IN THE UNITED STATES DISTRICT COURT
FOR THE 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, No. 08 Civ. 5523 (LAK)

Civil Action No. 09 MD 2017 (LAK)

ECF CASE

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT ERNST & YOUNG LLP'S MOTION TO DISMISS

Miles N. Ruthberg
Jamie L. Wine
LATHAM & WATKINS LLP
885 Third Avenue
New York, NY 10022-4834
Tel: (212) 906-1200
Fax: (212) 751-4864

Kevin H. Metz, *pro hac vice*
LATHAM & WATKINS LLP
555 Eleventh Street, NW
Washington, DC 20004-1304
Tel: (202) 637-2200
Fax: (202) 637-2201

Peter A. Wald, *pro hac vice*
LATHAM & WATKINS LLP
505 Montgomery Street, Suite 2000
San Francisco, CA 94111-2562
Tel: (415) 391-0600
Fax: (415) 395-8095

Attorneys for Defendant Ernst & Young LLP

Date: June 4, 2010

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Defendant Ernst & Young LLP ("EY"), independent auditors of the financial statements of Lehman Brothers Holdings, Inc. ("Lehman"), respectfully submits this Memorandum of Law in Support of its Motion to Dismiss Plaintiffs' Third Amended Complaint ("TAC" attached as Ex. 1)[1] pursuant to Federal Rules of Civil Procedure 8, 9(b), 12(b)(1), and 12(b)(6), and the Private Securities Litigation Reform Act of 1995 ("PSLRA").

PRELIMINARY STATEMENT

Relying almost exclusively on the recently-released Lehman Bankruptcy Examiner's Report ("Examiner's Report" or "Report"),[2] Plaintiffs have for the first time added EY as a defendant in this litigation. Plaintiffs attempt to assert claims against EY under Section 11 of the Securities Act and Section 10(b) of the Exchange Act, arising out of statements in EY's audit opinion on Lehman's 2007 year-end financial statements, and EY's quarterly review reports in 2007 and 2008. They rely heavily on the Examiner's discussion of certain Lehman repurchase transactions, called "Repo 105s," to support their claims against EY, yet conveniently ignore two fundamental tenets of that discussion, which underscore the conclusion that no such claims lie.

First, the Examiner did not find that Lehman's accounting for the Repo 105 transactions was wrong. Report at 964. Indeed, Lehman's accounting for those transactions was consistent with Statement of Financial Accounting Standards No. 140 ("SFAS 140"), the controlling guidance under Generally Accepted Accounting Principles ("GAAP") at the time. Plaintiffs do not—because they cannot—identify any guidance within GAAP establishing that it was improper for Lehman to account for Repo 105 transactions as sales instead of as financings; on the contrary, the governing literature expressly contemplates such sale accounting treatment. Nor can they point to any contemporaneous guidance requiring specific disclosure of the Repo

[1] Citations to "Ex. __" refer to exhibits attached to the Declaration of Christopher S. Turner filed herewith.

[2] Report of Anton R. Valukas, Examiner, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (S.D.N.Y. Mar. 11, 2010) (Ex. 2).

105 transactions. Only in June 2009, well after EY's audit and Lehman's bankruptcy, did the Financial Accounting Standards Board ("FASB") issue revised accounting standards requiring disclosure of such transactions on a prospective basis. EY cannot be liable for an opinion concerning accounting treatments and disclosures that complied with then-existing GAAP.

Second, the Examiner acknowledged what is obvious from the housing and financial crises of 2008: Lehman's audited financial statements and its accounting for Repo 105 transactions were not the cause of its collapse. Rather, as the Examiner determined, Lehman "failed because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity to meet its current obligations." Report at 16. The growing illiquidity of Lehman's asset base and its 2007 business decision to "double-down" in the real estate sector—disclosed in Lehman's financial statements and understood by the market—coupled with the dramatic and unanticipated constriction of the credit markets and subsequent run on the bank in 2008, caused the company's precipitous decline and failure. As is clear from the TAC, Lehman's accounting for Repo 105 transactions did not conceal these risks.

Not only are no claims against EY warranted—no claims against EY are stated. Review of the TAC and documents incorporated therein establishes that Plaintiffs have failed to state a claim against EY under either the Securities Act or the Exchange Act. As Lehman's independent auditors, EY opined that it conducted its year-end 2007 audit in accordance with Generally Accepted Auditing Standards ("GAAS"),[3] and that Lehman's financial statements "present[ed] fairly, in all material respects" Lehman's consolidated financial position and results of operations "in conformity with U.S. [GAAP]." 2007 10-K (Ex. 3) at 84. Plaintiffs fail to allege, even as a general matter, that EY "did not truly hold [its] opinion at the time it was issued." *Fait v.*

[3] "GAAS" refers to audit and review standards of the Public Company Accounting Oversight Board ("PCAOB").

Regions Fin. Corp., --- F. Supp. 2d ---, 2010 WL 1883487, at *3 (S.D.N.Y. May 10, 2010). As this Court recently held in *Regions*, such allegation is a threshold requirement under the Securities Act for pleading an opinion's falsity—and this holding applies equally to the Exchange Act. Absent such allegation, Plaintiffs have not pled falsity as to EY's statements, and dismissal of Plaintiffs' claims under the Securities and Exchange Acts is required.

In addition, the Court should dismiss Plaintiffs' Exchange Act claims because the TAC fails to allege with the particularity required by Rule 9(b) of the Federal Rules of Civil Procedure (1) that Lehman's financial statements violated GAAP, and that EY's audit and reviews violated GAAS; (2) a strong inference of scienter as to EY, approximating actual intent to defraud and equivalent to showing that EY performed "no audit at all;" and (3) loss causation, or a showing that the risk materializing in Lehman's bankruptcy—Lehman's inability to fund its operations—was concealed by Lehman's accounting for or disclosures regarding its Repo 105 transactions. Plaintiffs' Securities Act claims arising out of the same course of conduct similarly fail: (1) the TAC fails to allege with the particularity required by Rule 9(b), or alternatively Rule 8, that Lehman's year-end 2007 financial statements violated GAAP and EY's audit violated GAAS; and (2) the TAC itself reveals that EY's alleged misstatements did not cause Plaintiffs' loss.

BACKGROUND

A. Lehman's Financial Reports And Offering Statements

Lehman filed annual reports ("10-Ks") and quarterly reports ("10-Qs") with the U.S. Securities and Exchange Commission ("SEC"). Plaintiffs allege that Lehman's 2007 10-K and its 10-Qs for 2007 and the first and second quarters of 2008 were materially misleading. Specifically, Plaintiffs allege, *inter alia*, that Lehman did not make proper disclosures regarding its Repo 105 transactions (TAC ¶¶ 29-60), risk management practices (TAC ¶¶ 70-84, 104-09), bankruptcy and liquidity risks (TAC ¶¶ 85-88), and real estate asset valuations (TAC ¶¶ 89-103).

Plaintiffs allege that Lehman incorporated these purported misrepresentations into 119 offerings ("the Offerings") issued between March 30, 2007 and June 30, 2008, and conducted pursuant to a May 30, 2006 Shelf Registration Statement and Prospectus. TAC ¶ 23, App'xs A, B. Plaintiffs do not allege misrepresentations in the Offerings or Shelf Registration Statement. Instead, they contend that any 10-K, 10-Q, or 8-K filed by Lehman prior to such Offering is incorporated therein, and that all allegedly actionable statements arise out of these prior filings.

B. EY's Role As Independent Auditor

EY has been named as a defendant solely in its capacity as the independent auditor of Lehman's financial statements. TAC ¶¶ 15, 124. EY audited Lehman's annual financial statements for the year ending November 30, 2007, and issued an unqualified audit opinion, which was included in Lehman's Form 10-K for 2007. *Id.* ¶ 40(f); 2007 10-K at 83.[4] As with all audits, EY's opinion covered Lehman's financial statements and the footnotes to those financial statements, but not Lehman's Management Discussion and Analysis ("MD&A") or other statements made by Lehman or its management. *See Amorosa v. Ernst & Young LLP*, 682 F. Supp. 2d 351, 361 (S.D.N.Y. 2010) (limiting auditor liability to "release of audited financial statements or other statements formally attributed to the auditor at the time of dissemination"). Even as to the financial statements themselves, EY's unqualified opinion stated on its face that it provided only "reasonable assurance" that the statements were correct in all material respects. 2007 10-K at 83; AU § 110.01 (Ex. 4). EY also provided reports on Lehman's 10-Qs for 2007 and the first two quarters of 2008. TAC ¶ 40(d). In accordance with governing professional standards, EY's reviews of Lehman's quarterly financial statements were limited in scope and

[4] For purposes of this Motion to Dismiss, EY assumes the truth of the allegations in Plaintiffs' TAC and the public filings on which such allegations rely. On a motion to dismiss, "the court may consider also documents attached to or incorporated by reference in the complaint as well as legally required public disclosure documents and documents possessed by or known to the plaintiff upon which it relied in bringing the suit." *In re Lehman Bros. Sec. & ERISA Litig.*, 684 F. Supp. 2d 485, 489 & n.13 (S.D.N.Y. 2010).

consisted of basic analytical procedures and inquiries of management. *See* AU §§ 722.07, 722.15 (Ex. 5). EY issued reports following its reviews of these unaudited quarterly financial statements, stating that it had conducted review procedures in accordance with GAAS and was "not aware" of any changes needed to make those statements materially compliant with GAAP. No audit opinion was issued in connection with these quarterly reviews.

C. "Repo 105" Transactions

Plaintiffs' claims against EY turn on the allegation that Lehman accounted for "Repo 105" transactions incorrectly and failed to make sufficient disclosures regarding those transactions in the footnotes to its financial statements. As background, Repo 105s are a form of repurchase agreement ("repo"); the global repo market is immense, involving trillions of dollars. Major financial institutions, including Lehman, have long engaged in repo transactions as sellers, buyers, or traders. Banks are not the only players in the repo market; the U.S. government and other governments are also major participants. *See* Report at 750-51, 766-68.

1. Accounting For Repo 105 Transactions

In a repo transaction, the buyer exchanges its cash for the seller's securities or other assets for a period of time (the "term"). During the term of the repo, the seller has use of the cash, and the buyer has use of the transferred assets. At the end of the repo term, the seller is expected to reacquire its assets from the buyer and to pay the buyer interest on the use of the cash during the term. Typically, the buyer demands assets of a greater value than the cash it provides. The difference between the value of the transferred assets and the amount of cash provided is called the "haircut," which the buyer imposes on the seller. For sellers, repos provide a source of funding, which may be used to fund their balance sheet or meet customer needs. For buyers, repos provide a short-term opportunity to invest cash and make a profit. *Id.*

During the years leading up to Lehman's bankruptcy, the accounting for repo transactions

was governed by SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (Ex. 6). Under SFAS 140, the appropriate accounting treatment for a repo—indeed, for any transfer of financial assets—depends upon whether the seller retains "effective control" over the transferred securities. SFAS 140 at ¶¶ 9, 151. If the seller retains control over the transferred assets, the transaction is recorded as a secured borrowing; if not, the transaction is accounted for as a sale. *Id.* ¶¶ 9, 12. Under SFAS 140, one key factor in determining whether the seller has relinquished effective control is the amount of cash received.[5] The seller is deemed to have transferred effective control if it does not receive cash sufficient to purchase "substantially all" of the same or similar securities in the open market in the event of a buyer's default. *Id.* ¶ 49. Conversely, the seller is deemed to have retained effective control if it receives enough cash to repurchase "substantially all" of the same or similar securities in the event of a buyer default. *Id.* The bigger the haircut (the amount by which the value of the seller's transferred assets exceeds the cash it receives), the less likely it is that the seller will be able to repurchase substantially all of the same or similar assets if the buyer defaults. *Id.*

At some point, the seller will be deemed to have lost "effective control" over the securities—even though it has a contractual right to repurchase them at the end of the term—because the seller will not have received cash sufficient to ensure its ability to repurchase the securities in the open market if the buyer defaults. *Id.* ¶ 218. In such circumstances, GAAP requires treatment of the transfer as a sale. *Id*. Paragraph 218 of SFAS 140 establishes a guideline for determining whether the seller maintains effective control over the securities transferred to the buyer: the seller is able to repurchase "substantially all" of its assets when the

[5] The amount of cash the seller receives is not the only factor that the FASB considers important to the question of who controls the security. SFAS 140 at ¶ 151. To qualify as a sale, the transferred assets must also be isolated from the seller and its creditors. *Id*. Parties to repo transactions often obtain legal opinions to determine whether the seller has sufficiently isolated the securities to satisfy SFAS 140.

assets' value does not exceed 102% of the cash received from the buyer. *Id.* SFAS 140 acknowledges that other arrangements "typically fall well outside that guideline." *Id.* Thus, sale accounting typically is appropriate for a transaction in which the seller provides assets valued at more than 102% of the cash received.[6]

Applying SFAS 140, Lehman established an accounting policy stating that where the value of fixed rate securities sold was 105% or more of the cash received—well over the 102% guideline set forth in SFAS 140—the repo transaction would be accounted for as a sale.[7] TAC ¶ 31; Report at 732 n.2847; 2007 10-K at 96. Reflecting the 105%, Lehman called these "Repo 105" transactions.[8] Treating these transactions as sales is entirely consistent with the "control" model on which SFAS 140 is based: if the buyer in the Repo 105 transaction were to default at the end of the transaction's term, Lehman would be forced to enter the market and purchase these highly-liquid securities from another party on arms-length terms.[9] Stating the obvious, if Lehman attempted to purchase the same or similar securities valued at $105 but had only $100 in available cash from the seller, it would be unable to find another party from whom to purchase "substantially all" of the replacement securities. For this reason, Lehman lost "effective control" over the securities, and sale treatment was appropriate. SFAS 140 at ¶ 218.

