Ex. 23) at 13-14 (categorizing numerically residential mortgages into categories of Prime/Alt-A, Europe, Subprime/Second Lien, ABS-CDO, Asia-Pacific and Other U.S and categorizing commercial mortgage inventory by geographic location in the Americas, Europe and Asia-Pacific); 2008 1Q Call (Ex. 35) at 10 (disclosing 85% of commercial mortgage securities are AA and AAA rated and geographical location of commercial whole loans in U.S., Europe and Asia); 2008 1Q Report (Ex. 33) at 54-58 (providing detailed breakdown of Alt A/Prime, subprime and commercial mortgage assets); 6/16/08 8-K Ex. 99.2 (Ex. 27) at Attachment I-VII (providing seven tables of information concerning mortgage and asset backed securities); 2008 2Q Call (Ex. 36) at 17 (stating majority of Alt-A/Prime inventory is Alt-A).

18) at 22. Lehman cautioned that its risk mitigation models were based in part on the "historical correlations among prices of various asset classes or other market indicators, and *in times of market stress or other unforeseen circumstances there may be material changes*" in these correlations. 2007 10-K (Ex. 18) at 22 (emphasis added). In sum, the Company warned investors that if faced with unprecedented market movements, it "may not be able to reduce our positions or our exposure in a timely, cost-effective way or in a manner sufficient to offset the increase in measured risk." 2007 10-K (Ex. 18) at 22.

Value at risk ("VaR") is one of the primary risk management tools that the SEC requires registered securities firms to select among to provide investors with information on the magnitude of risk facing them. SEC Regulation S-K, Item 305, Quantitative and Qualitative Disclosures About Market Risk, 17 C.F.R. § 229.305 (2008) (Ex. 38). Lehman's VaR estimated with a 95% level of confidence the amount that Lehman's portfolio could lose in any one day. 2007 10-K (Ex. 18) at 70. This, of course, as Lehman explicitly said in its public filings, meant that there was a 1 in 20 chance that a single day's trading losses could exceed that figure by an unknown amount. *See*, *e.g.*, 2007 3Q Report (Ex. 32) at 77; 2007 10-K (Ex. 18) at 70. As disclosed, Lehman relied on historical data to measure VaR, which meant that VaR measurements had "inherent limitations," including that "historical market conditions and historical changes in market risk factors may not be accurate predictors of future market conditions or future market risk factors." *See*, *e.g.*, 2007 10-K (Ex. 18) at 70. Importantly, Lehman cautioned that "*VaR is not intended to capture worst case scenario losses and we could incur losses greater than the VaR amounts reported*." *Id*. (emphasis added).

From the first quarter of 2007 through the first quarter of 2008, Lehman disclosed that its quarterly average historical VaR had increased each quarter – from $63 million at the beginning

of that period to $130 million at its end – "in large part, from an increase in equity price risk" and a "higher level of interest rate risk."[30] And for its second quarter of 2008, when VaR had actually decreased, Lehman explained that the decrease was due to its significant asset sales, which were still partially offset by increased market volatilities. 2008 2Q Report (Ex. 34) at 95.

For real estate assets that were held for sale and thus not included with the VaR figure, Lehman relied on stress testing. *See*, *e.g.*, 2007 10-K (Ex. 18) at 71. Throughout the Class Period, Lehman disclosed each quarter its potential net revenue loss if the value of its real estate assets hypothetically declined 10%. Significantly, this figure increased from a potential $270 million revenue loss for the quarter before the Class Period begins (4th quarter 2006) to a potential $1.3 billion revenue loss for the second quarter of 2008. This was a six-fold increase over seven reporting periods. *See*, *e.g.*, 2006 10-K (Ex. 17) at 61; 2007 2Q Report (Ex. 19) at 75; 2008 2Q Report (Ex. 34) at 95.

Plaintiffs conveniently ignore Lehman's disclosures of VaR, stress testing, the inherent limitations of any risk mitigation technique or hedging strategies and the actual difficulties the Company disclosed that it was encountering with such techniques and strategies in the turbulent months leading up to its bankruptcy.

E. The Onset Of The Credit Crisis

In 2007, industry and government leaders believed that the problems in the subprime real estate market were confined to that sector and that the correction in the housing market had already taken place.[31] Lehman took proactive steps to curtail its subprime mortgage operations,

---

[30] *See* 2007 1Q Report (Ex. 21) at 71 (average historical simulation VaR at $63 million); 2007 2Q Report (Ex. 19) at 75 ($78 million); 2007 3Q Report (Ex. 32) at 78 ($96 million); 2007 10-K (Ex. 18) at 71 ($124 million); 2008 1Q Report (Ex. 33) at 79 ($130 million).

[31] *See* Ex. 2 at Tab 8 (Chairman Bernanke stating, "[T]he impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."); *id.*

including closing its subsidiary focused on that segment, BNC, in August 2007. 8/22/07 8-K, Ex. 99.1 (Ex. 39); SAC ¶ 276. In September 2007, the Company took the added step of "rescal[ing] its [residential mortgage origination] operations in the U.S. and UK" and "clos[ed] its Korean mortgage business." 9/6/07 8-K, Ex. 99.1 (Ex. 40).

Instead, the real estate crisis defied predictions and accelerated. In January 2008, Lehman substantially reduced its resources and capacity in the U.S. residential mortgage origination market and suspended the wholesale and correspondent lending activities of its subsidiary Aurora, which had focused on the Alt-A segment. 1/17/08 8-K, Ex. 99 at 1 (Ex. 41); *see also* SAC ¶ 97.

For the first quarter of 2008, credit markets and commercial real estate-related products continued to decline. Lehman took writedowns for real estate-related assets carried on its balance sheet at fair value. 2008 1Q Report (Ex. 33) at 53. Because the market had become highly illiquid for subprime residential mortgage-related assets, commercial mortgage-backed securities and whole loans for large commercial properties during the credit crisis,[32] the determination of the fair value of such assets required subjective business judgment, as Lehman explained. *See*, *e.g.*, 2007 3Q Call (Ex. 42) at 17 ("Level 3 [assets][33] are the ones that require the

---

at Tab 18 (Former Chairman Greenspan stating "[the] worst is over"); *id.* at Tab 16 (then-Treasury Secretary Paulson stating, "I don't deny there's a problem with subprime mortgages, but I really do believe that's containable.").

32 2007 4Q Call (Ex. 31) at 13; 2007 10-K (Ex. 18) at 41, F-6.

33 In accordance with SFAS 157, Lehman categorized the real estate assets that it measured at fair value into a three-level classification: "Fair value measurement . . . that use quoted prices in active markets for identical assets or liabilities are generally categorized as Level I. . . . Level II – Inputs . . . are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life. . . and fair value measurements . . . that have no direct observable levels are generally categorized as Level III. The lowest level input that is

most management judgment in determining their value, and it typically relates to things like private equity instruments, where there has to be a lot of judgment, because these instruments don't trade and sometimes don't have anything that looks like them that trades that looks sufficiently like them, so we use judgment in determining the values on these.").[34]

Despite the continued slide in these markets, through the first quarter of 2008 Lehman was able to mitigate the loss in the value of its assets through its hedging activities, which continued to prove largely effective. For this quarter, Lehman's gross writedowns, after mark-to-market adjustments were made, were ($4.7 billion). But, after hedges were taken into account, Lehman's net writedowns were only ($1.8 billion). 2008 1Q Report (Ex. 33) at 54; 2008 1Q Call (Ex. 35) at 5. Specifically, as to residential mortgage-related positions, as Lehman disclosed, the Company's gross writedowns, after mark-to-market adjustments, were ($3 billion); however, the net writedowns after hedges were only ($800 million). For commercial mortgages and related real estate, Lehman disclosed that it made gross writedowns, after mark-to-market adjustments, of ($1.4 billion). But after hedges, its net writedowns were ($1 billion). 2008 1Q Call (Ex. 35) at 5. As discussed below, Lehman wrote down the value of these assets further in the ensuing months in response to additional information and the unexpectedly large deterioration in several markets.

---

significant to the fair value measurement of a financial instrument is used to categorize the instrument and reflects the judgment of management." 2007 10-K (Ex. 18) at 41, F-6.

[34] Lehman volunteered to be a part of a program that required the Company to expose itself to more detailed federal oversight. After adopting in 2004 its Consolidated Supervised Entities program for U.S. investment banks, the following year the SEC approved Lehman as one of the entities. The program was designed to allow the SEC to monitor for financial or operational weakness. To qualify as a CSE, Lehman had to agree to continuing SEC supervision of its procedures to test whether Lehman "robustly" implemented its "marking to market of complex and less-liquid positions." *See* Final Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Aug. 20, 2004, http://www.sec.gov/rules/final/34-49830.htm (Ex. 43).

In March 2008, the financial markets were shocked when Bear Stearns, formerly the fifth largest U.S. securities firm, was acquired in a firesale by JPMorgan Chase. The sale was supported by guarantees from the Federal Reserve Bank of New York.[35] In the wake of the Bear sale, Lehman's stock fell 31% in a five-day period.[36]

Even after the collapse of Bear Stearns, business and public leaders sounded the same sentiment throughout the spring 2008 – the credit crisis was near its end, for example:

- **Standard and Poor's (March 13, 2008, two days before Bear Stearns was sold in a fire sale)**: "The end of write-downs is now in sight for large financial institutions." Ex. 2 at Tab 23.

- **Then-Treasury Secretary Paulson (May 6, 2008)**: "[T]he worst is likely to be behind us." *Id*. at Tab 25.

- **Former Federal Reserve Chairman Greenspan (June 13, 2008)**: "The worst is over in the financial crisis or will be very soon . . . . There is a reduced possibility of a large, intense recession." *Id*. at Tab 27.

Like these financial leaders, in the spring of 2008, Lehman CEO Fuld also believed that "the worst is behind us."[37]

Despite this widespread optimism, during the spring of 2008, Lehman pursued several measures to increase its liquidity. First, it raised $15.5 billion in capital. In April and May alone, Lehman executed $5.5 billion of public benchmark long-term debt and $4 billion of

---

[35] J.P. Morgan Chase & Co., Current Report (Form 8-K) (Mar. 24, 2008) (Ex. 44) at 1-2 (discussing how J.P. Morgan will be liable for the first $1 billion in mortgage-backed securities losses while the Fed will take on losses for the remaining $29 billion).

[36] Lehman Brothers Holdings, Inc. Closing Share Price, Mar. 13, 2008—Mar. 17, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on Mar. 20, 2009) (stock fell from 45.99 on March 13 to 31.75 on March 17) (Ex. 45).

[37] Josh Fineman & Yalman Onaran, *Lehman's Fuld Says 'Worst is Behind Us' in Crisis*, Bloomberg.com, Apr. 15, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5JCJBH76_VU (Ex. 46). Fuld also stated that the "current environment remains challenging." *Id*.

convertible preferred stock. *See, e.g.,* 4/4/08 Pro. Supp. (Ex. 47); 6/16/08 8-K (Ex. 27) at 2. In June, Lehman reported an oversubscribed share sale comprised of $4 billion in common stock and $2 billion in convertible securities.[38] By the end of its second quarter 2008, Lehman had increased its "liquidity pool" – an available pool that covered expected cash outflows for twelve months in a stressed liquidity environment – to a record level of $45 billion.[39]

Second, Lehman took steps to reduce its asset exposure and thereby decrease its leverage. The Company reduced its exposure to residential mortgage assets by 22% and to real estate held for sale by 19%. *See* 2008 2Q Call (Ex. 36) at 6. At the same time, Lehman reduced its acquisition and finance exposure by almost 37% and its high yield or non-investment grade debt inventory by 35%. *Id.* at 7. The net effect of these measures was significant: a reduction of total assets by approximately $130 billion and of net leverage from 15.4 to 12. *Id.* at 6. Lehman also pursued cost-cutting measures such as streamlining its workforce and reducing expenses. *Id.* at 2–6.