Properly treating the Repo 105 transactions as sales of securities for cash, Lehman removed the securities it sold (in our example, securities valued at $105) from the assets on its

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[6] Lehman's immediate business purpose in entering all repo transactions, including Repo 105 transactions, was to obtain financing for its operations. *See, e.g.*, TAC ¶ 29. The accounting literature's express recognition that it is appropriate to account for Repo 105 transactions as sales, *see infra* at 7-8, eviscerates Plaintiffs' naked assertion (TAC ¶ 63) that these transactions had no business purpose—simply because they also had a balance sheet effect.

[7] As the TAC concedes, because Lehman executed its Repo 105 transactions in London, Lehman obtained a legal opinion from a UK law firm stating that such transactions qualified as "true sales" under English law. TAC ¶ 65.

[8] Lehman also conducted "Repo 108" transactions collateralized with equities exceeding 108% of the value of the cash received. Report at 732 & n.2847.

[9] Contrary to media reports, Lehman's Repo 105 transactions were not an effort to get "bad assets" off its books. As the Examiner confirmed in his report, the securities supporting Lehman's Repo 105 transactions were highly liquid, generally government-backed securities. Report at 755 n.2922.

balance sheet, and concurrently added to its balance sheet both the amount of cash received ($100) and the right to repurchase $105 in securities for $100 (valued at $5) as a derivative forward contract. Thus, the Repo 105 transactions did not themselves increase or decrease the amount of assets on the balance sheet—they simply exchanged $105 of liquid securities assets for $100 of cash and a $5 derivative ($105 of total assets). Report at 756-57.[10]

During 2007 and 2008, SFAS 140 did not require companies to make any specific disclosures in financial statements regarding repo transactions accounted for as sales. SFAS 140 at ¶ 17. Only in June 2009 (effective in 2010), well after EY's audit and Lehman's bankruptcy, did the FASB require such disclosure of transfers which, like Repo 105 transactions, were accounted for as sales. *See* SFAS 166, *Accounting for Transfers of Financial Assets* (Ex. 7).

2. Leverage, Liquidity, And Repo 105 Transactions

Lehman reported in the MD&A section of its 2007 10-K selected unaudited, non-GAAP metrics known as "leverage ratios" and "net leverage ratios." 2007 10-K at 29. Lehman defined its "leverage ratio" as the measure of total assets divided by total stockholders' equity. *Id.* at 30 n.9. It defined "net leverage ratio" as the measure of "net assets" divided by its "tangible equity capital." *Id.* at 30 n.10. "Net assets" were defined as total assets *less* three specific categories of assets Lehman described as "low-risk," "non-inventory" assets; this measure included not only real estate investments, but also liquid assets like cash and government securities. *Id.* at 30 n.3.[11]

"Leverage" is a blunt measure—unaffected by the nature of the assets or the inherent risk they pose. For that reason, many investors—including the U.S. government—do not consider reported leverage to be significant. Report at 909 (noting that Moodys considered the net

[10] This exchange of one asset (a security) for two other assets of equal value (cash and a derivative) similarly had no effect on Lehman's income. *Id.*

[11] The asset categories excluded from "net assets" are (1) segregated cash and securities (*e.g.*, in client accounts), (2) collateralized lending agreements, and (3) intangible assets and goodwill. *Id.* "Tangible equity capital" includes stockholder equity and junior subordinated notes, and excludes intangible assets and goodwill. *Id.* at 30 n.5.

leverage ratio to have "limited usefulness" and that the SEC CSE Division had the "strong view that, for complicated financial institutions, leverage information is not often going to give you the right answer for a variety of business reasons"). At the end of 2007, Lehman held total assets of $691 billion. *Id.* at 30. Because Lehman's "leverage ratio" was a function of total assets and did not depend on the *types* of assets held, that ratio would be the same whether this $691 billion was held in cash or government-backed securities—or less liquid real estate investments. At the end of 2007, Lehman held "net assets" of $373 billion. *Id.* Again, because Lehman's "net leverage ratio" was a function of "net assets," that ratio would also be the same, whether those net assets consisted of cash, liquid, or less liquid investments.

Balance Sheet Assets (Total and Net) Disclosed in Lehman's 2007 10-K (in millions)	
Asset Category	**Amount**
Cash and cash equivalents	7,286
Financial instruments and other inventory positions owned	
(a) Mortgage and asset-backed securities	89,106
(b) Government and agencies	40,892
(c) Corporate debt and other	54,098
(d) Corporate equities	58,521
(e) Real estate held for sale	21,917
(f) Commercial paper and other money market instruments	4,000
(g) Derivatives and other contractual agreements	44,595
Receivables	43,277
Property, equipment and leasehold provisions	3,861
Other assets	5,406
NET ASSETS:	**372,959**
Cash and securities segregated and on deposit for regulatory and other purposes	12,743
Collateralized agreements	
(a) Securities purchased under agreements to resell	162,635
(b) Securities borrowed	138,599
Identifiable intangible assets and goodwill	4,127
TOTAL ASSETS:	**691,063**

These facts have two important implications for Plaintiffs' TAC—and for this motion. *First*, as the Examiner acknowledged, Lehman's entering into Repo 105 transactions had no

effect on its leverage or net leverage ratios. Report at 758. Repo 105 transactions, just like common asset sales, exchanged one asset (typically, highly liquid government securities) for other assets of equal value (cash plus a small derivative). *Id.* at 755 n.2922. The balance sheet line items affected by Repo 105 transactions—"financial instruments owned," "cash," and "derivatives"—were included in total assets and net assets. 2007 10-K at 29. As the sum of the assets in those line items remained constant in a Repo 105 transaction, such transactions did not change Lehman's leverage or net leverage ratio at all.[12]

Second, Lehman's use of and accounting for Repo 105 transactions did not change the value or conceal the presence of less liquid ("sticky") assets on its balance sheet. This follows from the fact that Lehman's "asset/net asset" base—and therefore its "leverage/net leverage" ratios—included both liquid and less liquid assets.[13] As summarized in the chart above, Lehman clearly disclosed in its financial statements the components of its asset base, including the amounts held in liquid "government and agency" securities, and in less liquid "mortgage and asset-backed securities." An investor concerned about "sticky" mortgage-backed securities would see that repurchase transactions involving government securities—whether treated as "sales" or "secured borrowings"—had no effect on the amount of Lehman's mortgage-backed

[12] A hypothetical given by the Examiner demonstrates how Repo 105 transactions did not affect leverage or net leverage: "Lehman receives $50 billion in cash, exchanging one form of asset for another, so total assets are unchanged; Lehman records no liability to return the cash borrowing so liabilities likewise remain unchanged; at the moment of the Repo 105 transactions, leverage is unaffected." Report at 758. Lehman typically used the cash received in Repo 105 transactions to pay down liabilities. Such action had the obvious and reported effect of reducing cash—and therefore net assets and net leverage. However, as discussed herein, Lehman reported its different asset classes, and financial statement readers were thus able to understand that this reported reduction in leverage was due to a reduction in liquid assets (cash)—*not* illiquid assets. Indeed, in reducing leverage by spending cash, Lehman *increased* the ratio of illiquid to liquid assets, as reflected on its balance sheet. *See infra* at 10.

[13] For this reason, the Examiner described "net leverage ratio" as a "brutal, rudimentary measurement," which "did not capture the quality of the assets" Lehman held. Report at 805.

securities. *See, e.g.*, 2007 10-K at 103.[14] The market needed only to look (and did look[15]) beyond the leverage ratios to the underlying reported asset categories, in order to understand the quality of Lehman's assets. Contrary to Plaintiffs' assertion that Repo 105 transactions "masked the Company's … true liquidity issues" (TAC ¶ 248), Repo 105 transactions exchanged liquid securities for cash; they could not and did not mask Lehman's exposure to "sticky" assets and the risks arising from the proportion of such assets on Lehman's balance sheet.

D. Lehman And The Mortgage And Credit Crises

In late 2007 and 2008, the real estate market suffered a dramatic, unprecedented decline, resulting in falling home prices, surging foreclosures, and a freeze in the market for mortgage-backed securities. In 2008, Lehman's liquidity began to collapse, fueled in part by its declining asset values, swift constriction of the credit market, and loss of market confidence. TAC ¶¶ 247-48. This perfect storm of adverse events caused massive losses and devaluation for Lehman and its peer institutions. Some (Bear Stearns, Merrill Lynch) were bought out. Others (Goldman Sachs, Morgan Stanley) were bailed out. Lehman was neither bought nor bailed out, and on September 15, 2008 filed for bankruptcy. *Id.* ¶ 247.

E. The Claims Against EY

In the wake of Lehman's bankruptcy, numerous plaintiffs filed federal class actions against many of the bank's former directors, officers and underwriters. EY was not named in

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[14] Had the Repo 105 transactions been accounted for as secured borrowings, the effect would have been to retain highly secure, highly liquid government securities on Lehman's balance sheet, to add cash, and to increase liabilities by the exact same amount. Even if this had the effect of increasing reported assets (and therefore leverage) by the amount of cash received, an investor would be able to see that such increase resulted exclusively from the addition of cash—and did not alter Lehman's exposure to illiquid assets. Indeed, such treatment would have *reduced* the ratio of less liquid to liquid assets reflected on Lehman's balance sheet. *See supra* at 10 n.12.

[15] Analysts looked directly to Lehman's reported assets in assessing their quality. *See* Exs. 8 at 1 (Feb. 12, 2008 Bank of America report stressing "$39B gross [Commercial Mortgage Backed Securities] book, $37B in [Residential Mortgage Backed Securities] (including $5B sub-prime), $12B in commercial real estate & $4B in leveraged loan commitments (plus $12.8B in net high yield loans)"), 9 at 16 (Feb. 28, 2008 Bernstein Research report citing Lehman as the "most exposed to Commercial Mortgage Backed Securities as a % of tangible equity" and as having "the greatest gross exposure to [the mortgage-backed securities asset] class at $91 billion").

any of these proceedings. On April 23, 2010, Plaintiffs filed their TAC, for the first time naming EY as a defendant. Plaintiffs assert claims under Section 10(b) of the Securities Exchange Act of 1934 for alleged misrepresentations by EY in Lehman's public filings, and under Section 11 of the Securities Act of 1933 for alleged false statements by EY incorporated into Lehman's Offering statements. EY now moves to dismiss these claims pursuant to Rules 8, 9(b), 12(b)(1), and 12(b)(6) of the Federal Rules of Civil Procedure.

STANDARD OF LAW

In deciding a motion to dismiss, a court ordinarily accepts as true all well-pleaded factual allegations and draws all reasonable inferences in Plaintiffs' favor. *Lehman Bros.*, 684 F. Supp. 2d at 489. Dismissal is proper, however, unless Plaintiffs' claims are supported by "factual allegations sufficient 'to raise a right to relief above the speculative level.'" *ATSI Commc'ns v. Shaar Fund*, 493 F.3d 87, 98 (2d Cir. 2007) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555, 127 S. Ct. 1955 (2007)). Thus, Plaintiffs' claim for relief must be not merely possible, but "plausible on its face." *Ashcroft v. Iqbal*, --- U.S. ---, 129 S. Ct. 1937, 1949 (2009). Plaintiffs' claims also must satisfy the heightened standard of Federal Rule of Civil Procedure 9(b), which requires Plaintiffs to plead facts in support of their claims with "particularity"—and for their Exchange Act claims, in a manner giving rise to a "cogent and compelling" inference of scienter. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319, 127 S. Ct. 2499 (2007). Pursuant to these standards, dismissal of all claims against EY is warranted.

ARGUMENT

I. PLAINTIFFS FAIL TO STATE A CLAIM UNDER THE EXCHANGE ACT.

To state a claim under Section 10(b) of the Exchange Act, Plaintiffs must allege facts showing that the defendant "(1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs

relied; and (5) that plaintiffs' reliance was the proximate cause of their injury." *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005). Under the PSLRA and Rule 9(b), "'the circumstances constituting fraud … shall be stated with particularity.'" *Plumbers & Steamfitters Local 773 Pension Fund v. CIBC*, No. 08 Civ. 8143, 2010 WL 961596, at *7 (S.D.N.Y. Mar. 17, 2010) (quoting *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000)). Claims based on "speculation and conclusory allegations" will not survive a motion to dismiss. *Id.*

Plaintiffs identify two types of documents allegedly containing materially false and misleading statements attributable to EY. First, EY's year-end audit opinion, included in Lehman's 2007 10-K, stated that EY "conducted [its] audit in accordance with [GAAS]" and that "in [EY's] opinion," Lehman's financial statements "present[ed] fairly, in all material respects, the consolidated financial position of Lehman … in conformity with [GAAP]." TAC ¶ 224; 2007 10-K at 84. Second, EY's quarterly review reports included in Lehman's 10-Qs for 2007 and 2008, stated that EY "conducted [its] review in accordance with [GAAS]" and that EY was "not aware of any material modifications that should be made to [Lehman's] consolidated financial statements … for them to be in conformity with [GAAP]." *Id.* Plaintiffs have not pled with particularity facts showing that any of these statements were false or misleading. Moreover, Plaintiffs have not shown that EY acted with scienter, or that EY's statements were the cause of Plaintiffs' financial loss. Consequently, Plaintiffs' Exchange Act claims must be dismissed.