Despite taking such actions, Lehman disclosed an almost $3 billion loss when it announced its second quarter earnings a week early on June 9, 2008, the result of two developments. 2008 Pr. 2Q Call (Ex. 51) at 2. First, the Company reported gross writedowns of approximately $4 billion on components of its financial inventory, including $2.4 billion gross writedowns in residential mortgage-related positions and $1.3 billion gross writedowns on commercial mortgage and real estate-related investments. SAC ¶¶ 212, 215-216; 2008 2Q Report (Ex. 34) at 67-68. A major reason for these writedowns was that Lehman had

---

[38] *See* 6/9/08 Preferred Pro. Supp. (Ex. 48); 6/9/08 Common Pro. Supp. (Ex. 49).

[39] *See* 2008 Pr. 3Q Call (Ex. 50) at 10 (discussing record level liquidity pool for second quarter 2008 and continued strength for the third quarter 2008); *see also*, *e.g.,* 2008 1Q Report (Ex. 33) at 65 (describing Lehman's "liquidity pool").

information from sales of certain of its real estate assets over the quarter that indicated further writedowns of mark-to-market assets was appropriate for those categories. In addition, the value of residential mortgage assets dropped due to unforeseen events that caused significant price deteriorations in residential assets: the collapse of a large mortgage hedge fund, Peloton, and the events around Bear Stearns. *Id.* A second development that contributed to Lehman's large losses for the quarter was that – for the first time – its hedges had failed to mitigate the bulk of its losses from writedowns. For its second quarter of 2008, Lehman's residential hedges provided **only a 17% offset as compared with a 70% offset for the prior quarter** and similarly large percentage in the second half of 2007. 2008 Pr. 2Q Call (Ex. 51) at 4. Lehman explained that the ineffectiveness of its hedges was the result of an "unprecedented dislocation between our derivative hedges and the underlying cash markets." *Id.* at 3.

Lehman stated on this June 16, 2008 earnings call that it was not clear when markets would improve. 2008 2Q Call (Ex. 36) at 12.[40] Against the backdrop of market uncertainty, the Company reported additional steps it had taken to increase its liquidity, including: (1) increasing its cash capital surplus from $7 billion to $15 billion at the end of the first quarter and its liquidity pool from $34 billion to $45 billion; (2) having $47 billion of assets funded in its bank as of the second quarter, up from $44 billion at both the end of the first quarter and year-end 2007; (3) having its holding company liquidity position available to mitigate the liquidity impact of a severe stress event; and (4) issuing long-term debt. 2008 2Q Call (Ex. 36) at 9-10.

---

40 *See also* 2008 1Q Call (Ex. 35) at 11 ("Let me talk about outlook for a moment, which you've probably gotten the message so far, but looking forward, despite the positive developments of [F]ed actions in the past few days and few weeks, we still don't anticipate the challenging market conditions abating any time soon and we have planned our business accordingly.").

While Lehman was shoring up capital to weather unforeseen circumstances, world leaders continued to believe "[t]he worst is over in the financial crisis or will be very soon. . . ."[41]

F. Lehman Is Destroyed By A Classic Run On The Bank

Over the summer of 2008, Lehman discussed with the Federal Reserve the possibility of converting the firm into a bank holding company with the aim of creating additional liquidity. Lehman's overtures to become a bank holding company were not given favorable consideration – although less than a week after Lehman's September 15, 2008 bankruptcy filing, on Sunday, September 21, 2008, the Federal Reserve agreed to let two of the three remaining investment banks, Goldman Sachs and Morgan Stanley, convert into bank holding companies.[42] Over the summer of 2008, Lehman also discussed with the Korean Development Bank ("KDB") the possibility of that company making a capital injection or taking an equity stake in Lehman, also with the aim of further improving liquidity.[43] Meanwhile, by the end of August 2008, U.S. banks' and other companies' announced global losses related to the credit crisis had mounted to $510 billion.[44]

September proved to be one of the most volatile months the equity markets have ever experienced. On Sunday, September 7, 2008, the federal government placed Freddie Mac and

---

[41] *See* Ex. 2 at Tab 27 (quoting former Federal Reserve Chairman Greenspan on June 13, 2008).

[42] Morgan Stanley 2008 Annual Report (Form 10-K) (Jan. 28, 2009) (Ex. 52) at 1; Goldman Sachs Current Report (Form 8-K) (Sept. 22, 2008) Ex. 99.1 (Ex. 53).

[43] Fremont Compl. ¶ 60 (Ex. 54) (case has been transferred to Judge Kaplan and this action, pending filing of Court order, for consolidated pretrial proceedings).

[44] Ingo Fender & Jacob Gyntelberg, *Overview: Global Financial Crisis Spurs Unprecedented Policy Actions*, BIS Q. Rev. at 2 (Dec. 2008), *available at* http://www.bis.org/publ/qtrpdf/r_qt0812a.pdf (Ex. 55).

Fannie Mae into conservatorship.[45] This takeover came on the heels of assurances less than a month earlier from then-U.S. Treasury Secretary Paulson that "[w]e have no plans to insert money into either of those two institutions."[46] The stock prices of some of the largest banks plummeted to record lows.[47]

Two days later, on September 9, 2008, news broke that Lehman's talks with KDB had faltered.[48] As one of the original complaints in this action stated, that announcement – which was ***not*** an announcement about writedowns or subprime losses – caused Lehman's stock to drop 45%. Initial Amended Class Action Complaint ("Initial Compl.") ¶ 482. On September 10, Lehman pre-released its third quarter 2008 results. SAC ¶ 136. The Company reported a $3.9 billion loss, including $1.7 billion in gross writedowns on its residential and commercial real estate holdings. *Id.* Lehman also announced plans to divest $25 billion to $30 billion of its commercial real estate assets into a separate entity. *Id.*

Despite the fact that Lehman's liquidity pool remained strong at $42 billion, up $6 billion from the same quarter of the prior year,[49] the "run on the bank" had started. As many as 32.8

---

[45] Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. Times, Oct. 23, 2008 (Ex. 12) (cited by SAC ¶ 315).

[46] Ex. 2 at Tab 32 (August 10, 2008 statement by Paulson); *see also id.* at Tab 29 (July 16, 2008 statement by Chairman Bernanke that Fannie Mae and Freddie Mac "are adequately capitalized" and "are in no danger of failing").

[47] For example, the stock of Washington Mutual and Merrill Lynch dropped 19% and 7.5%, respectively, from Friday, September 5, 2008 to Monday, September 9, 2008. Merrill Lynch & Co. Closing Share Price, Sept. 5, 2008- Sept. 9, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on Apr. 6, 2009) (Ex. 56); Washington Mutual Closing Share Price, Sept. 5, 2008-Sept. 9, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on Apr. 6, 2009) (Ex. 57).

[48] *See* Fremont Compl. ¶ 60 (Ex. 54).

[49] *Compare* 2007 3Q Report (Ex. 32) at 62 ($36 billion liquidity pool) *with* 2008 Pr. 3Q Call (Ex. 50) at 10 ($42 billion liquidity pool). In fact, the liquidity pool for each quarter

million Lehman shares were sold and not delivered to buyers as of September 11.[50] This was a more than 57-fold increase from the prior year's peak of 567,518 failed trades. These failed transactions can be linked to "naked short selling," which can manipulate the market by massively driving down a company's share price, thereby irreparably damaging the confidence of trading partners and customers. JPMorgan Chase, Lehman's clearing agent, demanded that Lehman post additional collateral to cover lending positions. SAC ¶ 351. Counterparties to the numerous transactions that Lehman had conducted on a daily basis began to withdraw business and to demand increased collateral for trades. *See, e.g.* SAC ¶ 7, Initial Compl. ¶ 267. Liquidity was frozen by clearing banks, and hedge fund customers began migrating to other firms.[51]

On Friday, September 12, Lehman held an emergency meeting with the Federal Reserve, the heads of major financial institutions, the Treasury Secretary and the SEC's Chairman. *See* Transcript of Hearing, *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (Bankr.

---

announced in 2008 increased substantially from the same quarter the previous year. *Compare* 2007 1Q Report (Ex. 21) at 55 ($29.8 billion liquidity pool) *with* 2008 1Q Report (Ex. 33) at 65 ($34 billion liquidity pool); *compare also* 2007 2Q Report (Ex. 19) at 59 ($25.7 billion liquidity pool) *with* 2008 2Q Report (Ex. 34) at 80 ($45 billion liquidity pool).

[50] *See*, *e.g.*, SEC, Frequently Requested FOIA Document: Fails-to-Deliver Data – Archive Data, http://www.sec.gov/foia/docs/failsdata-archive.htm (last visited Apr. 24, 2009) (Ex. 58) (collecting data on Lehman and other companies' shares sold, but not delivered, known as "failed trades").

[51] Carrick Mollenkamp, Susanne Craig, Jeffrey McCracken & Jon Hilsenrath, *The Two Faces of Lehman's Fall*, Wall St. J., Oct. 6, 2008 at A1 (Ex. 59) (cited by Plaintiffs in Am. Nat'l Compl. ¶ 171 (case was transferred to Judge Kaplan and this action for consolidated pre-trial proceedings)) *see also Testimony Concerning Lessons Learned in Risk Management Oversight at Federal Financial Regulators*, Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, March 18, 2009, *available at* http://www.sec.gov/news/testimony/2009/ts031809es.htm (Ex. 60) ("One lesson from the SEC's oversight of CSEs – Bear Stearns in particular – is that no parent company liquidity pool can withstand a 'run on the bank.' Supervisors simply did not anticipate that a run-on-the-bank was indeed a real possibility for a well-capitalized securities firm with high quality assets to fund.").

S.D.N.Y. Sept. 16, 2008) (Ex. 61) at 15. These emergency meetings continued through Saturday and Sunday, September 13 and 14, as the Company explored strategic alternatives. *Id.* Lehman worked hard to try to arrange a sale of the Company to potential buyers Barclays PLC or Bank of America. But government officials indicated that, unlike in the case of Bear Stearns in March 2008, and other institutions afterwards, the federal government would not provide guarantees of Lehman's obligations.[52] Nor would there be a federal bailout as was provided to AIG days later. *Id.* "[F]or reasons that only history will judge, regulators allowed Lehman to fail."[53]

Out of options, in the pre-dawn hours of Monday, September 15, 2008, Lehman filed for bankruptcy. SAC ¶ 1. It was the largest bankruptcy in history.[54] In the wake of the bankruptcy petition, plaintiffs began filing a slew of lawsuits against Lehman's officers, directors, underwriters and auditor. These suits became part of the nationwide explosion of securities litigation against companies with mortgage-related businesses. More than **520** lawsuits have been filed alleging similar securities allegations. *See* Exhibit 1.

---

[52] Transcript of Hearing, *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Sept. 19, 2008) (Ex. 14) at 165; Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. Times, Oct. 23, 2008, at A1 (Ex. 12) (cited by SAC ¶ 315).

[53] Glenn Hutchins, *After the Panic of '08*, Fortune, Mar. 16, 2009, http://money.cnn.com/2009/03/16/news/economy/panic08.fortune/index.htm (Ex. 62).

[54] Solton Compl. ¶¶ 15, 133 (Ex. 63) (case transferred to Judge Kaplan and this action for consolidated pre-trial proceedings).