A. Plaintiffs Fail To Plead Particularized Facts Showing That EY's Challenged Statements Were False.

Plaintiffs' allegations regarding EY's audit opinion and interim reports boil down to three purportedly false and misleading sets of statements: (1) EY's audit opinion that Lehman's year-end financial statements materially conformed with GAAP, (2) EY's quarterly review report statements that it was "not aware of" any material misstatements in Lehman's quarterly financial

statements, and (3) EY's statements that it conducted its audit and quarterly reviews in accordance with GAAS. TAC ¶ 224. A complaint that "lacks sufficient allegations demonstrating the falsity of any statements made by [defendant] during the class period" must be dismissed. *San Leandro Emerg. Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 812 (2d Cir. 1996). Plaintiffs fail this standard for each statement they challenge.

1. Plaintiffs Fail To Plead That EY's Audit Opinion Was False.

Plaintiffs challenge EY's 2007 year-end audit statement that "in our opinion," Lehman's financial statements were fairly stated in all material respects. TAC ¶ 224; 2007 10-K at 84. Of course, EY's audit opinion regarding Lehman's GAAP compliance was just that: an *opinion*.[16] As such, consistent with the Supreme Court's holding in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1094-96, 111 S. Ct. 2749 (1991), Plaintiffs must plead with particularity that EY's opinion was not only objectively false (*i.e.*, that Lehman's financial statements were not GAAP-compliant), but also subjectively false (*i.e.*, that EY did not genuinely hold the opinion stated). *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 154 (S.D.N.Y. 2004) ("[P]laintiffs who charge that a statement of opinion … is materially misleading, must 'allege with particularity' 'provable facts' to demonstrate that the statement of opinion is both objectively and subjectively false."); *see also In re AOL Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 243-44 (S.D.N.Y. 2004) (requiring plaintiffs to "show both that the directors did not actually hold the belief or opinion stated, and that the opinion stated was in fact incorrect"). Plaintiffs fail on both counts.

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[16] That an auditor expresses an opinion on the financial statements is self-evident. Even Plaintiffs admit as much. *See* TAC ¶ 234 ("One of the primary responsibilities of an external auditor is to express an *opinion* on whether the company's financial statements are presented fairly, in all material respects, in accordance with GAAP.") (emphasis added). This common sense conclusion is supported by the governing auditing literature, AU § 410.02 (Ex. 10) (construing GAAS "not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles"), and case law. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 763 (Cal. 1992) ("[A]n audit report is a professional opinion based on numerous and complex factors[.]").

a. **Plaintiffs Fail To Plead That EY's Audit Opinion Was Subjectively False.**

As a threshold matter, Plaintiffs fail to plead that EY's audit opinion was subjectively false. This Court has held that an opinion is actionable "only if the complaint alleges that the speaker did not truly hold the opinion at the time it was issued." *Regions*, 2010 WL 1883487, at *3 (dismissing Section 11 claims against EY based on failure to allege falsity of underlying opinion).[17] Indeed, this Court has already dismissed claims concerning statements about credit ratings—because such ratings were "statement[s] of opinion" and Plaintiffs' allegations were "insufficient to support an inference that the ratings agencies did not actually hold the opinion" stated. *Lehman Bros.*, 684 F. Supp. 2d at 495. Plaintiffs have not alleged, even generally, that EY did not believe the audit opinion set forth in Lehman's 2007 10-K. This alone compels dismissal of Plaintiffs' claims based on EY's audit opinion.

Importantly, Plaintiffs cannot remedy this pleading failure simply by asserting that the auditors did not hold the opinion they issued. Plaintiffs must plead particularized facts showing that EY did not actually believe its audit opinion. *See In re Salomon Analyst Level 3 Litig.*, 350 F. Supp. 2d 477, 493 (S.D.N.Y. 2004) (rejecting "conclusory assertions" that the opinion stated was not the opinion held); *Podany*, 318 F. Supp. 2d at 154-55 (rejecting facts purportedly showing the opinion to be "unreasonable" and evincing motive to deceive as insufficient to show the requisite "insincerity" of the challenged opinion). Yet Plaintiffs have made no such allegations here, and thus fail to plead that EY's audit opinion was subjectively false when made.

[17] Though several cases addressing subjective falsity do so in the context of Section 11 claims, the concept applies with equal force to the falsity element of claims under Section 10(b). *Cf. Tsereteli v. Residential Asset Securitization Trust 2006-A8*, No. 08 Civ. 10637, 2010 WL 816623, at *4 (S.D.N.Y. Mar. 12, 2010) (dismissing Section 11 claim based on opinion where plaintiffs did not allege "that the speaker did not truly have the opinion at the time it was made public"); *AOL Time Warner*, 381 F. Supp. 2d at 243-44 (requiring plaintiffs asserting Section 11 claims to "show both that the directors did not actually hold the belief or opinion stated, and that the opinion stated was in fact incorrect") *with Podany*, 318 F. Supp. 2d at 154-55 ("The sine qua non of a securities fraud claim based on [a] false opinion is that defendants deliberately misrepresented a truly held opinion.").

b. **Plaintiffs Fail To Plead That Lehman's Financial Statements Violated GAAP.**

In addition, Plaintiffs fail to plead particularized facts showing that EY's opinion was objectively false—*i.e.*, that Lehman's financial statements violated GAAP. Plaintiffs allege myriad accounting and reporting violations involving Lehman's Repo 105 practices (TAC ¶¶ 26-69), risk management practices (TAC ¶¶ 70-84, 104-09), bankruptcy and liquidity risks (TAC ¶¶ 85-88), and real estate asset valuations (TAC ¶¶ 89-103). All of these alleged violations (with the exception of Repo 105, and stray allegations regarding statements or omissions concerning risk concentration and real estate valuation) arise out of Lehman's quarterly filings, press releases, or MD&A—none of which are implicated by EY's audit opinion. *Amorosa*, 682 F. Supp. 2d at 361 (limiting auditor liability to the "release of audited financial statements or other statements formally attributed to the auditor at the time of dissemination"); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).[18]

Importantly, Plaintiffs have failed to allege a GAAP violation with respect to Lehman's accounting for and disclosure of Repo 105 transactions. Plaintiffs challenge Lehman's Repo 105 accounting and disclosures on four grounds, none of which is supported with particularized facts—and none of which is sufficient to demonstrate the falsity of Lehman's financial statements. *First*, Plaintiffs summarily assert that Repo 105 transactions should not have been treated as sales under SFAS 140 because they allegedly lacked a legitimate business purpose (TAC ¶ 63), required Lehman to repurchase the assets (TAC ¶ 64), and were supported by a UK true sale opinion (TAC ¶ 65). Yet the first claim is flatly contradicted by the accounting literature's express recognition that sale accounting is appropriate in a Repo 105 transaction, *see*

[18] EY's duty with respect to MD&A was limited to identifying any material inconsistencies between the MD&A and the audited financial statements (and discussing with management any inconsistencies or material misstatements of fact found). AU §§ 550.04-05 (Ex. 11). There were no such inconsistencies or material misstatements of fact, and, in any event, Plaintiffs have not alleged EY's failure to raise any specific material inconsistencies between the MD&A and the financial statements with Lehman. *Id.*

supra at 6-8, and Plaintiffs never explain how the latter two points render sale accounting improper under SFAS 140. In fact, each of them supports Lehman's accounting. *See supra* at 6-8 & n.7. *Second*, Plaintiffs assert that accounting for Repo 105 transactions as sales elevated "form over substance," but fail to explain why that would matter under SFAS 140, even if true. TAC ¶¶ 66-69. SFAS 140 has long been recognized as a "rules-based" standard, meaning that companies are bound to apply sale accounting treatment when certain conditions are met—regardless of whether such treatment can be said to elevate "form over substance." *See* Ex. 12 (SEC study identifying SFAS 140 as "rules-based"). *Third*, Plaintiffs challenge Lehman's failure to disclose the Repo 105 transactions. TAC ¶¶ 40(f), 61-69. But Plaintiffs do not and cannot point to anything in SFAS 140 or elsewhere in the applicable GAAP that required the disclosure of transfers accounted for as sales. Indeed, only well after Lehman's bankruptcy did the FASB issue guidance requiring specific disclosures for transfers which, like the Repo 105 transactions, are accounted for as sales. *See* SFAS 166; *see supra* at 8.

Fourth, Plaintiffs challenge Lehman's characterization of repo transactions in the footnotes to its financial statements. They contend that by describing "repurchase and resale agreements" as a category of transactions "[t]reated as collateralized agreements and financings for financial reporting purposes," Lehman represented that it was accounting for *all* repurchase transactions as financings and not sales. TAC ¶ 40(a). Plaintiffs' contention ignores the plain context and structure of this statement. The statement Plaintiffs cite neither refers nor applies to Repo 105 transactions. 2007 10-K at 97. The disclosure immediately *preceding* this statement describes Lehman's policy for classifying sales transactions, and states that Lehman "recognize[s] transfers of assets as sales" where effective control has been surrendered under the accounting rules set out in SFAS 140. *Id.* at 96. Taken together, these statements accurately

reflect Lehman's accounting policy under SFAS 140: whether a transaction is treated as a sale or a financing depends on whether effective control has been surrendered. That is, of course, precisely what SFAS 140 requires. Lehman's accounting for transactions pursuant to SFAS 140 is plainly and properly disclosed, and Plaintiffs' assertion that it is misleading is without basis.

As discussed in detail in Defendants' Joint Memorandum at 19-26, Plaintiffs have similarly failed to allege GAAP violations with respect to Lehman's statement that its "financial instruments and other inventory positions owned … are presented at fair value" (TAC ¶ 93),[19] or Lehman's alleged non-disclosure of risk concentrations in certain real estate investments (TAC ¶ 105).[20] Having failed to plead that Lehman's financial statements violated GAAP, Plaintiffs have failed to plead that EY's audit opinion on those financial statements was false.

2. Plaintiffs Fail To Plead That EY's Interim Reports Were False.

Plaintiffs also challenge EY's interim reports, included in Lehman's 10-Qs, which stated that EY was "not *aware* of any material modifications that should be made to the consolidated financial statements … for them to be in conformity with [GAAP]." TAC ¶ 224 (emphasis added). With regard to these statements, Plaintiffs must plead facts showing that Lehman's financial statements materially violated GAAP *and* that EY *knew* (*i.e.*, was "aware") of these GAAP violations. As discussed above and also below, *see* Section I.B, *infra*, Plaintiffs have failed to plead particularized facts establishing that Lehman's interim report statements were materially misstated and that EY *knew* of such misstatements when issuing its reports. As such Plaintiffs have failed to plead the falsity of EY's interim reports.

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[19] Notably, Plaintiffs have failed to allege that any specific assets were overvalued or were not "presented at fair value" in the 2007 10-K. *Cf.* TAC ¶¶ 94-95, 100-01 (citing overvaluation only in 2008 10-Qs).

[20] Insofar as these underlying accounting and disclosure decisions are matters of opinion, Plaintiffs must allege facts showing that Lehman management did not hold the opinion stated to plead falsity. *Regions*, 2010 WL 1883487, at *3. Here, as in *Regions*, "Plaintiff[s'] claims that E&Y's audit opinion misstated that [the] financial statements and E&Y's audits complied with GAAP and GAAS, respectively, are derivative of [Plaintiffs'] claims for misstatements"—and cannot survive if Plaintiffs' claims concerning these alleged misstatements fail. *Id.* at *4 n.46.

3. Plaintiffs Fail To Plead That EY's GAAS Opinion Was False.

a. Plaintiffs Fail To Plead That EY's GAAS Opinion Was Subjectively False.

Plaintiffs allege that EY's statements of GAAS compliance were false. TAC ¶¶ 40(d), 40(f). But these statements, like the audit opinion itself, are statements of opinion. The question of GAAS compliance fundamentally implicates questions of auditor judgment: how much evidence to collect, what form testing should take, what level of confirmation is required, and how discrepancies are to be identified and handled. *See, e.g.*, AU § 326.13 (Ex. 13) (noting that "evaluating the quality and quantity of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion" is a matter of "professional judgment"). This Court recently observed that similar professional assessments concerning the adequacy of analytical procedures employed are properly considered matters of opinion. *Tsereteli*, 2010 WL 816623, at *5 (holding that whether credit quality was "'properly considered' or 'adequate' to support a particular rating was not a matter of objective fact" but "a statement of opinion by each agency"). EY's judgments that its audit and reviews complied with GAAS similarly assessed whether evidence was "properly considered" and "adequate" to support its conclusions. EY's resultant statements of GAAS compliance are properly considered opinions.

Pursuant to *Virginia Bankshares*, Plaintiff must plead facts showing these statements to be subjectively false. *See supra* Section I.A.1.a. Plaintiffs fail to meet this burden. EY's opinion is actionable "only if the complaint alleges that the speaker did not truly hold the opinion at the time it was issued," *Regions*, 2010 WL 1883487, at *3, and Plaintiffs have made no allegations—much less pled particularized facts to show—that EY did not truly hold the opinions that its year-end audit and quarterly reviews were conducted in accordance with GAAS.

b. Plaintiffs Fail To Plead That EY's Audit And Reviews Violated GAAS.