ARGUMENT

I. THE EXCHANGE ACT CLAIMS SHOULD BE DISMISSED (COUNTS IV, V & VI)

A. The Legal Standard

The Supreme Court has set down the rigor with which courts must assess claims on a motion to dismiss a securities fraud action. Non-movants are no longer given the benefit of all reasonable inferences. Instead, district courts must sift and weigh the well-pleaded facts in the complaint. Under Rule 9(b), a heightened pleading standard is applied and the pleading must "state with particularity the circumstances constituting fraud or mistake." In addition, the Private Securities Litigation Reform Act ("Reform Act") "insists that securities fraud complaints 'specify' each misleading statement; that they set forth the facts 'on which [a] belief' that a statement is misleading was 'formed'; and that they 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 547 U.S. 71, 81-82 (2006) (quoting *Dura Pharm., Inc. v. Broudo*, 127 S.Ct. 1627, 544 U.S. 336, 345 (2005)). After assessing what facts, if any, have been pleaded with the requisite particularity, the court must consider all plausible non-fraudulent inferences. *Tellabs, Inc.*, 127 S. Ct. at 2509.

Plaintiffs assert their claims under the Exchange Act against the Executive Defendants only, and for a portion of the Class Period only, June 12, 2007 – September 15, 2008. To state a claim under § 10(b) and SEC Rule 10b-5, a plaintiff must plead with particularity: (1) a strong inference of scienter; (2) a material misrepresentation or omission; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. *Dura,* 544 U.S. at 341-42. The Exchange Act claims should be dismissed because, as demonstrated below, the SAC fails to adequately allege any material misstatements or omissions, scienter or loss

causation. Examination of the facts makes clear that the more plausible – indeed the only – inference is not that these Defendants committed fraud, but that Lehman fell victim to unforeseen and uncontrollable market forces that led to a run on the Lehman firm.

B. The SAC Does Not Adequately Allege Any Material Misstatements Or Omissions

1. The Heightened Standard Of The Reform Act

The Securities Act Motion sets forth in detail why the SAC fails to identify any material misstatements or omissions during the Class Period, and the relevant disclosures concerning the subject matter of the alleged misstatements and omissions that provided all material information to investors. The SAC's § 10(b) and Rule 10b-5 claims concerning the shorter Exchange Act Period are subject to the stringent pleading requirements not only of Rule 9(b), but also of the Reform Act, rendering the SAC's allegations even more clearly deficient. Under the heightened standards of Rule 9(b) and the Reform Act, the SAC must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *Rombach v. Chang*, 355 F.3d 164, 170 (2d Cir. 2004) (internal citation omitted). Courts must ignore allegations that do not expressly satisfy this standard, which the SAC's Exchange Act claims fail to do.

2. The Exchange Act Claims Against Defendant Gregory Who Made None Of The Challenged Statements Should Be Dismissed

In addition, with respect to Executive Defendant Gregory, the SAC does not attribute any statement to him.[55] For this reason alone, the Exchange Act claims against Mr. Gregory should be dismissed. *See Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993) (stating Rule 9(b) requires plaintiffs to "identify the speaker" of the alleged misrepresentation and "state

---

[55] Moreover, Gregory did not sign the Shelf Registration Statement, the 2006 Prospectus or any of the 13 Exchange Act filings at issue for the Exchange Act claims.

where and when the statements were made"); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 265 (2d Cir. 1993) (stating fraud cannot be pled through unattributed statements).

C. The SAC Does Not Adequately Allege Scienter

1. Plaintiffs Cannot Meet Their Burden Under Rule 9(b) And The Reform Act

The essence of any Exchange Act claim is intent. The Reform Act mandates that a complaint "state with particularity facts giving rise to a *strong* inference" that the defendant acted with scienter. 15 U.S.C. § 78u-4(b)(2) (emphasis added). "Plaintiffs must 'state with particularity facts giving rise to a strong inference that [each] defendant acted with the required state of mind.'" *In re Pfizer, Inc. Sec. Litig.*, 538 F. Supp. 2d 621, 635 (S.D.N.Y. 2008) (Kaplan, J.) (quoting 15 U.S.C. § 78u-4(b)(2)). Plaintiffs may satisfy this burden by alleging facts "(1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." *ATSI Commc'ns Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007) (internal citation omitted). Plaintiffs can survive a motion to dismiss "only if a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged." *Tellabs*, 127 S. Ct. at 2510 (emphasis added). The court must weigh all "plausible nonculpable explanations for the defendant's conduct," *id.*, and if after doing so, the inference of scienter is merely "plausible" or "reasonable," the complaint will not survive a motion to dismiss. *ATSI*, 493 F.3d at 104; *see also City of Brockton Ret. Sys. v. Shaw Group Inc.*, 540 F. Supp. 2d 464, 475 (S.D.N.Y. 2008).

The theme underlying Plaintiffs' scattershot fraud allegations is that various public statements during the Exchange Act Period concerning Lehman's real estate assets, hedging ability, risk management, accounting practices and finances were untrue and obscured the

Company's exposure to real-estate related losses. Based on a series of statements and allegations by primarily anonymous former employees of Lehman, Aurora and BNC, Plaintiffs opine that the Executive Defendants actually knew better.

The SAC, however, alleges a theory that is not even reasonable, and certainly not as compelling as the competing inference of good faith. Plaintiffs provide no "cogent" explanation for why the Lehman executives responsible for the challenged disclosures would knowingly direct Lehman into bankruptcy while retaining or increasing their Lehman holdings. If, as Plaintiffs posit, the Executive Defendants really knew that Lehman's vulnerability to continued market deterioration was greater than disclosed, or that its risk management and hedging capabilities would prove ineffective, or that the Company's valuations would have to undergo large writedowns, their actions would not make economic sense on either a Company or a personal level. *See Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) ("In looking for a sufficient allegation of motive, we assume that the defendant is acting in his or her informed economic self-interest.").

For example, if the Executive Defendants possessed the information that Plaintiffs allege, it would be wholly irrational for them to grow Lehman's mortgage and asset-back securities positions from $57.7 billion at year-end 2006 to $89.1 billion as of year–end 2007, to the Company's detriment. SAC ¶¶ 3, 94. The Second Circuit recently affirmed dismissal of a securities fraud case because the theory that the defendant acted contrary to its economic well being was "implausible." *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 203 (2d Cir. 2009). The *ECA* Court stated, "Plaintiffs fail to allege facts explaining why, if it was aware of Enron's problems, [Defendant] would have continued to lend Enron billions of dollars." *Id.* (internal citation omitted); *see also Kalnit v.*

Eichler, 264 F.3d 131, 140-41 (2d Cir. 2001) ("Where 'plaintiffs' view of the facts defies economic reason, . . . [it] does not yield a reasonable inference of fraudulent intent.'") (quoting *Shields*, 25 F.3d at 1130); *Davidoff v. Farina,* No. 04 Civ. 7617, 2005 WL 2030501, at *11 n.19 (S.D.N.Y. Aug. 22, 2005) (no possible inference of scienter when individuals alleged to know of fraud that would cause company to fail nonetheless invested heavily in that company, because "it would have made no economic sense for defendants to invest literally billions of dollars in a venture that they knew would fail.").

If Defendants truly knew what they are alleged to have known, they could have used that knowledge to enrich Lehman and themselves as officers of Lehman, or at least to avoid huge losses and save their jobs. *See In re Merrill Lynch & Co. Inc., Research Reports Sec. Litig.,* 272 F. Supp. 2d 243, 263 (S.D.N.Y. 2003) (when plaintiffs' allegations contradict the assumption that defendants would act in their own economic self-interest, "the allegations in the Complaint affirmatively refute scienter"); *see also Fadem v. Ford Motor Co.*, 352 F. Supp. 2d 501, 512, 525 (S.D.N.Y. 2005) (finding plaintiffs' view of the facts "defies economic reason," which "militates against [plaintiffs'] theory of scienter"), *aff'd*, 157 Fed. App'x 398, 399 (2d Cir. 2005); *Atl. Gypsum Co., Inc. v. Lloyds Int'l Corp.*, 753 F. Supp. 505, 514 (S.D.N.Y. 1990) (same). Instead, the far more reasonable course of action for Defendants would have been to short the mortgage markets or apply different hedging techniques.

At best, the SAC alleges mismanagement, which "can be reduced to a claim of poor business judgment, which is not actionable." *In re Corning Inc. Sec. Litig.*, No. 04-2845-CV, 2005 WL 714352, at *2 (2d Cir. Mar. 30, 2005) (affirming dismissal of securities fraud suit alleging GAAP violations concerning writedowns); *see also Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 477, 97 S.Ct. 1292, 1303 (1977) (finding allegations of mismanagement not "within

the scope of s[ection] 10(b)"); *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000) ("[P]oor business judgment is not actionable under section 10(b) and Rule 10b-5.") (citation omitted); *Ciresi v. Citicorp.*, 782 F. Supp. 819, 821 (S.D.N.Y. 1991) ("Even if well-pled, allegations of mismanagement are not actionable under section 10(b) of the federal securities laws.") (citation omitted).

2. The SAC Fails To Allege Motive Through "Insider Trading"

Plaintiffs offer no rational financial or other motive for the Executive Defendants to have defrauded Lehman shareholders. Plaintiffs' skeletal allegations of insider trading (SAC ¶ 355) and incentive-based compensation tied to short-term performance (SAC ¶¶ 357-58) are anemic and legally insufficient. Plaintiffs have failed to establish that any alleged trading activity was unusual in amount, timing or any other manner. *See In Re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74-75 (2d Cir. 2001) (stating that in determining whether stock sales are unusual or suspicious, factors considered include "the amount of profit from the sales, the portion of the stockholdings sold, the change in volume of insider sales, and the number of insiders selling"). Here, only one of the Executive Defendants is alleged to have made any stock sales during the Exchange Act Period. This sale occurred on the second day of the Exchange Act Period, nearly **one year before** any purported corrective disclosure. This single sale was only a small percentage of his overall holdings of more than 10 million shares, consistent with previous trading history and part of a portfolio that accumulated Lehman stock holdings during the Exchange Act Period.[56] Moreover, each of the other Executive Defendants either retained or even increased their significant holdings throughout the Exchange Act Period. And all Executive

[56] Fuld's holdings increased during the Class Period. *Compare* 2006 Proxy St. (Ex. 64) at 15 *with* 2007 Proxy St. (Ex. 65) at 18. In fact, Lehman's officers and directors collectively increased their total holdings from approximately 19.7 million shares to 20.3 million shares. *Id*.

Defendants shared in the pain of Lehman's collapse. Finally, as is clear from Lehman's SEC filings, the Executive Defendants' compensation was tied to the Company's long-term performance, where certain of the equity-based awards were tied to vesting periods as long as 10 years.

Of all the Executive Defendants, only one, Mr. Fuld, is alleged to have sold Lehman stock during the Exchange Act Period. But this allegation of a single sale fails to substantiate any plausible motive to defraud. His sale of 291,864 shares on the second day of the Exchange Act Period, June 13, 2007 (SAC ¶ 356), represented less than 3% of his Lehman holdings. Courts have consistently held no inference of scienter where sales represent such a small percentage of the individual's total holdings. For example:

Case Name	Percentage of Holdings Sold Found Insufficient to Infer Scienter
Acito v. IMCERA Group, 47 F.3d 47, 54 (2d Cir. 1995)	11%
In re KeySpan Corp. Sec. Litig., 383 F. Supp. 2d 358, 382-83 (E.D.N.Y. 2003)	less than 20%
In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1092 (9th Cir. 2002)	38%
In re Dura Pharm., Inc. Sec. Litig., No. 99CV0151-L(NLLS), 2000 WL 33176043, at *10 (S.D. Cal. July 11, 2000)	between 34% and 61%
In re Astea Int'l Inc. Sec. Litig., No. 06-1467, 2007 WL 2306586, at *14 (E.D. Pa. Aug. 9, 2007)	between 18.9% and 66%

Critically, as Lehman's stock price continually declined for the next fifteen months, Fuld **added** to his stock holdings and continued to hold over 10 million shares. And when the Company sought bankruptcy protection, Fuld remained one of the Company's largest individual

shareholders. Those shares he continued to hold were worth approximately $860 million at the peak of the Exchange Act Period, but worth next to nothing once Lehman sought bankruptcy protection. Lehman Closing Share Price, February 6, 2007 Bloomberg L.P. (accessed via Bloomberg Terminal on Mar. 15, 2009) (Ex. 66). That hardly evidences scienter. *See Rombach*, 355 F.3d at 177 (finding "no personal interest sufficient to establish motive" where defendants, all major shareholders, "shared the pain when the company failed"); *In re Credit Acceptance Corporate Sec. Litig.*, 50 F. Supp. 2d 662, 677 (E.D. Mich. 1999) (considering that one insider defendant lost more than any other individual when the company's stock plummeted as militating against a finding of fraudulent intent).