In addition, Plaintiffs fail to plead particularized facts showing that EY's opinion was objectively false—*i.e.*, that EY violated GAAS. Under Rule 9(b), Plaintiffs may not simply aver that an auditor violated GAAS. *See, e.g.*, *In re Tarragon Corp. Sec. Litig.*, No. 07 Civ. 7972, 2009 U.S. Dist. LEXIS 60160, at *46 (S.D.N.Y. Mar. 27, 2009). Nor does it suffice for Plaintiffs to identify audit standards and summarily assert their violation. *In re Cardinal Health, Inc. Sec. Litig.*, 426 F. Supp. 2d 688, 778 (S.D. Ohio 2006). To the contrary, Plaintiffs must support any allegations of GAAS violations with particularized facts substantiating their claim. *See Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1270 (11th Cir. 2006) ("While [plaintiff] broadly claims that E&Y failed to design and implement proper auditing procedures, [it] never describes how E&Y failed to do so."); *Lewis v. Straka*, No. 05C1008, 2007 WL 2332421, at *2 (E.D. Wis. Aug. 13, 2007) (dismissing claim that auditor "should have exercised greater professional skepticism" where "plaintiffs allege no supporting facts"). Claims based on "conclusory allegations" must be dismissed. *Kalnit v. Eicher*, 264 F.3d 131, 142 (2d Cir. 2001).

Yet conclusory allegations of GAAS violations are all that Plaintiffs provide. TAC ¶¶ 236-41. Plaintiffs do little more than cite an assortment of audit standards and summarily assert that EY did not sufficiently investigate certain issues, such as period-end increases in Repo 105 volume and Lehman's use of a UK firm's "true sale" opinion to govern its UK-based transactions.[21] Nor do Plaintiffs support their general allegations with any facts regarding what EY actually did or did not do in connection with its audit and reviews. *Compare* TAC ¶ 238 (criticizing EY's audit planning without any facts regarding who planned them or how they were

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[21] In doing so, Plaintiffs cherry-pick phrases from the audit standards and conveniently ignore the components of the standards that support the auditors' alleged conduct. For example, Plaintiffs allege that the Linklaters "true sale" opinion was insufficient audit evidence under AU § 336. TAC ¶ 240. But Plaintiffs fail to acknowledge that AU § 336.08 (Ex. 14) advises an auditor to consider the qualifications of a specialist, and that Linklaters—among the most prominent UK law firms—was ideally equipped to opine on a UK-based transaction. Reliance on a UK legal opinion from a prominent UK law firm for a transaction by a UK entity and governed by UK law can hardly be deemed evidence of an audit failure—let alone a "red flag." *See supra* Section I.B.2.b.

planned); *with Davis v. SPSS, Inc.*, 385 F. Supp. 2d 697, 718 (N.D. Ill. 2005) (dismissing similar allegation based on failure to plead "the planning the auditors conducted"). Such empty claims are not the particularized pleading necessary to satisfy Rule 9(b) and are insufficient as a matter of law. *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, No. 03 Civ. 2387, 2005 WL 1580611, at *2 (S.D.N.Y. July 5, 2005) (dismissing on Rule 9(b) grounds for failure "to allege facts sufficient to justify [plaintiffs'] assertion that the E&Y defendants did not independently corroborate the valuations by the Funds' managers").

Plaintiffs do not identify, even in general terms, any procedures that the auditors should have but failed to perform.[22] They do not allege, even in general terms, what the auditors would have found had they performed such procedures. And they do not plead, even in general terms, how EY's audit opinion would have changed based on the performance of such procedures. At base, Plaintiffs' allegations of GAAS violations boil down to selective recitations of audit standards accompanied by the bald assertion that EY violated those standards—because EY allegedly reached an incorrect conclusion about Lehman's financial statements. This is plainly insufficient to plead with the particularity required by Rule 9(b) that EY violated GAAS. *In re Cardinal Health*, 426 F. Supp. 2d at 778; *Davis*, 385 F. Supp. 2d at 718.[23]

B. Plaintiffs Fail To Plead Particularized Facts Giving Rise To A Strong Inference Of Scienter.

1. The Standard For Pleading An Auditor's Scienter Is Stringent.

The Private Securities Litigation Reform Act ("PSLRA") requires that facts supporting

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[22] This deficiency applies to Plaintiffs' allegations regarding EY's 2007 audit and with even greater force to Plaintiffs' allegations regarding EY's 2007 and 2008 quarterly reviews, which required the performance of very limited procedures. *See* AU §§ 722.07, 722.15. Plaintiffs have alleged *no* particularized facts showing that EY failed to perform appropriate procedures in its quarterly reviews. TAC ¶ 239.

[23] Furthermore, if Lehman's financial statements were GAAP-compliant, then EY's statements that its audit and reviews complied with GAAS, even if false, would be immaterial: "[A]n auditor's statement that it conducted an audit in compliance with GAAS, even if untrue, is not material if the company's financial statements do not materially violate GAAP because it is difficult to imagine how a reasonable investor could conclude, under those circumstances, that the purported misstatement of the auditor significantly altered the total mix of information available." *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1286 (N.D. Okla. 2005).

claims under Section 10(b) must give "rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). This "strong" inference of scienter "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, 551 U.S. at 321. Where, as here, there are no allegations of motive and opportunity, the requisite strong inference of fraud may be satisfied only by alleging facts "constituting strong circumstantial evidence of conscious misbehavior or recklessness.'" *Campo v. Sears Holdings Corp.*, No. 09-3589-cv, 2010 WL 1292329, at *1 (2d Cir. Apr. 6, 2010). Significantly, courts in the Second Circuit have established an even more "demanding" standard for pleading recklessness against auditors, given auditors' secondary role in financial reporting. *In re Marsh & McLennan Cos. Sec. Litig.*, 501 F. Supp. 2d 452, 488 (S.D.N.Y. 2006). The required showing of recklessness "must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000); *see also South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (same). The alleged facts must show that "the accounting practices were so deficient that the audit amounted to no audit at all, or to an egregious refusal to see the obvious, or investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008).

2. Plaintiffs Fail To Show That EY Auditors Ignored Alleged "Red Flags" In Their Audit And Reviews.

Plaintiffs attempt to establish that EY was reckless by identifying three alleged warning signs or "red flags"—all relating to Lehman's Repo 105 transactions[24]—which Plaintiffs claim

[24] To the extent Plaintiffs' Section 10(b) claims against EY rest upon statements within Lehman's financial reports regarding issues other than Repo 105, these claims necessarily fail, as the TAC allegations concerning EY's scienter relate exclusively to Repo 105. *Compare* TAC ¶¶ 226-33 (allegations of "EY's Scienter" concerning only Repo 105) *with* TAC ¶¶ 206-23 (allegations of other defendants' scienter bearing on other issues).

should have put EY on notice that Lehman's financial statements were materially misstated. TAC ¶¶ 226-32. "Merely labeling allegations as red flags, however, is insufficient to make those allegations relevant to a defendant's scienter." *Marsh & McLennan*, 501 F. Supp. 2d at 487. Indeed, a plaintiff seeking to establish scienter by alleging that an auditor recklessly ignored such "red flags" must plead facts showing three conditions. *First*, the auditor must have been aware of the alleged "red flag" (or the facts must be "so obvious that [the auditor] must have known" of them). *Stephenson v. Citgo Group Ltd.*, No. 09 CV 00716, 2010 WL 1244007, at *19 (S.D.N.Y. Mar. 31, 2010). *Second*, the alleged flag must be "red"—*i.e.*, it must be "sufficiently attention-grabbing to have alerted a reasonable auditor to the audited company's shenanigans." *AOL Time Warner*, 381 F. Supp. 2d at 240; *see also Nappier v. Pricewaterhouse Coopers, LLP*, 227 F. Supp. 2d 263, 278 (D.N.J. 2002) (requiring facts that "must be closer to smoking guns than mere warning signs"). *Third*, the auditor must have ignored the red flag. When an auditor addresses the apparent discrepancy, recklessness does not lie. *See, e.g.*, AU § 230.11 (Ex. 15).

Plaintiffs identify only three purported "red flags": (1) EY's receipt of a "netting grid" indicating the balance of (and accounting policy for) Repo 105 transactions, (2) the fact that the true sale opinion supporting these UK-based transactions came from a UK firm, and (3) EY's June 12, 2008 interview with Lehman executive Matthew Lee. These were not red flags.

a. **Lehman's "Netting Grid"**

Plaintiffs highlight EY's receipt of a "netting grid" from Lehman (TAC ¶ 227), but do not identify any information therein that fairly could be characterized as a red flag. The grid covered a number of "netting" and other adjustments that properly had the effect of reducing Lehman's balance sheet; with respect to Lehman's Repo 105 (and Repo 108) transactions, the netting grid simply listed the total amount of these transactions at two points in time (November 2006 and February 2007), identified the relevant GAAP provision (SFAS 140), and noted that

the current accounting was correct. *See* Ex. 16 at 26. If anything, the grid reaffirms that Lehman's policy permitting these transfers to be accounted for as sales was consistent with GAAP (SFAS 140), and reflects management's view that this accounting practice was correct. *See* Section I.A.1.b, *supra*. Plaintiffs allege that the grid "reflected therein" "the large volumes of Repo 105 transactions Lehman undertook at quarter-end" (TAC ¶ 227). Not so. The grid shows only the Repo 105 balances at two points in time—but does not indicate when Lehman "undertook" these transactions. *See* Ex. 16 at 26. In any event, nothing in the grid indicated that the underlying accounting for these transactions was wrong in any way. Plaintiffs never explain, as they must, how the grid's mention of Repo 105s would have alerted EY that the accounting for these transactions was improper—when on its face the grid states that these transactions were being accounted for as sales, in accordance with Lehman's accounting policy. TAC ¶ 227.

b. **Lehman's UK True Sale Opinion**

Nor was it a red flag for EY to learn "that Lehman was unable to obtain a true sale opinion under United States law for Repo 105 transactions" (TAC ¶ 228)—since the transactions were conducted primarily in the United Kingdom, a jurisdiction whose laws indisputably supported a true sale opinion. Even the Examiner has not questioned the legal opinion Lehman received from the Linklaters law firm in the UK or suggested that Lehman's Repo 105 accounting policy was incorrect. Report at 740, 964. Moreover, it was unremarkable—and certainly not a "red flag"—that Lehman conducted these transactions through its UK-based subsidiary. Lehman's largest operation outside the US was in London, which was the center of a large and robust European repo market, and a major world financial center. 2007 10-K at 11. Nothing in this "true sale" opinion shows that EY acted recklessly, or conducted "no audit at all," when it confirmed and relied upon the opinion's issuance to Lehman.

c. EY's Interview With Matthew Lee

As Plaintiffs allege, EY met with "whistleblower" Matthew Lee on June 12, 2008. TAC ¶¶ 230-32. In addition to what EY already knew from Lehman's netting grid and accounting policy, Plaintiffs allege Lee reported (1) that Lehman's Repo 105 activity increased at quarter-end, and (2) that Lehman had "moved $50 billion of inventory off its balance sheet" at the end of the second quarter of 2008 through the use of these transactions. *Id.* But these alleged facts are not "smoking guns" from which one could infer auditor recklessness. *Nappier*, 227 F. Supp. 2d at 278. Plaintiffs identify nothing about these facts suggesting that Lehman's accounting for Repo 105 transactions violated GAAP—and Matthew Lee is not alleged to have stated that the accounting or disclosures for Repo 105 transactions were improper in any way, or were inconsistent with Lehman's stated accounting policy.

C. Plaintiffs Fail To Plead Loss Causation.

To state a claim under Section 10(b), Plaintiffs must also plead facts showing that EY's statements—and not a "tangle of factors"—caused the loss they claim. *In re Omnicom Group, Inc. Sec. Litig.*, 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008), *aff'd*, 597 F.3d 501 (2d Cir. 2010) (quoting *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343, 125 S. Ct. 1627 (2005)). To plead loss causation, a plaintiff must satisfactorily allege "a causal connection between the material misrepresentation and the loss." *Dura*, 544 U.S. at 343 (noting that to "'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires"). Establishing loss causation is critical because the securities laws are 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 Omnicom Group, Inc. Sec. Litig.*, 597 F.3d 501, 510 (2d Cir. 2010).

In the Second Circuit, plaintiffs may meet their burden to allege loss causation in two ways. First, they may plead facts showing that "the market reacted negatively to a corrective

disclosure of the fraud." *Omnicom*, 597 F.3d at 511; *see also Lentell*, 396 F.3d at 175. Alternatively, they may plead facts showing that the events causing their loss "were a foreseeable materialization of the risk concealed by the fraudulent statement." *Omnicom*, 597 F.3d at 511; *see also ATSI Commc'ns*, 493 F.3d at 107. Plaintiffs have done neither.

1. Plaintiffs Fail To Plead Facts Showing Any Corrective Disclosure Attendant To Their Claimed Loss.

Plaintiffs here do not allege any loss concurrent with or tied to a corrective disclosure concerning Lehman's Repo 105 transactions. This is because, as Plaintiffs acknowledge, the Repo 105 transactions (and EY's review of them) were not made public until the Examiner's Report, which was released nearly eighteen months after Lehman's collapse. TAC at 1.

2. Plaintiffs Fail To Plead Facts Showing That Their Claimed Loss Was Caused By A "Materialization of The Risk" That EY's Statements Purportedly Concealed.

As a consequence, Plaintiffs must rely on the second means for pleading loss causation: they must allege facts showing that their loss was "caused by the materialization of the risk" that EY's alleged false statements concealed. *Omnicom*, 597 F.3d at 513. A misrepresentation is the "proximate cause" of an investment loss only if the risk that caused the loss was "within the zone of risk concealed by the misrepresentation." *Id.* (citing *Lentell*, 396 F.3d at 173). Plaintiffs assert that "the misrepresentations and omissions" set forth in the TAC concealed risks, the materialization of which caused declines in the price of Lehman's stock (and Plaintiffs' loss). TAC ¶¶ 242, 250. Specifically, they allege that the Repo 105 transactions allowed Lehman "to remove temporarily assets from its balance sheet" and thereby reduce artificially its net leverage ratio and create the appearance that Lehman was more capitalized than it was. *Id.* ¶ 248.

But this assertion makes no sense in light of Plaintiffs' allegations and what is evident from the financial statements themselves. Plaintiffs allege that "Lehman acquired tens of billions of dollars of highly risky, illiquid assets that ultimately required enormous write-downs and

triggered the liquidity crisis that ended Lehman's existence." TAC ¶ 248. Whatever Repo 105 transactions did, they did not conceal the risks of such business decisions—or the nature and extent of sticky assets added to Lehman's balance sheet as a result of those decisions. With or without Repo 105 transactions, the less liquid investments that Lehman made were plainly reflected in separate line item accounts on its balance sheet. *See* 2007 10-K at 103 (listing, *e.g.*, "mortgage-backed securities" and "real estate for sale"). Plaintiffs do not—nor could they—plead facts showing that the Repo 105 transactions caused or concealed the existence of these sticky assets, or the balance sheet relationship between Lehman's liquid and less liquid assets. Indeed, even if the accounting for Repo 105 transactions caused Lehman's "net leverage ratio" to be lower than it would have been had "ordinary" repos been used, this relative reduction in net leverage was due solely to a reduction in *liquid* assets—making it apparent to financial statement readers that the proportion of Lehman's sticky to liquid assets had actually *increased*.

In *Lattanzio v. Deloitte & Touche LLP*, the Second Circuit addressed a similar set of allegations and affirmed the dismissal of Section 10(b) claims against an auditor based on the plaintiffs' failure to plead loss causation. 476 F.3d 147, 158 (2d Cir. 2007). The *Lattanzio* plaintiffs, like Plaintiffs here, sought to allege facts showing that the auditor's misrepresentations concealed the risk of the audited company's bankruptcy. *Id.* at 157. The *Lattanzio* panel rejected these allegations and held that the auditors' statements did not conceal the risk of bankruptcy, which was apparent from other indicators of financial trouble, misstatements not attributable to the auditors, and warnings in the annual report. *Id.* In light of these disclosures, the plaintiffs' allegations showed "an insufficient connection between [the auditors'] misstatements and the bankruptcy." *Id.* The parallels to this case are clear and compelling:

- *First*, in *Lattanzio*, the Court of Appeals held that publicly available equity figures revealed the risk of bankruptcy to the market, notwithstanding the auditors' alleged misstatements. *Id.*

at 157. Likewise, here, Lehman's high leverage was publicly known and widely recognized. *See, e.g.*, Report at 852 n.3276 (June 9, 2008 Bank of America report that "Lehman is the most levered large investment bank to the fixed income market, and hence a more challenging fixed income market … could hurt them the most"). Moreover, Lehman's Repo 105 transactions did not conceal the nature and extent of the less liquid assets in Lehman's portfolio, or their balance sheet significance relative to liquid assets. As a result, any purported failure to disclose these transactions did not mask what the market already knew: Lehman was highly leveraged, had an increasingly illiquid portfolio as a result of its business strategy, and was subject to significant risks of illiquidity in the event of a market downturn.

- *Second*, in *Lattanzio*, the Court of Appeals held that the disclosure of related risks in the 2007 10-K undermined a finding that the auditors' alleged misstatements masked a risk that later materialized, causing the plaintiffs' loss. 476 F.3d at 158. Here too, Lehman disclosed the very risks that Plaintiffs acknowledge ultimately materialized in Lehman's bankruptcy. TAC ¶ 248. Lehman warned its investors that in the event of market volatility, the Company "may not be able to reduce [its] positions or [its] exposure in a timely, cost-effective way or in a manner sufficient to offset the increase in measured risk." 2007 10-K at 22. This disclosure told the market that Lehman might not be able to liquidate its assets in the event of a market downturn, which in turn could cause a liquidity crunch.

Having failed to allege facts showing that the accounting for or disclosure of Repo 105 transactions concealed the risk materializing in their losses, Plaintiffs have failed to plead that EY's challenged statement caused their loss, and their 10(b) claims must be dismissed.

3. Plaintiffs Fail To Plead Facts Permitting The Trier Of Fact To Apportion The Loss Caused By EY's Alleged False Statements.

Even if Plaintiffs had pled facts sufficient to show that EY's purported misrepresentations caused Lehman's alleged stock price inflation (which they have not), it is clear that such alleged misstatements were not the primary, let alone sole, cause of Plaintiffs' losses. Plaintiffs must thus "allege[] facts that would allow a factfinder to ascribe some rough proportion of the whole loss to [the alleged] misstatements." *Lattanzio*, 476 F.3d at 158.[25]

Here, Plaintiffs expressly allege that other Lehman statements (not subject to EY's audit)

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[25] Distinguishing EY's alleged misconduct from the "tangle of other factors that affect a stock's price" is particularly important here, given the global market decline that coincided with Lehman's bankruptcy. *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). As discussed in detail in Defendants' Joint Memorandum at 50-51, Plaintiffs inexplicably ignore the effect of the unprecedented mortgage and credit crises, on Lehman and other financial firms. "[W]hen the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases." *National Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994) (dismissing claims brought in the wake of a real estate market collapse).

caused Lehman's stock price to decline. Plaintiffs allege that Lehman's MD&A misrepresented the company's risk profile and misstated its liquidity position. TAC ¶¶ 74, 79, 83, 87. Plaintiffs must—but do not—plead facts permitting the trier of fact reasonably to distinguish loss caused by the auditors' limited statements from loss caused by these other alleged misstatements. *Lattanzio*, 476 F.3d at 158 (dismissing claim against auditor where facts alleged did not allow apportionment of loss to the auditor's "misstatements, among others (made by [the audited company]) that were much more consequential and numerous"). Plaintiffs' blanket assertion that the decline in Lehman's share price was "attributable to the disclosure of information and materialization of risks" concealed by Repo 105 transactions (TAC ¶ 250) is unaccompanied by facts sufficient to support an inference that EY's alleged misstatements "were the proximate cause of plaintiffs' loss." *Lattanzio*, 476 F.3d at 158. Plaintiffs' Section 10(b) claims against EY fail on loss causation grounds, as well as falsity and scienter grounds, and must be dismissed.

II. PLAINTIFFS FAIL TO STATE A CLAIM UNDER THE SECURITIES ACT.

Plaintiffs also assert claims under Section 11 of the Securities Act based on EY's statements in Lehman's 2007 10-K and certain 2007 and 2008 10-Qs, purportedly incorporated by reference into Lehman's Offerings issued between March 30, 2007, and June 30, 2008. TAC ¶¶ 23-144. A claim under Section 11 must be dismissed unless a plaintiff alleges facts showing "that (1) it purchased a registered security, (2) the defendant adequately participated in the offering in a manner giving rise to liability under Section 11, and (3) the registration statement 'contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.'" *Lehman Bros.*, 684 F. Supp. 2d at 490-91 & n.14 (quoting 15 U.S.C. § 77k(a)). Plaintiffs' Securities Act claims must be dismissed because Plaintiffs fail to plead an actionable false statement by EY, and the

TAC itself shows that EY's challenged statements did not cause Plaintiffs' loss.[26]

A. Plaintiffs Fail To Plead Facts Showing That EY's Audit And GAAS Opinions Were False.

Plaintiffs seek to assert Section 11 claims against EY based not only on statements made in EY's year-end 2007 audit opinion, but also on EY's reviews of Lehman's 10-Qs in 2007 and the first two quarters of 2008. TAC ¶ 124. Plaintiffs are squarely foreclosed from doing so. Accountants are liable only insofar as they "prepared or certified any report or valuation which is used in connection with the registration statement." 15 U.S.C. § 77k(a)(4). And a quarterly "report on unaudited interim financial information" is not "considered … a report prepared or certified by an accountant" within the meaning of Section 11 and does not, *as a matter of law*, give rise to auditor liability under Section 11. 17 C.F.R. § 230.436(c).[27] As a result, Plaintiffs' Section 11 claims are properly limited to two statements in EY's 2007 audit opinion: (1) that EY "conducted [its] audit in accordance with [GAAS]" and (2) that "in [EY's] opinion," Lehman's financial statements "present[ed] fairly, in all material respects, the consolidated financial position of Lehman … in conformity with [GAAP]." TAC ¶¶ 40(f), 124; 2007 10-K at 84. Plaintiffs fail to plead falsity as to either of these statements, as they expressly disclaim any allegation that these opinions were subjectively false (TAC ¶ 120), and they fail to allege facts showing that EY violated GAAS or Lehman violated GAAP. *See* Section I.A, *supra*.

1. This Court's Decision In *Regions* Compels Dismissal Of Plaintiffs' Section 11 Claims Against EY.

Both EY statements—that Lehman's financial statements were GAAP-compliant and that EY's audit was GAAS-compliant—are statements of *opinion*. *See supra* Sections I.A.1.a,

[26] Plaintiffs have certified that they purchased securities pursuant to only 71 of the 119 Lehman Offerings. *See* TAC App'xs A, B. They have no standing to assert Section 11 claims for the remaining 48 Offerings. *Lehman Bros.*, 684 F. Supp. 2d at 490-91; *see* Defs.' Joint Memo. at 1-2. Nor do Plaintiffs have standing with respect to the 37 offerings for which the newly-added plaintiffs serve as the only representatives. *Id.* at 2-4.

[27] *See In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 665 (S.D.N.Y. 2004) (Rule 436 "assure[s] auditors that their review of unaudited interim financial information would not subject them to liability under Section 11").

I.A.3.a. In order to plead falsity, Plaintiffs must, as required by the Supreme Court in *Virginia Bankshares*, plead facts showing that these statements are both subjectively and objectively false. 501 U.S. at 1094-96; *Tsereteli*, 2010 WL 816623, at *4. As a threshold matter, Plaintiffs fail to plead subjective falsity, as they fail to allege even generally that EY "did not truly hold [either] opinion at the time it was issued." *Regions*, 2010 WL 1883487, at *3. There is no allegation in the TAC that EY did not believe that Lehman's financial statements were GAAP-compliant or that EY had conducted a GAAS audit. This is fatal to Plaintiffs' Section 11 claims against EY.

2. Plaintiffs' Section 11 Claims Fail Under Rule 9(b).

In addition, Plaintiffs have failed to plead the objective falsity of these GAAP and GAAS opinions. The relevant pleading standard applicable to a Section 11 claim depends on the nature of the complaint. "Where the claims are 'premised on allegations of fraud,' the allegations must satisfy the heightened particularity requirements of Rule 9(b)[.]" *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 358 (2d Cir. 2010). As such, a plaintiff must choose whether to rely on allegations of fraud to support a Section 11 claim. *See Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004). It follows that a plaintiff may not disparage a defendant by alleging a fraudulent "course of conduct" but then disclaim Rule 9(b)'s application to its Section 11 claims. *In re Marsh & McLennan*, 501 F. Supp. 2d at 492 (citing "Rule 9(b)'s mandate to safeguard a defendant's reputation from improvident charges of wrongdoing").

Here, the unified course of conduct Plaintiffs allege against EY unquestionably "sounds in fraud" and thus must be pled with particularity. Plaintiffs artificially attempt to segregate their claims, but the same course of conduct relating to the same audit and quarterly reviews provides the basis for their claims under Sections 10(b) and 11, thereby triggering Rule 9(b). *See Rombach*, 355 F.3d at 171 (applying Rule 9(b) to "the conduct alleged" and not merely to "allegations styled or denominated as fraud"). Having alleged that EY "took affirmative steps to

cover-up the Repo 105 fraud" (TAC ¶ 231), Plaintiffs cannot disclaim that serious allegation when pleading misrepresentations regarding Repo 105 as the basis for their Section 11 claim (*id.* ¶¶ 26-43). *In re AXIS Capital Holdings, Ltd. Sec. Litig.*, 456 F. Supp. 2d 576, 598 (S.D.N.Y. 2006) (rejecting "disclaimer of fraud" and applying Rule 9(b) to Section 11 claim "inextricably intertwined with the allegations underlying plaintiffs' fraud claims").

Under Rule 9(b), Plaintiffs' Section 11 claims fail for the same reasons as their Section 10(b) claims. As discussed above, *see* Section I.A, *supra*, Plaintiffs have not pled particularized facts showing that EY's challenged statements were materially false. They have not pled particularized facts showing GAAP and GAAS violations—both of which must be adequately pled in order for EY's statements to be materially false. *See* Sections I.A.1.b, I.A.3.b, *supra*. Indeed, Plaintiffs have failed to allege a GAAP violation at all; pursuant to the governing accounting standard, SFAS 140, Lehman properly accounted for its Repo 105 transactions as sales. SFAS 140 at ¶ 218. Furthermore, neither SFAS 140 nor any other applicable standard required specific disclosure of these transfers accounted for as sales. *Id.* ¶ 17. Nonetheless, Lehman disclosed its policy to "recognize transfers of assets as sales" where, as in Repo 105 transactions, effective control has been surrendered. 2007 10-K at 96. Similarly, Plaintiffs fail to allege with particularity facts showing that EY violated GAAS. Plaintiffs do not allege any procedures the auditors should have performed, what the auditors would have found had they performed such additional procedures, or—even in general terms—how such procedures would have changed EY's opinion that Lehman's financial statements complied with GAAP. *See* Section I.A.3.b, *supra*.[28] As the TAC fails to plead particularized facts establishing GAAP and GAAS violations, Plaintiffs' Section 11 claims against EY must be dismissed.

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[28] And again, if Lehman's financial statements materially conformed to GAAP, then any alleged GAAS failure on EY's part would be immaterial. *See supra* at n.23.