In addition, although Plaintiffs provide no information regarding Fuld's prior sales, publicly available records show that the June 2007 sale was consistent with his previous trading history.[57] *See In re Bisys Sec. Litig.*, 397 F. Supp. 2d 430, 445 (S.D.N.Y. 2005) (Kaplan, J.) (faulting complaint for failure to provide any facts that would suggest defendants' sales during the class period deviated from their pattern of sales before and after the class period).

Moreover, Plaintiffs do not allege that the sale was suspicious in its timing. A sale on only the second day of the Exchange Act Period was not close in time to any significant event or disclosure; indeed, the date of the first alleged corrective disclosure is June 9, 2008 – almost a year after Fuld's June 13, 2007 stock sale.[58] "The law in this Circuit is clear that. . . stock sales are not indicative of scienter when they are more than two months before the announcement in question." *In re Bausch & Lomb, Inc. Sec. Litig*., 529 F. Supp. 2d 323, 345 (W.D.N.Y. 2008);

---

[57] *See* Fuld Forms 4 (Ex. 67) (Fuld selling approximately 500,000 shares on September 14, 2006; 500,000 shares on July 20-25, 2006; and 115,000 shares on March 16-17, 2006); 2007 Proxy St. (Ex. 65) at 18 (listing Fuld as holding 10,851,590 shares).

[58] Plaintiffs allege corrective disclosures on June 9 and September 8 and 10, 2008. SAC ¶¶ 363-65.

see also City of Brockton, 540 F. Supp. 2d at 475 ("the facts relating to the stock sales rebut any inference of fraud" when defendant sold his shares "more than ten weeks before the end of the putative class period"); *In re NVE Corp. Sec. Litig.*, 551 F. Supp. 2d 871, 889-90 (D. Minn. 2007) (scienter allegations were insufficient when defendant's stock sales "occurred less than one year into the two-year Class Period," even though majority of stock was sold at close to peak price); *Ressler v. Liz Claiborne Inc.*, 75 F. Supp. 2d 43, 60 (E.D.N.Y. 1999) (no inference of scienter where sales were "remote in time" and "did not closely follow the alleged misstatements [or] were not temporally related to the bad news.").

Furthermore, the Second Circuit has repeatedly held that where, like here, multiple defendants are named, the failure of other defendants to sell their stock undermines a plaintiff's theory that negative information was withheld by any defendant to obtain a higher sales price. *See San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996) (finding sale of stock by only one company executive netting more than $2 million in profit did not give rise to a strong inference of fraudulent intent); *Acito*, 47 F.3d at 54 ("The fact that the other defendants did not sell their shares during the class period undermines plaintiffs' claim that defendants delayed notifying the public 'so that they could sell their stock at a huge profit.'") (internal citation omitted).

Similarly, the fact that all the Executive Defendants either retained or increased their holdings throughout the 15-month Exchange Act Period negates any inference of scienter. *In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 561 (S.D.N.Y. 2004) ("*[I]ncreased* . . . holdings during the Class Period [is] a fact wholly inconsistent with fraudulent intent.") (emphasis in original); *see also In re Sina Corp. Sec. Litig.*, No. 05 Civ. 2154, 2006 WL 2742048, at *12 (S.D.N.Y. Sept. 25, 2006) (inference of scienter negated because "Individual

Defendants collectively held 31,532 *more* shares of [the company's] stock" after class period) (emphasis in original); *In re Keyspan*, 383 F. Supp. 2d at 383 (stating that the "acquisition of shares cuts against the notion that defendants sought to unload their holdings of . . . stock before their likely diminution in value following the disclosure of negative insider information").

Defendants Lowitt and O'Meara, each the CFO for a portion of the relevant time, both *increased* their holdings during the Exchange Act Period as their compensation-based restricted stock units ("RSUs") converted to freely-transferable common stock that they did not sell. On the first day of the Exchange Act Period, O'Meara and Lowitt owned 7,860 and 14,702 shares of Company common stock, respectively. Their respective ownership stakes increased substantially to 11,998 and 20,945 shares on November, 30, 2007 upon conversion of RSUs to common stock. *See* O'Meara Form 4 (Ex. 68); Lowitt Form 4 (Ex. 69). Similarly, during the time that she was Chief Financial Officer, Defendant Callan did not sell any of the 4,352 shares of Company common stock she held as of December 1, 2007. *See* Callan Forms 3 and 4 (Exs. 70 & 71). The CFOs "would have been essential participants in any scheme" and thus their having sold no stock undermines any suggestion of knowledge on the part of the Executive Defendants. *In re Comshare Inc. Sec. Litig*., No. 96-73711-DT, 1997 WL 1091468 (E.D. Mich. Sept. 18, 1997) at *10; *see also In re Credit Acceptance Corp. Sec. Litig*., 50 F. Supp. 2d at 677-678 ("[F]act that [CFO] did not sell any shares during the class period undermines the suggestion that the Defendants engaged in securities fraud in order to profit from their own stock sales.").

The SAC also alleges that the Executive Defendants were motivated to make false statements because their compensation "was directly tied to the Company's reported short-term performance." This allegation is false, as will be shown below, so it is not "well-pled." But, even on its face, it is entirely insufficient to establish an inference of fraudulent intent. *See Acito*,

47 F.3d at 54 ("[I]ncentive compensation can hardly be the basis on which an allegation of fraud is predicated."). To support an inference of scienter, motive allegations "must assert a concrete and personal benefit to the individual defendants resulting from the fraud." *Kalnit*, 264 F.3d at 139 (internal citation omitted). None of the Executive Defendants derived a "concrete" or "personal" benefit from Lehman's securities offerings. Motives such as those pleaded by Plaintiffs "that are generally possessed by most corporate directors and officers do not suffice." *Id.*; *see also In re Elan Corp. Sec. Litig.*, 543 F. Supp. 2d 187, 216 (S.D.N.Y. 2008) (noting "[a]ny corporation would be motivated to make a profit, to avoid bankruptcy, or to finance the successful launch of a promising product" and thus such allegations "do not support an inference of scienter").

Moreover, this allegation is not well-pled. It ignores the fact that officer compensation was comprised largely of **RSUs that could not be sold for five years**. Lehman's compensation philosophy was to provide "a significant portion of total compensation in equity-based awards, thereby further aligning the financial interests of employees with those of stockholders and encouraging prudent long-term strategic decisions and risk management." 2008 Proxy St. (Ex. 65) at 20. For example, "Messrs. Fuld, Gregory, . . . O'Meara and Lowitt received 88%, 85%, . . . 70% and 70% of their total annual compensation in RSUs, respectively." 2008 Proxy St. (Ex. 65) at 27. Plaintiffs also disregard the fact that Defendant Fuld had previously **extended** vesting on his stock from seven years to ten years. *See* 2007 Proxy St. (Ex. 64) at 22-23; *The Causes and Effects of the Lehman Bankruptcy: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 178 (Oct. 6, 2008) (Testimony of Richard S. Fuld, Jr.) (Preliminary Transcript) (Ex. 72) at 178. The Executive Defendants clearly had more to gain by

protecting the long-term health of the Company than by defrauding investors to financially benefit from a fraudulent short-term performance.

A complaint fails to plead scienter when the inference of fraudulent intent is less compelling than the inference of innocent conduct. The only inference that can be drawn from the Executive Defendants' substantial, and in some cases growing Lehman stock holdings, and the fact that their RSUs were required to be held long term, is that they believed that Lehman had a positive future. Far from having any motive to defraud investors, the Executive Defendants had "every incentive" to ensure Lehman's long-term financial success. *In re Advanta Corp. Sec. Litig*., 180 F.3d 525, 540-41 (3d Cir. 1999). Plaintiffs fail to satisfy the "motive and opportunity" prong for scienter.

3. There Is No Circumstantial Evidence Of Scienter

a. The SAC Improperly Alleges Fraud Or Reckless Conduct By Hindsight

Because the SAC fails to allege any compelling (indeed, any plausible) motive to mislead investors, Plaintiffs' burden to allege strong circumstantial evidence of conscious misbehavior or recklessness "must be correspondingly greater." *Kalnit*, 264 F.3d at 142 (quoting *Beck v. Mfrs. Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987)). To overcome this hurdle, a plaintiff must allege facts representing "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rothman*, 220 F.3d at 90 (*quoting Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978)). Given how many other financial institutions, government officials and world financial leaders believed the same things about the credit crisis, *see* Ex. 2, it is absolutely impossible to satisfy this standard of an "extreme departure from the standard of ordinary care."

Plaintiffs try to make the circular and contradictory argument that the Executive Defendants either had actual knowledge of the alleged misrepresentations and omissions or were reckless in failing to obtain such knowledge "[a]s demonstrated by their overstatements and misstatements of the Company's financial condition and performance," SAC ¶ 373, i.e., that the Executive Defendants must have known that Lehman's prospects were bleak because its actual performance turned out to be. Plaintiffs are relying merely on the ultimate outcome to plead that the Executive Defendants had knowledge, or should have obtained knowledge as early as June 2007, that their financial strategies would prove unsuccessful 16 months later. This is impermissible fraud-by-hindsight pleading. *See Ciresi*, 782 F. Supp. at 821 (dismissing securities fraud action because, like other complaints pending against defendant and other banks, the "claims in essence try to penalize banking institutions for failing to show greater clairvoyance") (internal quotations omitted); *Coronel v. Quanta Capital Holdings Ltd.*, No. 07 Civ. 1405 (RPP), 2009 WL 174656, at *27 (S.D.N.Y. Jan. 26, 2009) (finding allegations that defendant made improvident business decisions in the wake of the "unprecedented" hurricanes Katrina and Rita pleaded nothing more than hindsight); *Hershfang v. Citicorp*, 767 F. Supp. 1251, 1259 (S.D.N.Y. 1991) ("A complaint must contain more than vague allegations that, as shown by subsequent developments, the corporations true financial picture was not so bright in some respects as . . . painted and that the defendants knew, or were reckless in failing to know, this.") (citation omitted); *cf.* Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rules: Differences in Hindsight Bias*, 73 Or. L. Rev. 587, 587 (1994) ("Hindsight bias is the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted.").

Lawsuits such as this multiply following widespread financial crises, such as in the 1970s, 1980s and late 1990s. But courts in the Second Circuit have consistently rejected attempts to infer fraud following such broad market crises. In *Denny*, 576 F.2d at 470, the Court of Appeals rejected a claim that a bank failed to disclose "risky and speculative" loans during the economic crisis of the 1970s, holding that there was no liability for failing to predict "that foreign governments and enterprises might encounter difficulties, particularly in consequence of the dramatic increase in petroleum prices; that REITs . . . would run into serious trouble . . . and that New York City would come to the verge of bankruptcy." Likewise, in *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994), the Second Circuit dismissed a claim that the defendant knew loans were "precarious" and understated reserves in connection with the collapse of the commercial real estate market in the late 1980s. *See also In re Aegon N.V. Sec. Litig.*, No. 03 Civ. 0603 (RWS), 2004 WL 1415973, at *8 (S.D.N.Y. June 23, 2004) (dismissing Section 10(b) claim based on allegations that the company's bond default reserve was inadequate given the significant deterioration in the credit markets).