3. Plaintiffs' Section 11 Claims Fail Under Rule 8.

Alternatively, if Plaintiffs have successfully segregated their Section 10(b) and Section 11 claims—triggering application of Rule 8(a) to their Section 11 claims—they still have failed adequately to allege the falsity of any EY statement. Under Rule 8, Plaintiffs' claims must be "supported by facially plausible factual allegations." *In re Morgan Stanley*, 592 F.3d at 358 (citing *Iqbal*, 129 S. Ct. at 1949-50). "A claim has facial plausibility," the Supreme Court has held, "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 129 S. Ct. at 1949; *see also ATSI Commc'ns*, 493 F.3d at 98 (requiring "allegations sufficient 'to raise a right to relief about the speculative level.'") (quoting *Twombly*, 550 U.S. at 555). Indeed, Rule 8 is not a toothless pleading standard. *See, e.g.*, *Coronel v. Quanta Capital Holdings Ltd.*, No. 07 Civ. 1405, 2009 WL 174656, at *13 (S.D.N.Y. Jan. 26, 2009) (finding allegations of subjective falsity insufficient "even under the lenient pleading standards of Rule 8(a)").

As discussed above, Plaintiffs have not alleged a plausible GAAP violation. Plaintiffs' bald assertions that Lehman's accounting for and disclosure of Repo 105 transactions violated GAAP (TAC ¶¶ 40(d), 40(f)), find no support in the relevant accounting literature and are squarely foreclosed by SFAS 140. *See supra* at 6-8, Section II.A.2. These assertions do not suffice to carry Plaintiffs' pleading burden under *Twombly*.

Nor have Plaintiffs alleged a plausible GAAS violation. Indeed, if Plaintiffs have in fact successfully segregated their Section 10(b) and Section 11 claims, they are left without *any* alleged GAAS violations to support their Section 11 claims—because all of Plaintiffs' GAAS allegations are set forth exclusively in their Exchange Act claims. *See* TAC ¶¶ 234-41 (alleging GAAS violations), ¶¶ 120-21 (asserting Section 11 claims based on only the allegations in TAC

¶¶ 1-119).[29] As the TAC fails to allege plausible GAAP and GAAS violations, Plaintiffs fail to plead that EY's statements were false, and their Section 11 claims against EY must be dismissed.

B. It Is Apparent On The Face Of The Complaint That EY's Alleged False Statements Did Not Cause Plaintiffs' Loss.

Plaintiffs are not required to plead loss causation in support of their Section 11 claim. 15 U.S.C. § 77(e). But where the facts alleged on the face of a complaint demonstrate the absence of loss causation ("negative causation"), the claim must be dismissed. *See, e.g.*, *Akerman v. Oryx Commc'ns, Inc.*, 810 F.2d 336, 341-42 (2d Cir. 1987) (dismissing Section 11 claim on negative causation grounds where plaintiffs' losses occurred before first alleged corrective disclosure); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 255 (S.D.N.Y. 2003) (same). It is clear from the TAC's allegations that other events, not the Repo 105 transactions, caused Plaintiffs' loss. Plaintiffs acknowledge, as they must, that the disclosure of Lehman's Repo 105 transactions was not made public until release of the Examiner's Report on March 11, 2010, well after Lehman's collapse. TAC at 1. Thus, as in *Akerman* and *Merrill Lynch*, the complaint itself shows that Lehman's bankruptcy (and Plaintiffs' alleged loss) occurred *prior to* disclosure of the alleged misrepresentations.

Plaintiffs argue in their Exchange Act claims that the nondisclosure of Lehman's Repo 105 transactions concealed the risk that materialized in the Lehman's decline and bankruptcy. TAC ¶¶ 248-50.[30] But where, as here, the TAC reflects on its face that the risks associated with Lehman's decreasing liquidity were disclosed in Lehman's financial statements, and that the

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[29] In support of their Section 11 claims, Plaintiffs only summarily assert that "E&Y's audit of Lehman's FY07 financial results was not performed in accordance with GAAS." *Id.* ¶ 40(f). This "conclusory allegation" is wholly insufficient—even under Rule 8. *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 210 (5th Cir. 2004) (dismissing Section 11 claims because "mere conclusory allegations will not suffice to prevent a motion to dismiss").

[30] Plaintiffs allege loss causation in support of their Section 10(b) claims. Those allegations may be considered in assessing whether "negative causation" bars their Section 11 claims. Negative causation is assessed not on the face of a single claim, but on the face of the complaint. *Merrill Lynch*, 272 F. Supp. 2d at 254 (permitting negative causation argument on pleadings where the defense is "apparent from the face of the complaint").

Repo 105 transactions could not and did not mask those risks, Plaintiffs' Section 11 claims against EY based on the Repo 105 transactions must be dismissed for "negative causation." *See Blackmoss Invs. Inc. v. ACA Capital Holdings, Inc.*, No. 07 Civ. 10528, 2010 WL 148617, at *10-11 (S.D.N.Y. Jan. 12, 2010) (dismissing claims based on negative causation where alleged concealment of asset risks was undermined by contemporaneous accurate statements about asset portfolio). On the face of the TAC, Plaintiffs themselves state that Lehman's stock price decline and bankruptcy were caused by, *inter alia*, the company's decision to continue investing in troubled real estate assets (TAC ¶¶ 70-109), in anticipation of a market reversal that never came to pass. Such assets grew increasingly illiquid, causing Lehman's inability to fund its operations following a run on the bank. *Id.* ¶¶ 249-50. The nature and extent of Lehman's liquidity—and the relationship between Lehman's liquid and less liquid assets—were disclosed in Lehman's financial statements. Repo 105 transactions, which merely converted one form of liquid assets into another, could not and did not mask the relationship between Lehman's liquid and less liquid assets, or the risks associated with its real estate acquisitions.

CONCLUSION

For the reasons above, Plaintiffs' claims against EY should be dismissed with prejudice.

Dated: June 4, 2010

Respectfully submitted,

LATHAM & WATKINS LLP

By /s/ Peter A. Wald
Peter A. Wald, *pro hac vice*

LATHAM & WATKINS LLP
505 Montgomery Street, Suite 2000
San Francisco, CA 94111-2562

[*additional counsel listed on cover page*]

Attorneys for Defendant Ernst & Young LLP

Addendum of Unpublished Authority

LEXSEE 2009 U.S. DIST. LEXIS 60160

Analysis
As of: Jun 04, 2010

In re TARRAGON CORPORATION SECURITIES LITIGATION

07 Civ. 7972 (PKC)

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

2009 U.S. Dist. LEXIS 60160

March 27, 2009, Decided
March 27, 2009, Filed

SUBSEQUENT HISTORY: Related proceeding at *Tarragon Corp. v. Northland Portfolio, L.P. (In re Tarragon Corp.), 2009 Bankr. LEXIS 2106 (Bankr. D.N.J., July 27, 2009)*

PRIOR HISTORY: *In re Tarragon Corp. Sec. Litig., 2007 U.S. Dist. LEXIS 91418 (S.D.N.Y., Dec. 6, 2007)*

COUNSEL: [*1] For Paul Berger, Individually and on behalf of all others similarly situated, Lead Plaintiff: Jeffrey Simon Abraham, LEAD ATTORNEY, Lawrence Donald Levit, Abraham Fruchter & Twersky, L.L.P., New York, NY.

For Vivian Judelson, as a trustee of the Vivian Judelson Revocable Trust Dated 10/09/95, Leonard Judelson, as a trustee of the Vivian Judelson Revocable Trust Dated 10/09/95, Vivian S. Judelson Contributory IRA, individually and on behalf of all others similarly situated, Plaintiffs: Mario Alba, Jr, Coughlin Stoia Geller Rudman & Robbins, LLP (LI), Melville, NY.

For Henry Nelson, Consolidated Plaintiff: Evan J. Smith, Brodsky & Smith, L.L.C., Mineola, NY; Richard A. Maniskas, Schiffrin, Barroway, Topaz & Kessler, L.L.P., Radnor, PA.

For Tarragon Corporation, William S. Friedman, Robert P. Rothenberg, Erin D. Pickens, Beachwold Partners, L.P., Defendants: Daniel Robbins Marcus, Eliot Lauer, LEAD ATTORNEYS, Curtis, Mallet-Prevost, Colt & Mosle, LLP(NYC), New York, NY; Theresa Ann Foudy, LEAD ATTORNEY, Curtis, Mallet-Prevost, Colt and Mosle LLP, New York, NY.

For Grant Thornton LLP, Defendant: Jennifer Laurie Malin, Luke A. Connelly, Winston & Strawn LLP (NY), New York, NY.

For Tarragon Investor Group, Movant: Evan [*2] J. Smith, LEAD ATTORNEY, Brodsky & Smith, L.L.C., Mineola, NY.

For Reginald Barnett, Movant: Mario Alba, Jr, Coughlin Stoia Geller Rudman & Robbins, LLP (LI), Melville, NY.

For Pascual Rodriguez, Movant: Kim Elaine Miller, LEAD ATTORNEY, Kahn Swick & Foti, LLC, New York, NY.

JUDGES: P. Kevin Castel, United States District Judge.

OPINION BY: P. Kevin Castel

OPINION

MEMORANDUM AND ORDER

P. KEVIN CASTEL, District Judge:

Lead plaintiff Paul Berger alleges in an Amended Class Action Complaint (the "Complaint") that defendants violated the federal securities laws by failing to disclose an accurate picture of the finances, business metrics and future prospects of defendant Tarragon Corporation ("Tarragon," or the "Company"). He asserts the claims on behalf of a putative class of persons who purchased shares of Tarragon between July 5, 2005 and August 9, 2007. On January 12, 2009, Tarragon filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of New Jersey, 09-10555-DHS, and all claims against it are automatically stayed under *11 U.S.C. § 362*. All other defendants move to dismiss pursuant to *Rules 12(b)(6)* and *9(b), Fed. R. Civ. P.*, and the [*3] Private Securities Litigation Reform Act of 1995, *15 U.S.C. § 78u-4(b)(1)-(3)(A)* (the "PSLRA").

For the reasons explained below, the non-stayed defendants' motions are granted.

BACKGROUND

1. Procedural History.

This action was commenced on September 11, 2007, with the filing of a class-action complaint against Tarragon and individual defendants William S. Friedman, Robert P. Rothenberg and Erin D. Pickens, alleging violations of the federal securities laws. In a Memorandum and Order dated December 6, 2007, I consolidated three putative class actions that had been filed against Tarragon. Those actions are: Vivian and Leonard Judelson, et al. v. Tarragon Corporation, et al., 07 Civ. 07972 (PKC); Nelson v: Tarragon Corporation, et al., 07 Civ. 08438 (PKC); and Berger v. Tarragon Corporation, et al., 07 Civ. 8689 (PKC). I also appointed lead counsel and granted the plaintiff leave to file an amended complaint. *In re Tarragon Corp. Securities Litigation, 2007 U.S. Dist. LEXIS 91418, 2007 WL 4302732 (S.D.N.Y. Dec. 6, 2007)*.

The Complaint, filed on January 18, 2008, alleges violations of section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), *15 U.S.C. § 78j(b)*, and SEC *Rule 10b-5* promulgated thereunder, *17 C.F.R. § 240.10b-5*. [*4] It also asserts claims of control-person liability under section 20(a) of the 1934 Act, *15 U.S.C. § 78t(a)*, against William Friedman and Beachwold Partners L.P. ("Beachwold"). Defendants Friedman, Erin Pickens and Robert Rothenberg (collectively, the "Individual Defendants") move to dismiss the section 10(b) and *Rule 10b-5* claim against them, and Friedman and Beachwold move to dismiss the section 20(a) claim. By a separate motion, defendant Grant Thornton LLP ("Grant Thornton") also moves for dismissal of the section 10(b) and *Rule 10b-5* claim asserted against it.

2. The Defendants

Tarragon operates two distinct businesses. Its homebuilding business focuses on developing, renovating, building and marketing homes in high-density urban locations and in master-planned communities. (Compl. P 2.) Its real-estate services business provides asset and property management for residential and commercial properties. (Compl. P 2.) Tarragon's common stock is publicly traded on the National Market System of the National Association of Securities Dealers, with more than 28.6 million shares outstanding. (Compl. PP 7, 15.) In addition to its claim against Tarragon, which is stayed while the bankruptcy [*5] action is pending, the Complaint also brings claims against three of Tarragon's officers: Chief Executive Officer and Chairman William Friedman, Chief Operating Officer Robert Rothenberg, and Chief Financial Officer Erin Pickens. (Compl. PP 8-10.)

Defendant Beachwold, which is alleged to be a control person for the purposes of plaintiff's section 20(a) claim, is a Texas limited partnership, and defendant Friedman, Tarragon's C.E.O., is its sole general partner. (Compl. P 12.) Friedman's wife and four children also are partners in Beachwold. (Compl. P 12.) Beachwold is alleged to maintain assorted business relationships with Tarragon. (Compl. P 12.)

Lastly, the Complaint alleges section 10(b) and *Rule 10b-5* claims against Tarragon's accounting firm, Grant Thornton, which is a United States-based member firm of Grant Thornton International. (Compl. P 13.) In fiscal years 2004, 2005 and 2006, Grant Thornton rendered audit opinions that were included in Tarragon's annual Form 10-K filings. (Compl. P 13.) Grant Thornton also reviewed Tarragon's quarterly 10-Q forms prior to filing. (Compl. P 13.)

3. The Alleged Misconduct.

According to the Complaint, the defendants issued materially false and [*6] misleading statements regarding its financial results and business operations, resulting in artificially high prices for Tarragon common stock during the Class Period of January 5, 2005 to August 9, 2007. (Compl. PP 1, 3.) The Complaint alleges that Tarragon's public statements contained material misstatements and erroneous accounting judgments, which conveyed an inaccurate and incomplete picture of the Company's finances, income and future prospects. It alleges that Grant Thornton fraudulently signed off on Tarragon's inaccurate financial statements. According to the Complaint, Tarragon's true condition was eventually

revealed in three sets of disclosures. They are summarized as follows:

Disclosures Related to Ansonia Apartments L.P.

Tarragon formed a joint venture with Ansonia LLC (the "LLC"); the joint venture was structured as a limited partnership with the name Ansonia Apartments L.P. ("Ansonia"). (Compl. *P* 76.) Ansonia's purpose was to acquire older suburban apartment properties in Connecticut, and reposition or renovate them. (Compl. P 76.) According to the Complaint, at least four of the LLC's five principals were officers or affiliates of Tarragon, including defendant Rothenberg. [*7] (Compl. P 76.) By November 2005, Tarragon owned approximately 90 percent of Ansonia. (Compl. P 77.)

The Complaint alleges that the defendants unlawfully failed to consolidate Ansonia's finances into the Company's consolidated financial results. In December 2003, the Federal Accounting Standards Board ("FASB") adopted FASB Interpretation Number ("FIN") 46(R), a rule that changed the standards by which financial statements consolidate the variable interests of a company's affiliated entities. (Compl. PP 73-74.) According to the Complaint, under FIN 46(R), "a company is required to assess its equity investments to determine if they are 'variable interest entities' and to decide whether to consolidate the variable interest entity based on factors other than strict voting control. . . ." (Compl. P 73.) After the adoption of FIN 46(R), Tarragon's financial statements consolidated several of its joint ventures, but they did not consolidate Ansonia. (Compl. P 75.) Tarragon's financial statements for 2004 and 2005 recorded which partnerships had been consolidated and which had not, and included disclosures about Ansonia's assets and liabilities as a non-consolidated joint venture. (2005 10-K at 84-85.) [*8] [1]

1 It is appropriate for a court to consider statements in a company's SEC filings when deciding a motion to dismiss a securities fraud claim. See, e.g., *ATSI Communications, Inc. v. Shaar Fund. Ltd., 493 F.3d 87, 98 (2d Cir. 2007)*. In this case, the documents were explicitly incorporated into the Complaint's allegations of securities fraud.

On August 23, 2006, Tarragon announced that it would retroactively consolidate Ansonia's operations into its financial results for 2004, 2005 and the first quarter of 2006. (Compl. P 42.) Consolidation of Ansonia's financials increased Tarragon's assets by around $ 300 million, increased liabilities by about $ 400 million, and decreased cumulative earnings by about $ 75 million. (Compl. P 42.)

Plaintiff asserts that Generally Accepted Accounting Principles ("GAAP"), as set forth at FIN 46(R), required Tarragon to consolidate Ansonia losses as its own beginning in 2004, and that Tarragon fraudulently failed to do so. (Compl. P 78.)

April 2, 2007

On April 2, 2007, the Company announced that it would restate its consolidated statements of cash flows from 2004 and 2005 in order to reclassify certain items. (Compl. P 50.) Tarragon stated that management [*9] decided on this action after reviewing statements of cash flows, applicable accounting standards and the presentations of other companies. (Compl. P 50.) A company's statement of cash flows, along with related disclosures, is intended to provide investors with information sufficient to assess the ability to generate future positive cash flow, pay dividends, and make other financial assessments. (Compl. P 84.) According to a Form 8-K released by the Company, the restatement did not affect the net change in cash for 2004 or 2005 and had "no impact on the Company's consolidated balance sheets, consolidated statements of income and related earning per share amounts or consolidated statements of shareholders' equity." (Mar. 27, 2007 Form 8-K.)

August 9, 2007

On August 9, 2007, Tarragon announced that it was "experiencing liquidity issues caused by the sudden and rapid deterioration in the real estate credit markets." (Compl. P 60.) It announced that in light of revised evaluations, it expected to record impairment charges totaling more than $ 125 million. (Compl. PP 60-61.) Tarragon attributed its difficulties to an "accelerated deterioration of the homebuilding industry" in Tarragon's markets, [*10] particularly in the state of Florida. (Compl. P 60.) Tarragon noted that these difficulties in the housing market, as well as the Company's inability to attain loan modifications and additional financing, materially affected Tarragon's liquidity and "raise[d] doubt about Tarragon's ability to continue as a going concern." (Compl. P 60.) Tarragon delayed the filing of its second-quarter 10-Q. (Compl. P 60.) On the day that Tarragon announced these developments, Tarragon's stock price dropped $ 1.88, or 67%, to close at $ 0.94 per share. (Compl. P 62.)

On December 24, 2007, Tarragon filed Form 10-Qs for the second and third quarters of 2007. (Compl. PP 66-67.) Among other things, the filings disclosed that beginning in June 2007, Tarragon experienced increased buyer defaults in a New Jersey development, with Tarragon recording allowances of $ 17.9 million and $ 7.7 million in the second and third quarters of 2007 as a result of the defaults. (Compl. PP 66-67.)

STANDARD ON A MOTION TO DISMISS

"To survive a motion to dismiss, a complaint must plead 'enough facts to state a claim to relief that is plausible on its face.'" *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187, 196 (2d Cir. 2009)* [*11] (quoting *Ruotolo v. City of New York, 514 F.3d 184, 188 (2d Cir. 2008)*). The PSLRA "imposed heightened pleading requirements and a loss causation requirement upon 'any private action' arising from the Securities Exchange Act." *Stoneridge Investment Partners, LLC v. Scientific-Atlanta. Inc., 552 U.S. 148, 128 S.Ct. 761, 773, 169 L. Ed. 2d 627 (2008)* (quoting *15 U.S.C. § 78u-4(b)*). A securities fraud complaint must satisfy the statute's heightened pleading standards and *Rule 9(b), Fed. R. Civ. P.*, by stating with particularity the circumstances that constitute the fraud. *ECA, Local 134, 553 F.3d at 196* (citing *Tellabs, 127 S.Ct. at 2508*). This pleading threshold gives a defendant notice of the plaintiff's claim, safeguards a defendant's reputation and protects a defendant against strike suits. See *ATSI, 493 F.3d at 99*.

"The [PSLRA] 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.'" *Dura Pharmaceuticals. Inc. v. Broudo, 544 U.S. 336, 345, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005)* (quoting *15 U.S.C. § 78u-4(b)(1),* [*12] *(2)*). "A securities fraud complaint based on misstatements 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." *ATSI, 493 F.3d at 99* (citing *Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000)* (citations omitted)).

Along with a detailed account of the conduct alleged to be fraudulent, the PSLRA "requires plaintiffs to state . . . the facts evidencing scienter, i.e., the defendant's intention to 'deceive, manipulate, or defraud.'" *Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S.Ct. 2499, 2504, 168 L. Ed. 2d 179 (2007)* (quoting *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194, 96 S. Ct. 1375, 47 L. Ed. 2d 668 and n. 12 (1976)*). To qualify as "strong," the "inference of scienter must be more than merely plausible or reasonable -- it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Id. at 2504-05*.

As a result, while a court "'normally draw[s] reasonable inferences in the non-movant's favor on a motion to dismiss,' the PSLRA 'establishes a more stringent rule for inferences involving scienter' because the PSLRA requires particular [*13] allegations giving rise to a strong inference of scienter." *ECA, Local 134, 553 F.3d at 196* (quoting *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 194 (2d Cir. 2008)*).

DISCUSSION

Section 10(b) of the Securities Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." *15 U.S.C. § 78j(b)*. "The SEC rule implementing the statute, *Rule 10b-5*, prohibits 'mak[ing] any untrue statement of a material fact or [omitting] to state a material fact necessary in order to make the statements made, in light of the circumstance under which they were made, not misleading.'" *ECA, Local 134, 553 F.3d at 197* (alterations in original) (quoting *Rule 10b-5*).

As Judge Cote has observed, "[s]ection 10(b) of the Exchange Act is designed to protect investors by serving as a 'catchall provision' which creates a cause of action for manipulative practices by defendants acting in bad faith." *In re Openwave Sys. Secs. Litig., 528 F. Supp. 2d 236, 249 (S.D.N.Y. 2007)* (citing *Ernst & Ernst, 425 U.S. at 206*). [*14] A typical action brought under section 10(b) requires a plaintiff to prove (1) a material misrepresentation or omission; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Stoneridge, 128 S.Ct. at 768* (citing *Dura, 544 U.S. at 341-42*).

The securities laws do not provide a cause of action for second-guessing company business judgments, however. "Corporate officials need not be clairvoyant; they are only responsible for revealing those material facts reasonably available to them. . . . [A]llegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud." *Novak, 216 F.3d at 309* (citing *Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978)*); see also *Acito v. IMCERA Group, Inc., 47 F.3d 47, 53 (2d Cir. 1995)* ("lack of clairvoyance" is not securities fraud). "[A]s long as the public statements are consistent with reasonably available data, corporate officials need not present an overly gloomy or cautious picture of current [*15] performance and future prospects." *Novak, 216 F.3d at 309*.

The Individual Defendants and Grant Thornton have filed separate notices of motion, and set forth different theories as to why the Complaint's claims under section 10(b) and *Rule 10b-5* should be dismissed. I address their respective motions in turn.

I. The Individual Defendants' Motion to Dismiss is Granted.

The Individual Defendants argue that the claims against them should be dismissed because the Complaint fails to plead acts of fraud with particularity, and fails to set forth allegations raising a plausible inference of scienter, thereby failing to cross the pleading threshold required by the PSLRA. In addition, Friedman and Beachwold argue that the Complaint fails to state a claim of control-person liability under section 20(a).

A. The Individual Defendants' Motion to Dismiss for Failure to Plead Fraudulent Acts with the Necessary Particularity is Granted in Part and Denied in Part.

The Individual Defendants move to dismiss the Complaint on grounds that the Complaint fails to plead fraud with the particularity required by the PSLRA and *Rule 9(b)*. As noted above, ATSI set forth the minimal requirements for a plaintiff to satisfactorily [*16] allege securities fraud pursuant to *Rule 9(b), Fed. R. Civ. P.* Specifically, the complaint must specify the allegedly fraudulent statements, identify the speaker and when and where the statements were made, and explain why the statements were fraudulent. *ATSI, 493 F.3d at 99*.

Conclusory statements or statements unsupported by factual assertions are inadequate to state a claim for fraud. Id "[I]f an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *15 U.S.C. § 78u-4(b)(1)*. Citation to public documents may be sufficient to identify with specificity the basis for claims brought on information and belief. See *Novak, 216 F.3d at 312-13* (reliance on form 10-Q filings sufficient to set forth misleading statements on information and belief). However, with certain exceptions, the general rule is that fraud allegations pleaded upon information and belief "do not satisfy *Rule 9(b)*." *Stern v. Leucadia Nat'l Corp., 844 F.2d 997, 999 n.1 (2d Cir. 1988)*; accord *Luce v. Edelstein, 802 F.2d 49, 54 n.1 (2d Cir. 1986)*. "[F]raud allegations may be so pleaded as to facts peculiarly within [*17] the opposing party's knowledge; even then, however, the allegations must be accompanied by a statement of facts upon which the belief is founded." *Stern, 844 F.2d at 1003*. "It is not sufficient that plaintiffs have alleged that the undisclosed information was material. '[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts.'" *In re Optionable Sec. Litig., 577 F. Supp. 2d 681, 692 (S.D.N.Y. 2008)* (quoting *In re Time Warner Inc. Securities Litigation, 9 F.3d 259, 267 (2d Cir. 1993)*).

Here, prefatory language in the Complaint states that the "[p]laintiff alleges the following facts upon knowledge, with respect to his own acts, and on information and belief with respect to all other facts based on an investigation conducted by his counsel . . . ." (Compl. at p. 1.) The allegations are based solely on statements made by Tarragon in public filings with the SEC and in various press releases during the class period. It does not draw from any confidential sources or former employees [*18] or officers of Tarragon.

I now turn to whether the Complaint's allegations of fraud satisfy the particularity requirements of the PSLRA and *Rule 9(b)*. Specifically, I consider whether the Complaint sufficiently alleges why the statements of Tarragon were fraudulent.

1. Tarragon's Representations Concerning Ansonia.

Plaintiff alleges that Tarragon's statements in public filings relating to Ansonia were unlawful because FIN 46(R) required Tarragon to consolidate Ansonia into its financial statements. (Compl. P 75.) According to the Complaint, if the Company had earlier consolidated Ansonia into its financial statements, as FIN 46(R) required, "Tarragon's financial results would have been harmed." (Compl. P 78.) When the Ansonia properties were consolidated in 2006, it was revealed that the Company overstated its net income for 2004 and 2005 by 34 percent and 39 percent, respectively. (Compl. P 80.)

However, before Ansonia was consolidated into Tarragon's financial statements, Tarragon publicly disclosed, in extensive detail, Ansonia's assets and liabilities. (See 2005 10-K at 9, 30, 38, 83-86.) The only basis for the fraud claim is that they were denoted as unconsolidated rather than consolidated. [*19] FIN 46(R) became effective on March 15, 2004. (Compl. at P 73 n.1.) In August 2006, Tarragon, in consultation with Grand Thornton, reevaluated Ansonia's status and concluded that its decision not to consolidate it in its financial statements ran afoul of GAAP standards. (Compl. P 42.)