Courts have already applied this same reasoning to the current real estate and financial crisis. *In re 2007 Novastar Financial, Inc. Securities Litigation* concerned allegations similar to those here, that management concealed weak mortgage underwriting standards. No. 07-0139-CV-W-ODS, 2008 WL 2354367 (W.D. Mo. June 4, 2008). The *Novastar* Court held the facts were "more consistent with a company and executives confronting a deterioration in the business and finding itself unable to prevent it than they are with a company and executives recklessly deceiving the investing community." *Id.* at *4.

Likewise, in *Tripp v. IndyMac Financial Inc.*, the Court found no strong inference of scienter when the defendant mortgage originator drastically increased secondary market reserves,

increased loan loss reserves, and admitted "mistakes," because "an even stronger inference is that Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic change in the housing and mortgage markets and, once that inability became evident, IndyMac's financials were changed accordingly." No. CV07-1635-GW, 2007 WL 4591930, at *4 (C.D. Cal. Nov. 29, 2007); *see also In re Radian Secs. Litig.*, No. 07-3375, 2009 WL 974324, at *21 (E.D. Pa. Apr. 9, 2009) (finding "plaintiffs here are attempting to show that the defendants recklessly ignored trends in the subprime industry, as well as C-BASS's [mortgage investment and servicing company partially owned by defendant company] risky business, and that therefore they possessed the requisite scienter," but "nothing in the [complaint] establishes that [the company's] failure to report an impairment of its investment in C-BASS was an egregious departure from the range of reasonable business decisions, even in light of the deteriorating subprime market" and dismissing §§ 10(b) and 20(a) claims); *Pittleman v. Impac Mortgage Holdings, Inc.*, No. SACV 07-0970 AG, 2009 WL 648983, at *4 (C.D. Cal. Mar. 9, 2009) (rejecting allegations that mortgage lender's Alt-A underwriting practices during the current financial crisis violated securities laws, finding instead that "[t]his case is about a company involved in a volatile industry at the onset of a long, destructive economic downturn."); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 128 (Del. Ch. 2009) (finding "signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further, is not sufficient to show that the directors were or should have been aware of any wrongdoing at the Company or were consciously disregarding a duty somehow to prevent Citigroup from suffering losses").

The more plausible inference here also is that the Executive Defendants were adjusting their financial strategy and making corresponding disclosures in real time as the magnitude and

impact of the financial crisis became better known to them, but ultimately were unable to shield the Company and its shareholders (including themselves) from the unprecedented and unforeseen changes in the marketplace.

b. The SAC Fails To Plead That The Executive Defendants Received Facts Contradicting Their Public Statements

The Second Circuit recently affirmed that, "[w]here plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information" and must sufficiently plead that defendants "knew facts or had access to information suggesting that their public statements were not accurate." *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 196-97 (2d Cir. 2008) (finding plaintiffs "fail to allege the existence of information that would demonstrate that the statements made to investors were misleading, e.g., information showing that the primary cause of the bonds' poor performance was not the general weakness in the mobile homes market"). Plaintiffs in this action fail to raise an inference of scienter based on knowledge of or access to information demonstrating the inaccuracy of Lehman's and the Executive Defendants' public statements because they do not, nor can they, "compare (1) an allegedly false or misleading statement with (2) Defendants' prior receipt of information demonstrating that the statement would be false or misleading." *In re 2007 Novastar*, 2008 WL 2354367, at *4. As demonstrated below, Plaintiffs (1) improperly rely on the Executive Defendants' respective positions to infer knowledge suggesting alleged problems with Lehman's business; (2) ignore the fact that Lehman and the Executive Defendants consistently made timely disclosures of their best assessment of the impact of the unfolding crisis; (3) fail to allege that during the Exchange Act Period any of Plaintiffs' confidential witnesses actually interacted with or communicated to the Executive Defendants any set of facts contrary to those Defendants' public statements; and (4) cannot demonstrate

fraudulent intent to commit accounting fraud when the SAC simply shows that Lehman used its business judgment when valuing assets in accordance with GAAP.

(1) Allegations Of Scienter Based On The Executive Defendants' Respective Positions At Lehman Are Insufficient

Plaintiffs allege that the Executive Defendants' scienter can be inferred from their awareness as Lehman officers of developments in Company's business and access to data allegedly suggesting that Lehman's financial position was vulnerable. SAC ¶¶ 322, 325-26, 360. This is a claim based on these Defendants' respective positions within the Company. Such boilerplate allegations have been uniformly rejected as insufficient. *See*, *e.g.*, *In re LaBranche Sec. Litig.*, 405 F. Supp. 2d 333, 360-61 (S.D.N.Y. 2005); *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 381 (S.D.N.Y. 2004); *In re Sotheby's Holdings, Inc.*, No. 00 Civ. 1041(DLC), 2000 WL 1234601, at *7 (S.D.N.Y. Aug. 31, 2000). Allegations that the Executive Defendants regularly attended meetings during which risk exposure and risk-taking activities were discussed say nothing about fraudulent intent. *In re 2007 Novastar*, 2008 WL 2354367, at *4 (management's attendance at meetings and discussion of risks "is normal and expected, and does not indicate fraudulent intent"); *In re Health Mgmt. Sys., Inc. Sec. Litig.*, 97 Civ. 1865, 1998 WL 283286, at *6 (S.D.N.Y. June 1, 1998) ("[C]ourts have routinely rejected. . . attempt[s] to plead scienter based on allegations that because of defendants' board membership and/or their executive managerial positions, they had access to information concerning the company's adverse financial outlook.").

(2) Vague Allegations Of Internal Reports That Do Not Contradict The Executive Defendants' Statements Do Not Plead Scienter

Plaintiffs' allegations that the Executive Defendants prepared and received internal "reports," "memoranda" and "presentations" that supposedly "revealed" the deterioration in

Lehman's mortgage and real estate businesses and hedging strategy likewise do not plead scienter.[59] Plaintiffs primarily refer to (1) statements by confidential witnesses relating to internal documents that allegedly "discussed how a meltdown in the commercial mortgage market would follow a meltdown in the residential market" and an alleged report that was "likely commissioned for Fuld's office" on the "danger to the commercial mortgage and CMBS markets beginning in mid 2007," SAC ¶ 337; (2) a January 2008 internal presentation made by a Lehman executive that allegedly alerted Lehman to possible impacts on liquidity and operations from the subprime crisis, *id.* ¶ 347; and (3) a June 2008 internal memorandum that allegedly discussed Lehman's exposure to that crisis. *Id.* ¶ 348.

However, Plaintiffs fail to identify any statement made by Lehman that these internal sources contradict. That is understandable because Lehman consistently disclosed in its public filings that the global real estate decline and liquidity crisis were having a direct effect on the Company's business. *See*, *e.g.*, 2007 1Q Report (Ex. 21) at 44 ("spreads on mortgage-backed securities widened, especially in the subprime sector" and "U.S. subprime residential mortgage market experienced challenges in the first quarter of 2007 with increased delinquencies and significantly wider credit spreads."); 2008 Pr. 2Q Call (Ex. 51), at 3 ("The overall efficiency of hedges this quarter was significantly impacted from the unprecedented dislocation between our derivative hedges and the underlying cash market, a theme that took place throughout the broader capital markets.").

The Executive Defendants consistently made timely disclosures of their best assessment of the impact of the unfolding crisis. In response to the changing financial situation, instead of selling their stock, the Executive Defendants pre-announced earnings for the second and third

[59] SAC ¶¶ 336-41, 347-48.

quarters of 2008. *See* 6/9/08 8-K Ex. 99.1 (Ex. 73) at 9 (pre-releasing Lehman's earnings and disclosed a gross writedown of $3.6 billion and a net writedown of $3.7 billion); 9/10/08 8-K, Ex. 99.1 (Ex. 74) at 1 (pre-releasing Lehman's preliminary earnings for the quarter and informing investors of a gross mark-to-market adjustment of $7.8 billion, net $5.6 billion, including $5.3 billion on residential mortgage-related positions and $1.7 billion on commercial real estate positions.).

Courts in the Second Circuit routinely find that the early disclosure of losses before the company's financial statements are due weakens any inference of scienter. *See*, *e.g.*, *Steinberg v. Ericsson LM Tel. Co.*, No. 07 CV 9615 (RPP), 2008 WL 5170640, at *13 & n.6 (S.D.N.Y. Dec. 10, 2008) (noting pre-announcement of earnings undermines claims of motive and recklessness); *In re Nokia Oyj (Nokia Corp.) Sec. Litig*., 423 F. Supp. 2d 364, 408 n.16 (S.D.N.Y. 2006) ("[A]ny early disclosure of negative results tends, at least to some degree, to disprove alleged recklessness."); *Patel v. Parnes*, No. CV 07-05364 MMM, 2008 WL 2803076, at *25 (C.D. Cal. May 19, 2008), (company's negative disclosures regarding deteriorating market conditions, slowing sales and falling earnings created "a compelling inference of *nonfraudulent* intent") (emphasis in original). Lehman's negative and early disclosures plainly show management acting in good faith.

(3) Allegations By Employees With No Contact With Executive Defendants Cannot Impute Scienter

The SAC relies heavily on so-called "warning signs" from anonymous Aurora, BNC and Lehman employees to allege that the Executive Defendants either knew or should have known that Lehman's Aurora and BNC subsidiaries were engaged in high-risk underwriting and lending practices producing numerous risky loans with subprime characteristics, and purchasing

mortgages of poor quality.[60] As discussed below, these allegations cannot impute scienter because these confidential witness statements (1) are made by persons with no contact with the Executive Defendants; (2) reflect at most an employee expressing a contrary view on a matter of business judgment; (3) are vague and conclusory and lack the particularity required to plead securities fraud; (4) are made by witnesses lacking personal knowledge of the facts at the relevant time; and (5) present credibility issues, including that ex-employees may have an "ax to grind" against Lehman.

Plaintiffs do not allege that during the relevant period any witnesses actually interacted with or communicated to the Executive Defendants facts contrary to those Defendants' public statements.[61] Lehman was a global company with over 28,000 employees and 60 offices,[62] and it is simply not plausible that comments made or reports generated by primarily mid-level employees at Lehman and the California-based BNC and Colorado-based Aurora about those subsidiaries' underwriting practices could establish a strong inference of scienter for high-ranking executives. *See Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270-71 (2d Cir. 1996) (holding fraud could not be inferred on the part of the parent company for alleged improprieties at its subsidiary); *Steinberg*, 2008 WL 5170640, at *13 (rejecting scienter when "all three of Plaintiff's confidential sources were mid-level managers . . . who claim no contacts or communications with Defendants"); *In re Am. Express Co. Sec. Litig.*, No. 02 Civ. 5533, 2008 WL 4501928 (WHP), at *7 (S.D.N.Y. Sept. 26, 2008) (holding complaint did not plead scienter when

---

[60] SAC ¶¶ 98-104, 106, 109-13, 116, 331-34, 345.

[61] Without providing any basis, one of Plaintiffs' confidential witnesses asserts that one report "was likely commissioned" for the CEO's office. SAC ¶ 337. On its face, it is no more than a surmise and cannot establish a strong inference of scienter on the part of any Executive Defendant.

[62] 2007 10-K (Ex. 18) at 14, 22.

confidential sources did not show that concerns of GAAP violations were communicated to defendants); *In re Elan*, 543 F. Supp. 2d at 221 (noting that low-level employees "do[] not ordinarily participate in discussions with [a company's] executives."); *Mizzaro v. Home Depot Inc*., 544 F.3d 1230, 1239-40 (11th Cir. 2008) (rejecting confidential witness allegations as basis for pleading scienter where none of the witnesses claimed to have met the individual defendants nor stated that any of the individual defendants ever discussed or knew about the alleged fraud); *In re Diebold Sec. Litig*., No. 5:05CV2873, 2008 WL 3927467, at *6 (N.D. Ohio Aug. 22, 2008) (stating the Reform Act is not satisfied where "the complaint is lacking in factual particulars that any confidential witness had knowledge regarding exactly what information was known by each individual [d]efendant"). This defect alone requires the Court to dismiss these allegations as evidence of scienter.

Moreover, these confidential witness statements are irrelevant because most show at best a disagreement, a dissent, or an employee expressing a contrary view or different business judgment, to the extent any of the CWs even had knowledge of the business judgment they criticize such as the valuation of mortgage assets. *See*, *e.g*., SAC ¶ 103 (CW3 complaining "Lehman and Aurora were much slower than the rest of the industry to tighten their underwriting guidelines"); ¶ 130 (CW7 describing Lehman's commercial real estate deals as "troubling" and "not being marked down the way they should have been"). Plaintiffs' reliance on them is akin to alleging that everyone in an organization should share identical views of all issues at all times, and that if there is difference of views, that means there was fraud. Courts have repeatedly rejected securities fraud actions that claim in essence, as here, a difference in business judgment. *E.g*., *Shufkin v. Golden State Vintners, Inc.*, 471 F. Supp. 2d 998, 1017 (N.D. Cal. 2006) (allegations by confidential witnesses showed nothing more than "that several . . . employees

disagreed with the business decisions and financial reports of . . . upper management" and were not sufficient to show scienter); *Druskin v. Answerthink, Inc.*, 299 F. Supp. 2d 1307, 1334 (S.D. Fl. 2004) (former employees' alleged statements simply reflected differing business judgments and were insufficient to establish scienter).

Third, many of Plaintiffs' confidential witness allegations are vague and/or conclusory, and lack the particularity necessary to support a strong inference of scienter required for securities fraud. *See Malin v. XL Capital, Ltd.*, 499 F. Supp. 2d 117, 140 (D. Conn. 2007) ("Generic and conclusory allegations based upon rumor or conjecture are indisputably insufficient to satisfy the heightened pleading standard of [the Reform Act].") (internal quotations omitted), *aff'd*, 2009 WL 481897 (2d Cir. Feb. 26, 2009). For example, Plaintiffs rely on the statement of CW9, a contract administrator and repurchase coordinator at Aurora from fall of 2004 to fall of 2006, who was not even employed at Aurora or Lehman during the Exchange Act Period. CW9 allegedly has made several vague assertions that "many of the loans Aurora acquired went into default immediately upon their acquisition," "Lehman was faced with a large number of repurchase requests from its securitizations," and "Aurora continued to buy loans from certain lenders even though they had large numbers of outstanding unpaid repurchase claims." SAC ¶ 111. However, CW9 left the subsidiary months before the relevant period starts, and does not specify the number of loans Aurora acquired, the number that went into default, what percentage of Aurora's overall loan portfolio this represented, what impact this had on Aurora's overall portfolio, or the timing of these acquisitions and defaults. As a result, the statements attributed to this unnamed individual cannot support an inference of scienter.[63] *See*

---

[63] *See also*, *e.g.*, CW8's vague and conclusory allegation that underwriters at BNC were told that they were "not going to make the loans [they] used to, because there's a problem on the horizon." SAC ¶ 345.

Pittleman, 2009 WL 648983, at *3 (finding mortgage lender employees' statements "vague accusation[s] and conjecture" insufficient to show securities fraud as they did not specify "which loans were recommended for rejection, why they were recommended for rejection, or who approved them for sale."); *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 998 (9th Cir. 2009) (rejecting confidential witnesses' allegations which do not establish "the witnesses' personal knowledge or reliability by recounting the particulars of the alleged transgressions").

Fourth, Plaintiffs rely mainly on allegations from witnesses who had stopped working at Lehman, Aurora or BNC by the start of the Exchange Act Period or shortly thereafter, and on allegations from confidential sources concerning events that occurred prior to the Period.[64] Such witnesses lack personal knowledge of facts at the relevant time and their allegations therefore have no bearing on Executive Defendants' state of mind during the period at issue. Rule 9(b), the Reform Act and basic fairness require specific allegations of "*contemporaneous* statements or conditions," and such temporal mismatches should be rejected. *See Ronconi v. Larkin*, 253 F.3d 423, 432 (9th Cir. 2001) (emphasis added) ("[T]he complaint must contain 'contemporaneous statements or conditions' that demonstrate the intentional or the deliberately reckless, false or misleading nature of the statements when made."); *see also Mills v. Polar Molecular Corp.*, Nos. 91 Civ. 0249, 91 Civ. 0902, 1992 WL 309592, at *7 (S.D.N.Y. Oct. 14,

---

[64] Indeed, little more than half of Plaintiffs' witnesses appear to have been employed by Lehman or its subsidiaries during a significant portion of the relevant period that begins on June 12, 2007. *See* SAC ¶ 339 n.4 (CW1 worked at Aurora until August 2006); *id.* ¶ 111 (CW9 worked at Aurora from the fall of 2004 to the fall of 2006); *id.* ¶ 100 (CW16 worked at Aurora from late 2004 to the fall of 2007); *id.* ¶ 116 (CW10 worked at BNC from mid 2005 to October 2007); *id.* ¶¶ 103, 113 (CW3 worked at Aurora from 2002 until the fall of 2007); *id.* ¶ 339 n.4 (CW19 worked at Aurora from 2005 until October 2007); *id.* ¶ 340 (CW10 worked at BNC from mid-2005 to October 2007); *id.* ¶ 340 (CW20 worked at BNC from early 2006 until the fall of 2007); *id.* ¶ 345 (CW8 worked for BNC from 2003 until October 2007).

1992) ("[P]laintiffs have not pointed to any fact contemporaneous with the signing of the employment contracts which demonstrates malice or deliberate intent to defraud.").[65]

Fifth, confidential sources present various credibility issues, and after *Tellabs*, statements by confidential witnesses are viewed with circumspection. *See, e.g., Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 535 (5th Cir. 2008) ("Following *Tellabs*, courts must discount allegations from confidential sources [because] [s]uch sources afford no basis for drawing the plausible competing inferences required by *Tellabs*."); *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007) ("It is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences.").

Allegations from someone unwilling to be identified should be discounted for that reason alone. But here, allegations made by ex-BNC and ex-Aurora employees must also be discounted because such employees likely have "an ax to grind" against Lehman. *Higginbotham*, 495 F.3d at 757; *see also Ind. Elec. Workers' Pension Trust Fund IBEW*, 537 F.3d at 535. Lehman closed BNC's mortgage business in August 2007 and suspended certain lending activities at Aurora in January 2008. SAC ¶ 107. These moves resulted in thousands of layoffs, and it is quite likely that many of the confidential witnesses who as former employees were among them. SAC ¶ 107; 8/22/07 8-K, Ex. 99.1 (Ex. 39) (announcing closure of BNC Mortgage business and layoff of 1,200 employees); 1/17/08 8-K, Ex. 99.1 (Ex. 41) (announcing suspension of Aurora wholesale mortgage loan origination businesses, closure of regional operations centers in California, New Jersey and Florida and layoff of 1,300 employees).

---

[65] In fact, Plaintiffs' confidential witnesses actually describe efforts by Lehman and Aurora to *strengthen* internal underwriting guidelines. *See, e.g.,* SAC ¶ 345 (asserting that in the spring of 2007, Lehman wanted to "tighten up [underwriting] guidelines").

(4) Plaintiffs' Allegations Regarding Valuations And Accounting Methods Fail To Plead Scienter

Plaintiffs make a number of allegations regarding Lehman's valuation and accounting methodology. However, as discussed below, these allegations fail to plead scienter because: (1) Plaintiffs cannot plead fraud by pointing to different valuation and accounting decisions taken by other firms; (2) allegations of GAAP violations alone, without evidence of corresponding fraudulent intent, do not establish scienter; (3) Plaintiffs do not allege that the Executive Defendants received any reports concerning GAAP violations or accounting irregularities; (4) Plaintiffs do not allege that Lehman restated any of its financial statements or received a qualified audit opinion; and (5) the valuation of assets and application of other sophisticated accounting standards leaves broad scope for judgment and Plaintiffs simply plead that Lehman used its business judgment when valuing assets in accordance with GAAP.

Plaintiffs make allegations to the effect that, beginning in 2007, a certain number of Lehman's peer institutions were taking larger write-offs than it did and that Lehman should have followed suit by taking larger and earlier writedowns. SAC ¶¶ 147-48.[66] However, Plaintiffs cannot allege fraud against Lehman by pointing to actions taken by others relating to different assets and different circumstances. Plaintiffs have not shown that these other investment firms' assets were the same as Lehman's. Plaintiffs must allege with particularity what amount of

---

[66] The SAC points to the fact that "in June 2007, two Bear Stearns-managed funds suffered significant losses related to securities linked to impaired subprime loans." SAC ¶ 147. Ironically, a complaint filed against Bear Stearns – by counsel for one of the Plaintiffs here – touts evidence of fraud in Bear Stearns' alleged delay in revealing losses stemming from the two funds. *See* Exhibit 1, Complaint No. 7 ¶¶ 205-16. Indeed, all of the financial firms Plaintiffs point to as examples of companies that took writedowns of mortgage related holdings sooner and more "adequately" – Merrill Lynch, Citigroup, UBS and Bear Stearns – have, like Lehman, also been sued for overvaluing their assets and/or for not taking writedowns even earlier than they did. *Id.* at Complaint Nos. 240 ¶¶ 56-57 (UBS), 7 ¶¶ 110-11 (Bear Stearns), 109 ¶¶ 576, 579 (Citigroup) and 275 ¶¶ 34, 40 (Merrill Lynch).

write-off the Lehman Executive Defendants should have taken, when and on what basis. Challenging the amount and timing of valuations and writedowns does not by itself give rise to an inference of scienter. *See Stevelman v. Alias Research, Inc.,* 174 F.3d 79, 84 (2d Cir. 1999) ("Mere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud.") (internal citations omitted); *see also Caiafa v. Sea Containers Ltd.*, 525 F. Supp. 2d 398, 413 (S.D.N.Y. 2007) (a securities fraud claim requires pleading misstatements "coupled with evidence of corresponding fraudulent intent") (quoting *Novak*, 216 F.3d at 309). Moreover, "there is little basis to assume that a decline in projected revenue for [defendants] competitors would necessarily lead to a decline in [defendants'] projected revenues as well." *Steinberg,* 2008 WL 5170640, at *15; *see also In re PXRE Group Ltd.*, No. 06 Civ. 3410 (RJS), 2009 WL 539864 (S.D.N.Y. Mar. 4, 2009).

Likewise, Plaintiffs' various allegations of GAAP violations – even if true, which they are not – cannot establish scienter. Plaintiffs allege that Lehman violated FAS 5 because the Company purportedly did not take writedowns. SAC ¶ 121-122. They also allege that Lehman violated FAS 107, as amended by FAS 133, by grouping Alt-A with Prime mortgage-related assets and therefore inadequately disclosing its concentrations of credit risk. SAC ¶¶ 118-120. Even the publication of data that fails to follow GAAP, however, would not establish scienter. "Only where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." *Novak*, 216 F.3d at 309; *see also Davidoff v. Farina*, No. 04 Civ. 7617 (NRB), 2005 WL 2030501, at *17 (S.D.N.Y. Aug. 22, 2005) (finding plaintiffs' "failure to allege motive is fatal because allegations of GAAP violations or accounting irregularities alone are insufficient to state a securities fraud claim."); *In re Bisys*, 397 F. Supp. 2d at 448 (noting "plaintiffs' allegations that the Company's financial reports violated GAAP or their own internal

policies merely establish that the reports were false" and "do not establish that the Individual Defendants issued those reports with the requisite fraudulent intent").

In addition, courts have recognized that "[v]aluations of assets . . . as well as the application of sophisticated accounting standards like 'fair value,' leave broad scope for judgment and informed estimation; this is another way of saying that determinations on such matters can differ reasonably and sizably" and therefore "Plaintiffs cannot transform inherently nuanced conclusions into fraudulent misstatements or omissions simply by saying that there were abuses or misuses of the GAAP rules." *Ind. Elec. Workers' Pension Trust Fund IBEW*, 537 F.3d at 535-36; *see also Fraternity Fund Ltd. v. Beacon Hill Asset Mgm't LLC*, 376 F. Supp. 2d 385, 396 (S.D.N.Y. 2005) (Kaplan, J.) (noting in § 10(b) context that valuation of illiquid securities is "not a matter of looking up closing prices in the *Wall Street Journal*, but involved the exercise of judgment").

Moreover, the SAC does not allege that the Executive Defendants received any reports concerning GAAP violations or accounting irregularities even from the anonymous confidential witnesses. *See Am. Express*, 2008 WL 4501928 (WHP), at *7 (holding complaint alleging GAAP violations concerning writing down high yield debt to fair value did not plead scienter when confidential sources did not show that concerns of GAAP violations or valuation irregularities were communicated to defendants). Nor do Plaintiffs specify which particular assets were valued improperly under GAAP, why the valuation procedure was improper, nor the approximate amount by which the valuations were misstated, which the Second Circuit requires to prove a strong inference of scienter for accounting fraud. *See Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 115-16 (2d Cir. 1982); *Caiafa*, 525 F. Supp. 2d at 410-11; *In re Polaroid Corp. Sec. Litig.*, 134 F. Supp. 2d 176, 186 (D. Mass. 2001) ("In order to plead adequately

financial fraud based on improper revenue recognition [under GAAP], the complaint must describe the violations at issue with sufficient particularity, setting forth such basic details as the particular transaction in which revenues were improperly recorded; the approximate amount by which revenues and earnings were overstated; the identities of the customers or employees involved in the transactions; the terms of the specific transaction; the dates of the transactions; the approximate amount of the transaction; and the products involved.") (internal citation omitted).

Similarly, Plaintiffs do not, and cannot, allege that Lehman restated any of its financial statements or received a qualified audit opinion. Such "omissions suggest that reasonable accountants could differ" on how a financial accounting standard applied and negate Plaintiffs' scienter allegations. *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1229 (S.D.N.Y. 1992) (holding area of accounting requiring "subjective analysis of various factors" was "clearly an area in which reasonable accountants can differ, and such reasonable disagreements cannot support an inference of recklessness or fraud").

It is also most telling that Plaintiffs have dropped their allegations against the Company's auditors. The most compelling inference here is that if Plaintiffs thought they could prove GAAP violations, they would have sued those responsible for auditing the accounting.

Far from alleging that the Executive Defendants acted with fraudulent intent to commit accounting fraud, the SAC shows Lehman simply used its business judgment when valuing assets in accordance with GAAP.[67] *See Fadem*, 2003 WL 22227961, at *4 (stating "[c]ourts do

---

[67] Circuit courts have "unanimously agreed that allowing Sarbanes-Oxley certifications to create an inference of scienter in 'every case where there was an accounting error or auditing mistake made by a publicly traded company' would 'eviscerat[e] the pleading requirements for scienter set forth in the PSLRA.'" *Zucco*, 552 F.3d at 1004 (internal citation omitted) (collecting cases from 11th, 8th and 5th Circuits); *see also Cozzarelli v. Inspire Pharms.,*

not second guess the decisions made in the course of business operations, lest every strategy that goes awry becomes subject to a lawsuit, and corporations are inhibited from following all but the most conservative path.").

4. The Most Logical Inference Is That The Executive Defendants Were Merely Responding To Unforeseen Market Conditions

It is contrary to law and common sense to impute to Lehman executives perfect foresight of the mortgage and credit crises based upon a smattering of selected reports discussing market-wide risks of the mortgage markets, and, based upon this alleged prescience, infer fraud. These very crises were the ones that substantially diminished the net worth of the Defendants themselves. The SAC merely pleads facts alleging the inability of Defendants – like many others in the financial sector – to successfully predict the scope of and manage the snowballing mortgage and credit crisis. This does not plead scienter. *See, e.g., Shields*, 25 F.3d at 1129 (pleading "suggests that the defendants should have been more alert and more skeptical, but nothing indicates that management was promoting a fraud").

These same mismanagement allegations could be leveled against nearly every financial institution, mortgage lender, bank and insurer during the current financial crisis. Indeed, virtually every major financial institution in the country, if not in the world, has been accused of the nearly identical "fraud." *See* Ex. 1 (collecting over 520 securities cases and allegations). It defies common sense to conclude that most of the financial institutions and mortgage lenders in

---

Inc., 549 F.3d 618, 628 n.2 (4th Cir. 2008). "Sarbanes-Oxley certifications are not sufficient, without more, to raise a strong inference of scienter," *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 747 (9th Cir. 2008), and Plaintiffs fail to establish facts that such signatories were "severely reckless in certifying the accuracy of the financial statements," or "facts establishing that the officer who signed the certification had a 'reason to know,' or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions." *Ind. Elec. Workers' Pension Trust Fund IBEW*, 537 F.3d at 544-45.

the United States at the same time yet independent of one another committed the same fraud. The more plausible inference is that everyone – including former U.S. Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke, former Chairman Alan Greenspan, the IMF, the nation's most sophisticated financial institutions and financial experts around the world – was surprised by the severity and longevity of the economic crisis. The Second Circuit has been careful not to infer fraud from major disasters. *E.g.*, *Denny*, 576 F.2d at 470 (lack of "clairvoyance" to anticipate economic crisis of the 1970s does not constitute fraud); *Shields*, 25 F.3d at 1129 (no securities fraud for alleged understated reserves in connection with the collapse of the commercial real estate market in the late 1980s); *In re Aegon*, 2004 WL 1415973, at *10-11 (no securities fraud for allegedly understating reserves during dramatic decline in equity and credits markets in 2000); *see also supra* Section C.3.a (collecting cases finding courts have not inferred fraud from current financial crisis).

D. Plaintiffs Do Not Plead Loss Causation

The SAC also fails to allege the essential element of "a causal connection between the material misrepresentation and the loss." *Dura*, 544 U.S. at 342. "Establishing loss causation is critical because Section 10(b) is not meant to 'provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.'" *In re Rhodia S.A. Sec. Litig.*, 531 F. Supp. 2d 527, 544 (S.D.N.Y. 2007) (quoting *Dura*, 544 U.S. at 345).

Loss causation is generally pleaded by pointing to a "corrective disclosure" that reveals the falsity of the prior statements, followed by a drop in the stock price. *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 (2d Cir. 2005). Plaintiffs must plead loss causation with sufficient specificity to enable the court to evaluate whether the necessary causal link exists. *Id.* at 172. In addition, the Supreme Court has recognized that a decline in stock price does not by itself

indicate that the inaccuracy of a prior statement has been revealed, but may reflect a number of factors, such as "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events." *Dura*, 544 U.S. at 343.

1. The Decline In Lehman's Stock Price Did Not Follow Any Corrective Disclosure

Under well-settled law, a disclosure is corrective only if it reveals the falsity of the prior statements at issue. For example, courts in this Circuit have found:

- **Second Circuit**: "These allegations do not amount to a corrective disclosure, however, because they do not reveal to the market the falsity of the prior recommendations." *Lentell*, 396 F.3d at 175 n.4.

- **Judge Pauley**: "[W]here a disclosure does not reveal the falsity of the alleged misstatements, it does not qualify as 'corrective.'" *In re Omnicom Group, Inc. Sec. Litig*., 541 F. Supp. 2d 546, 552 (S.D.N.Y. Jan. 29, 2008).

- **Judge Batts**: "[T]he loss causation requirement is satisfied only if the public disclosure causing injury addressed the specific fact allegedly concealed." *In re Rhodia*, 531 F. Supp. 2d at 545.

- **Judge Daniels**: Loss causation "requires a showing that plaintiff suffered an economic loss fairly attributable to the public airing of the alleged fraud. . . . It is the exposure of the falsity of the fraudulent representation that is the critical component of loss causation." *In re Winstar Communications*, No. 01 CV 3014, 2006 WL 473885, at *13-14 (S.D.N.Y. Feb. 27, 2006).

- **Judge Cote**: "A concealed fact cannot cause a decrease in the value of a stock before the concealment is made public." *In re WorldCom, Inc. Sec. Litig*., No. 02 CV 3288, 2005 WL 375314, at *6 (S.D.N.Y. Feb. 17, 2005) (internal quotation omitted).

The section of the SAC titled "Loss Causation" refers to three Lehman announcements, including one that is followed by two analysts' "predict[ions]" concerning what Lehman might do in the future, and Lehman's bankruptcy. SAC ¶¶ 363-66. None of these constitutes a corrective disclosure. It is telling that the Loss Causation section does not even allege that either the Lehman announcements or the analysts' predictions contained any corrective disclosure on

the subject of Lehman's capitalization and liquidity, one of the principal subjects of alleged misstatements on which the SAC rests.

The first disclosure upon which Plaintiffs rely is Lehman's June 9, 2008 announcement that in the second quarter (during which the real estate, mortgage and credit markets continued to deteriorate) it wrote down the value of its real estate assets – the very thing Plaintiffs criticize Lehman for allegedly not having done (*see*, *e.g.*, SAC ¶ 229) – and incurred losses. The second disclosure upon which they rely is Lehman's September 8, 2008 announcement of when the Company would release its third quarter results and two analyst predictions that Lehman would take further writedowns. The third disclosure upon which they rely is Lehman's September 10, 2008 announcement that in the third quarter (during which there was further market deterioration) it also wrote down real estate assets and incurred losses.

These announcements simply do not constitute a corrective disclosure because the writedowns or predictions of writedowns say or prove nothing with respect to the correctness of Lehman's valuation of assets in prior periods with better economic conditions, and because poor financial performance by itself does not establish that fraud was committed or misstatements were made. *See*, *e.g.*, *In re Downey Sec. Litig*., No. CV 08-3261-JFW, 2009 WL 736802, at *15 (C.D. Cal. Mar. 18, 2009) (dismissing securities fraud claim alleging misrepresentations regarding the quality of subprime loan portfolio and underwriting practices on loss causation and other grounds, holding "the public disclosures referenced in the [complaint] do not contain a disclosure of wrongdoing, and, at best, demonstrate only that the market learned of and reacted to [the company's] 'poor financial health' rather than any alleged fraud."); *In re Rhodia*, 531 F.

Supp. 2d at 545 (stating the "[d]isclosure of financial losses generally – even if those financial losses are a result of the specific concealed fact – is not sufficient" to show loss causation).[68]

The fact that Lehman's stock price dropped following these events does not establish that the drop is attributable to a corrective disclosure, as opposed to new or different bad news. *See Leykin v. AT&T Corp.*, 423 F. Supp. 2d 229, 245 (S.D.N.Y. 2006) ("*Dura* itself makes clear that loss causation is not pled upon allegations of drops in stock price following an announcement of bad news that does not disclose the fraud.") (internal citation omitted). And the fact that a company filed for bankruptcy protection does not establish that prior thereto its officers were engaged in securities fraud. *See Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 (2d Cir. 2007) (affirming dismissal because plaintiffs failed to allege a sufficient connection between the defendant's misstatements and the company's subsequent bankruptcy).

Lehman and the Executive Defendants never contradicted, corrected or revised any descriptions of the Company's mortgage and real estate business, the risks associated with that business, or its hedging strategies. They never indicated that Lehman was inadequately capitalized or lacked sufficient liquidity. The SAC merely pleads that Lehman's stock price fell following the disclosure of negative **developments** in the value of its real estate assets and quarterly losses, not any corrective disclosure or other causal connection between the alleged fraud and Plaintiffs' losses.

---

[68] With respect to the second Lehman announcement and analysts' statements, the SAC alleges: "On September 8, 2008, Lehman announced that it would release its third quarter 2008 results and key strategic initiatives for the Company on September 18. In this respect, analysts at Bernstein Research and Oppenheimer predicted further writedowns in the third quarter of between $4 and $5 billion. As a result of this news, Lehman's shares finished the trading day down 12.7%." SAC ¶ 364. A company's identification of the date on which it will release results can hardly constitute a corrective disclosure. Nor can analyst predictions that for the third quarter in the face of market declines Lehman would write down assets, as it had in the second quarter in the face of market declines. Neither statement reveals any wrongdoing on the part of Lehman.

2. Plaintiffs' Losses Were Caused By Unforeseen And Uncontrollable Market Forces, Not Alleged Misstatements Or Omissions

In the face of a global market downturn, Plaintiffs "must distinguish the alleged fraud from the 'tangle of [other] factors' that affect a stock's price." *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, No. 02 CIV 9690, 2008 WL 2324111, at *7 (S.D.N.Y. June 4, 2008) (internal quotation omitted). Courts have rejected securities fraud complaints on causation grounds when the claims coincided with market-wide declines.

One Second Circuit decision is entirely dispositive of the fraud claims here. In *First National Bank v. Gelt Funding Corp.*, the Second Circuit affirmed the 12(b)(6) dismissal of a claim brought in the wake of a real estate market downturn precisely because plaintiffs could not appropriately allege causation:

> [W]hen the plaintiff's loss coincides with a market-wide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases. . . . [A plaintiff's claim fails when it has not] adequately plead facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events.

27 F.3d 763, 772 (2d Cir. 1994); *see also Powers v. British Vita. P.L.C.*, 57 F.3d 176, 189 (2d Cir. 1995) (affirming dismissal for failure to state a claim on loss causation grounds due to "presence of a second direct intervening cause" of loss); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (if the defendants' business failed because of "industry-wide phenomena that destroyed all or most such ventures," then plaintiffs "lost nothing by reason of the defendants' fraud and have no claim to damages").

Plaintiffs must allege and prove loss causation. They have not alleged facts sufficient to show that their losses were caused by the Executive Defendants' purported misrepresentations, rather than by the real estate and financial crisis. Lehman's stock collapsed amid what former

Federal Reserve Chairman Alan Greenspan called a "once in a century credit tsunami."[69] Indeed, the stock price of other financial firms showed an erosion similar to that of Lehman's stock during the Exchange Act Period, with the S&P 500 Financial Sector Index dropping nearly 50% during that time.[70] Plaintiffs acknowledge that Lehman was only one part of a broader industry collapse. They characterize the real estate and mortgage markets as "in the midst of an unprecedented meltdown," SAC ¶ 2, and in their Initial Complaint[71] allege that the market "environment" during the relevant period was defined by, among other things "severe financial difficulties experienced by mortgage originators and other investment banks," including "Citigroup, Merrill Lynch, Morgan Stanley, Bear Stearns, and UBS." *Id.* ¶ 3.

3. The SAC Fails To Apportion Losses Between The Disclosed And Allegedly Concealed Information

It is Plaintiffs' burden to separate loss caused by alleged misstatements from loss caused by other events. Here, as the chart below shows, some of Lehman's biggest stock price drops followed the announcement of news concerning third parties. For example, following the collapse of Bear Stearns in mid-March 2008, Lehman's stock fell 35% over a five-day period.[72] Likewise, following the news of severe problems with Fannie Mae and Freddie Mac in July

---

[69] *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight*, 110th Congress 1 (Oct. 23, 2008) (testimony of Dr. Alan Greenspan) (Ex. 13).

[70] Google Finance, Chart of S&P 500 Financial Sector Index from June 2007 to Present (covering Exchange Act Period), http://www.google.com/finance?q=INDEXSP:.SPSY (last visited Apr. 24, 2009) (Ex. 75).

[71] "[S]tatements in superseded pleadings . . . are still admissions for evidentiary purposes." *In re Initial Public Offering Sec. Litig.*, 544 F. Supp. 2d 277, 291 n.96 (S.D.N.Y. 2008).

[72] Lehman Brothers Holdings, Inc. Closing Share Price, Mar. 13, 2008-Mar. 17, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on Mar. 20, 2009) (Ex. 45) (stock fell 35%, from 45.99 on March 13, 2008 to 31.75 on March 17, 2008).

2008, Lehman's stock fell 45% from July 9, 2008 to July 14, 2008.[73] And in their Initial Complaint, Plaintiffs even admitted that Lehman's stock price declined as a result of news that Lehman's negotiations with the Korean Development Bank were not going well, e.g.: "[o]n Wednesday June 11, 2008, Financial Times reported that Lehman had sought to raise additional capital from South Korean financial institutions. On this news, Lehman's shares closed down 13.6%." Initial Compl. ¶ 3. And on September 9, Lehman's stock dropped 37% on news that talks with KDB had ended. *Id.*

SUBSTANTIAL PARTS OF LEHMAN'S STOCK DROP HAD NOTHING TO DO WITH ITS WRITEDOWNS OR REAL ESTATE ASSETS		
DATE	EVENT	STOCK DROP
Mid-March 2008	Bear Stearns Collapse	35%
June 11, 2008	Reports Of Talks With KDB Not Going Well	13.6%
July 2008	News Of Fannie Mae, Freddie Mac Problems	45%
September 9, 2008	Talks With KDB Ended	37%

While the severity and longevity of the financial crisis were unexpected by Lehman (and most others), the risks that materialized had been consistently disclosed by the Company. Both before and during the Exchange Act Period Lehman issued numerous clear warnings to investors regarding the nature and extent of its involvement in mortgage and real estate asset businesses, and the risks facing the Company, including from those businesses and the inherent limitations in its hedging strategies and other risk mitigation techniques. *See, e.g.*, Section D, *supra*. Plaintiffs

[73] Lehman Brothers Holdings, Inc. Share Prices, July 9, 2008-July 14, 2008, Bloomberg L.P. (accessed via Bloomberg Terminal on Mar. 24, 2009) (Ex. 76) (stock fell 45% from $22.44 at the opening on July 9, 2008 to $12.40 at the closing on July 14, 2008).

do not, and cannot, allege "facts sufficient to support an inference that it was defendant's fault" – rather than the sweeping market collapse – "that proximately caused plaintiff's loss." *Lentell*, 396 F.3d at 177.

The Second Circuit requires plaintiffs to plead facts sufficient "to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment." *Lentell*, 396 F.3d at 177; *see also Lattanzio*, 476 F.3d at 158 (holding plaintiff must "allege[] facts that would allow a factfinder to ascribe some rough proportion of the whole loss to [defendant's] misstatements"). Plaintiffs have not alleged any facts that would permit the Court to apportion any drop in Lehman's stock price between on the one hand any alleged misrepresentations and on the other hand the extraordinary financial crisis in which the Company became embroiled and the materialization of the risks that were repeatedly disclosed by the Company.

Instead, Plaintiffs merely speculate that the decline in Lehman's share price during the Exchange Act Period – including the share price declines that occurred *before* Lehman's first alleged corrective disclosure on June 9, 2008 – "are directly attributable to the market's reaction to the disclosure of information that was previously misrepresented or concealed." SAC ¶ 367. In so doing, Plaintiffs fail to acknowledge the unquestionable impact of the economic crisis affecting Lehman and other peer institutions. As such, the SAC fails to adequately plead loss causation. *See In re Initial Pub. Offering Sec. Litig.*, 399 F. Supp. 2d 298, 309 n.61 (S.D.N.Y. 2005) (dismissing securities fraud claims where plaintiffs failed to meet the "heavy burden of alleging specific losses that are connected to the risks that were actually *concealed*, rather than those risks that were *disclosed* by defendants in their cautionary statements") (emphasis in original); *In re The Warnaco Group, Inc. Sec. Litig.*, 388 F. Supp. 2d 307, 318 (S.D.N.Y. 2005)

(dismissing securities fraud claims in part because "[t]he amended complaint contains no allegations relating to the apportionment of plaintiffs' losses between the disclosed and concealed portions of the risk that materialized").

E. Plaintiffs' §§ 20(a) And 20A Claims Should Be Dismissed

Plaintiffs' failure to state a claim under § 10(b) and Rule 10b-5 dooms both their § 20(a) claim against all of the Executive Defendants and their § 20A claim against Fuld.

To state a claim for control person liability under § 20(a) Plaintiffs must plead, *inter alia*, a predicate violation of the Exchange Act. *ATSI Commc'ns,* 493 F.3d at 108; *SEC v. First Jersey Sec., Inc*., 101 F.3d 1450, 1472 (2d Cir. 1996). Because Plaintiffs do not properly allege a primary violation of the Exchange Act as set forth above, their claim against the Executive Defendants under § 20(a) fails as a matter of law. *See, e.g.*, *ECA*, 553 F.3d at 207 (granting defendants motion to dismiss under § 20(a) for failure to adequately allege a primary violation of the Exchange Act).

Plaintiffs' claim against Fuld for liability under § 20A similarly fails. Plaintiffs must allege, *inter alia*, "a predicate insider trading violation of the Exchange Act." *In re Take-Two Interactive Sec. Litig*., 551 F. Supp. 2d 247, 309 (S.D.N.Y. 2008) (internal citations omitted). Because the SAC fails to plead a predicate insider trading violation, *see supra* Section I.C., Plaintiffs' § 20A claim against Fuld necessarily fails. *See Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co*., 32 F.3d 697, 704 (2d Cir. 1994) (holding that a § 20A claim "must plead as a predicate an independent violation of the '34 Act").

CONCLUSION

For all the reasons set forth above, the Executive Defendants respectfully request that the Court dismiss the Exchange Act Claims of the SAC in its entirety and with prejudice. Because the SAC has already been amended and because it rests on a non-actionable premise, the Exchange Act Claims should be dismissed without leave to further amend.

Dated: New York, New York
April 27, 2009

SIMPSON THACHER & BARTLETT LLP

By _/s/ Michael J. Chepiga__________________

Michael J. Chepiga
(mchepiga@stblaw.com)
Mary Elizabeth McGarry
(mmcgarry@stblaw.com)
Marissa Piropato
(mpiropato@stblaw.com)
Erika H. Burk
(eburk@stblaw.com)
425 Lexington Avenue
New York, New York 10017-3954
Telephone: (212) 455-2000
Facsimile: (212) 455-2502

Attorneys for Defendants Joseph M. Gregory, Ian Lowitt and Christopher M. O'Meara

ALLEN & OVERY LLP

By _/s/ Patricia M. Hynes__________________

Patricia M. Hynes
(patricia.hynes@newyork.allenovery.com)
Todd Fishman
(todd.fishman@newyork.allenovery.com)
1221 Avenue of the Americas
New York, NY 10010
Telephone: (212) 610-6323
Facsimile: (212) 610-6399

Attorneys for Defendant Richard S. Fuld, Jr.

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP

By __/s/ Audrey Strauss____________________

Audrey Strauss
(audrey.strauss@friedfrank.com)
Israel David
(israel.david@friedfrank.com)
One New York Plaza
New York, New York 10004
Telephone: (212) 859-8218
Facsimile: (212) 859-4000

Co-Counsel for Joseph M. Gregory

PROSKAUER ROSE LLP

By _/s/ Robert J. Cleary____________________

Robert J. Cleary
(rjcleary@proskauer.com)
Dietrich L. Snell
(dsnell@proskauer.com)
Mark E. Davidson
(mdavidson@proskauer.com)
Seth D. Fier
(sfier@proskauer.com)
1585 Broadway
New York, NY 10036
Telephone: (212) 969-3000
Facsimile: (212) 969-2900

Attorneys for Defendant Erin Callan