GAAP establishes "the conventions, rules, and procedures that define accepted accounting practices." *United States v. Arthur Young & Co., 465 U.S. 805, 811 n.7, 104 S. Ct. 1495, 79 L. Ed. 2d 826 (1984)*. It "'include[s] broad statements of accounting principles amounting to aspirational norms as well as more specific guidelines and illustrations.'" *In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1420, n.10 (3d Cir. 1997)* (alteration in original; quotation marks omitted). SEC Regulation S-X, *17 C.F.R. § 210.4-01(a)(1)*, states in relevant part: "Financial statements filed with the Commission which are not prepared in accordance with [GAAP] will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided." However, "[i]t has

been the long-held view in this Circuit that GAAP neither establishes nor shields guilt in a securities fraud case." *United States v. Rigas, 490 F.3d 208, 220 (2d Cir. 2007)* [*20] (citing *United States v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969)* (Friendly. J.)), cert. denied,*128 S. Ct. 1471, 170 L. Ed. 2d 296 (2008)*. Instead of providing a basis for a substantive violation of the securities laws, GAAP compliance is relevant to whether a party acted in good faith. Id. (citing *United States v. Ebbers, 458 F.3d 110 (2d Cir. 2006)*).

An allegation of GAAP non-compliance is not alone sufficient to state a claim for securities fraud. Even if the Complaint's allegations as to Ansonia were sufficient to state a claim based on a GAAP violation, the plaintiff would face the additional hurdle of adequately pleading scienter. See *Stevelman v. Alias Research Inc., 174 F.3d 79, 84 (2d Cir. 1999)* ("'[A]llegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim.'") (quoting *Chill v. General Electric Co., 101 F.3d 263, 270 (2d Cir. 1996)*); accord *ECA, Local 134, 553 F.3d at 200*. I separately address the adequacy of the Complaint's scienter allegations below.

2. Tarragon's August 9. 2007 Announcement of a $ 125 Million Impairment Charge.

On August 9, 2007, Tarragon issued a press release stating that [*21] it "currently expects to record impairment charges in excess of $ 125 million" as a result of "its evaluation of property impairment charges and other write-downs necessitated by the recent decision to sell certain properties under current adverse market conditions." (Compl. P 60.) The press release cited the adverse effects of "accelerated deterioration in the homebuilding industry," specifically in Florida, as well as the difficulties of obtaining loan modifications and additional financing. (Compl. P 60.)

The Individual Defendants argue that the Complaint sets forth no facts showing that the write-downs and impairment charges were untimely, and that the Complaint does not explain which prior alleged misstatements were misleading. However, the August 9 press release came on the heels of a July 25, 2007 release issued by Tarragon. The July 25 release was headed, "Tarragon Corporation Comments on Unusual Trading Activity." (Marcus Dec. Ex. H.) It noted that "unusual trading activity in its common stock . . . has occurred over the past two days and that has resulted in significant price volatility." (Id.) Tarragon asserted that it has a policy not to respond to rumors or speculation, [*22] but that "there has been no material change to the Company's business outlook, financial position or any other aspect of its business that would account for such trading activity." (Id.) The press release proceeds to quote Friedman, who asserted that Tarragon was "demonstrating that we're continuing to manage the challenges we face in [Florida's condominium] market." (Id.)

The plaintiff has pleaded that the sanguine depiction of Tarragon's affairs in the July 25 announcement was part of an effort to conceal a far less optimistic reality about the Company's condition. While the Individual Defendants emphasize the August 9 announcement's description of "the recent decision to sell certain properties under current adverse market conditions" (emphasis added), the close timing between the July 25 statement and the August 9 statement is sufficient to demonstrate, for pleading purposes, why the July 25 statement may have been fraudulent. In addition, the July 25 statement specifically indicated that Tarragon was successfully managing its sales goals in the "Florida condominium conversion communities," while the August 9 statement specifically singled out changes in the Florida homebuilding [*23] market as a reason for the Company's difficulties. (Compl. P 60.) The Complaint sufficiently pleads the particulars of the plaintiff's securities fraud claim.

However, there remains the separate issue of whether the Complaint adequately sets forth allegations that raise a strong inference of scienter, which is addressed below.

3. Tarragon's Non-Compliance with Debt Covenants, as Announced in its August 9, 2007 Release.

Also included in the August 9, 2007 press release was an assertion that "Tarragon has not made its August 2007 debt service payments as well as certain other vendor payments," that "Tarragon currently is not in compliance with a financial covenant contained in its existing subordinated debt," and that after certain write-downs were recorded, "Tarragon will not be in compliance with certain net worth maintenance and other financial covenants contained in this and other debt agreements." (Compl. *P* 60.) Those August 9 statements contrast with aspects of the July 25 press release, which stated, inter alia, that "[w]e're also making excellent progress toward our 2007 debt reduction goals . . . . Over the next few quarters, we expect to close sales of over $ 600 million of completed [*24] rental properties which are expected to generate over $ 450 million in debt repayment and approximately $ 150 million in net cash proceeds . . . ." (Compl. P 59.)

The contrast between the optimistic projections of Tarragon's statement of July 25, 2007, and the disclosures 15 days later, without any apparent intervening event, raises a legitimate question of fraud. Here, as in *Novak*, "the complaint alleges that the defendants did more than just offer rosy predictions," *216 F.3d at 315*, because the July 25 press release is alleged to have stated

with specificity that the Company was making progress on its debt reduction, only for a very different depiction of the Company's debt obligations to be acknowledged days later.

There remains the separate issue of whether the Complaint adequately sets forth allegations that raise a strong inference of scienter, which is addressed below.

4. Tarragon's Statements Concerning Revenue Recognition.

According to the Complaint, Tarragon unlawfully recognized revenue according to the "percentage-of-completion method when it lacked a reasonable assurance that persons making initial deposits for purchases of condominiums would follow through on their initial [*25] commitments." (Compl. P 63(d).) Plaintiff cites to a variety of statements made in Tarragon press releases and public filings related to the Company's revenues in 2006 and 2007, which the plaintiff contends were unduly optimistic. (Compl. PP 43-45, 47-49, 51-52, 54, 56.) The Complaint alleges that the Company's true condition was revealed only when it filed its Form 10-Q for the fiscal quarters ending on June 30, 2007 and September 30, 2007, respectively. (Compl. PP 66-67.)

Plaintiff specifically emphasizes statements in the Company's 2006 10-K filing concerning revenues from condominium sales in new developments. (Compl. PP 52-53.) In that filing, Tarragon noted that it "may be required, in some cases, to collect additional deposits" from buyers "in order to recognize revenue under the percentage of completion method" required by the FASB. (Compl. P 52.) Plaintiff cites statements concerning a New Jersey development called One Hudson Park. (Compl. PP 53, 86.) According to the Complaint, "the need to collect additional deposits or payments from prospective condominium purchasers was not a mere possibility," because higher deposits from prospective purchasers were required in order "to [*26] demonstrate a commitment on the part of those prospective purchasers" that the sales would be final. (Compl. P 53.) According to the Complaint, Tarragon recognized revenue under a "percentage-of-completion" method in spite of relatively small deposits and "no reasonable expectation that full payment would be made and without conducting adequate due diligence . . . ." (Compl. P 86.)

The allegations regarding Tarragon's revenue-recognition statements do not state a claim for securities fraud. To satisfy *Rule 9(b)* and the PSLRA, a complaint must "explain why the statements were fraudulent." *Acito, 47 F.3d at 51*. The allegations that One Hudson Park purchasers fell below a certain minimum threshold for purchasing deposits are wholly conclusory. At heart, the plaintiff takes issue with Tarragon's assertion in its 2006 10-K that additional deposits "may be required," (Compl. P 52) (emphasis added) while the plaintiff asserts that the need for additional deposits "was more than a mere possibility . . . ." (Compl. *P* 53; emphasis added.) However, the Complaint does not allege that Tarragon had actual awareness of facts that elevated a need for additional deposits beyond that of a "mere [*27] possibility," or allege with any specificity why it was reckless or intentionally misleading for Tarragon to conclude that additional deposits "may be required" instead of reaching a more concrete conclusion. Tarragon's use of the conditional "may" recognized the possibility that the deposits may have been inadequate and that more would be required, and is not a viable basis for a securities fraud claim.

B. The Complaint Fails to Allege Scienter Under the Standard Set Forth in *Tellabs*.

The PSLRA requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2)*. The statute "unequivocally raise[d] the bar for pleading scienter." *Tellabs, 127 S.Ct. at 2509* (alteration in original; quotation marks omitted). In scrutinizing a complaint's allegations of scienter, a court is to consider "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id. at 2509* (emphasis in original). A court also "must take into account plausible opposing inferences." *Id. at 2509*. [*28] This requires close scrutiny of the factual allegations:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite "strong inference" of scienter, a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, i.e., of the "smoking-gun" genre, or even the "most plausible of competing inferences[.] . . . Yet the inference of scienter must be more than merely "reasonable" or "permissible" -- it must be cogent and compelling, thus strong in light of other explanations. A complaint will survive, we hold, 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.

Id. at 2510. Defendants' pecuniary motive is a relevant consideration, although an absence of motive is not alone dispositive. *Id. at 2511*. Personal financial gain [*29] on the part of a defendant weighs in favor of a scienter inference. *Id. at 2511*. If a complaint contains ambiguities or omissions, those weigh against inferring scienter. *Id. at 2511*.

In the Second Circuit, scienter may be pleaded 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, 493 F.3d at 99*. Circumstantial evidence may go toward showing "deliberate illegal behavior," or "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care." *Novak, 216 F.3d at 308* (quotation marks omitted). "Intentional misconduct is easily identified since it encompasses deliberate illegal behavior, such as securities trading by insiders privy to undisclosed and material information, or knowing sale of a company's stock at an unwarranted discount." *Id. at 308* (internal citation omitted). As to recklessness, "allegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud." *Id. at 309*. "Motives [*30] that are generally possessed by most corporate directors and officers do not suffice." *Kalnit v. Eichler, 264 F.3d 131, 139 (2d Cir. 2001)*.

Tellabs requires that I weigh plausible opposing inferences, as well as consider the allegations collectively. *127 S.Ct. at 2509*. I will examine the face of the Complaint and the SEC filings on which it is based. I begin with a review of the parties' arguments as to the permissible and plausible inferences to be drawn.

1. The Individual Defendants' Alleged Motivations to Inflate Stock Prices.

Plaintiff argues that the Individual Defendants had motives to commit acts of fraud that inflated the Company's stock prices. Plaintiff contends that Friedman and Beachwold had "a substantial portion of their wealth ... tied up in Tarragon common stock," which was used as collateral for personal loans. (Mem. in Opp. to Tarragon at 15; Compl. P 100.) As the stock price dipped, Friedman's lenders sold Tarragon shares in order to meet margin calls. (Id.) However, the Individual Defendants note that they purchased Tarragon shares throughout the class period and sold no Tarragon shares until the final two days of the class period, when Friedman sold shares in response [*31] to forced margin sales. (Marcus Dec. Exs. M, N.) Defendants argue that holding shares during the class period does not, in itself, establish motive under the PSLRA. See *Kalnit, 264 F.3d at 141*; *In re Health Management Inc. Securities Litigation, 970 F. Supp. 192, 204-05 (E.D.N.Y. 1997)*. They also argue that the margin sales by Friedman were required, and do not reflect a desire for personal gain by Friedman.

Second, the plaintiff argues that Tarragon had a "collective program to utilize Tarragon's stock as currency to effectuate corporate goals." (Mem. in Opp. to Tarragon at 15.) Specifically, the plaintiff asserts that Tarragon used its stock to acquire minority interests in two partnerships, and to retire debt accrued through an offering initiated by the Company. Plaintiff cites to instances in 2005 and 2006 in which debt notes were converted into Tarragon shares, or else in which common stock was used as security for purchasing transactions. (Compl. PP 25, 28, 31, 46.) Defendants contend that the use of company stock to fund acquisitions may support an inference of fraud when defendants engage in a sustained program of multiple acquisitions but not when acquisitions are limited and [*32] spread out over time. See, e.g., *Rothman v. Gregor, 220 F.3d 81, 93 (2d Cir. 2000)* (observing that a desire to consummate corporate transactions may sometimes be evidence of fraud); *In re DRDGOLD Ltd. Securities Litigation, 472 F. Supp. 2d 562, 570-71 (S.D.N.Y. 2007)* (scienter not alleged when acquisitions via high stock prices "evince[] what ordinarily would be a laudable desire to diversify in order to protect shareholder investments"); *In re AOL Time Warner Securities & ERISA Litigation, 381 F. Supp. 2d 192, 218 (S.D.N.Y. 2004)* (alleged "obsession" with completing merger was not evidence of scienter). Tarragon contends that it did not consummate any acquisitions through the use of shares at inflated prices, but merely increased the Company's ownership interests in preexisting joint ventures. (Tarragon Mem. at 17, citing 2006 10-K at 88, Oct. 4, 2006 8-K at 2.) Simultaneously, in the same time period in which the plaintiff alleges that the defendants were fraudulently inflating share prices to fund asset acquisitions, Tarragon was purchasing shares of its own stock -- 1.6 million shares at an aggregate price of $ 27 million during the class period. (See 2Q 2005 Form 10-Q at 44; 3Q [*33] 2006 Form 10-Q at 51.)

Third, plaintiff argues that Tarragon's desire to maintain compliance with debt covenants is evidence of scienter. (Mem. in Opp. to Tarragon at 17.) The Complaint recites August 2007 notifications of default and acceleration from certain of Tarragon's lenders, which Tarragon then disclosed in its form 10-Q for the second quarter of 2007. (Compl. PP 65-66.) Tarragon argues that an allegation that a company sought to raise a share

value in order to reduce debt via conversion of senior convertible notes is insufficient as a matter of law to show a motive to commit fraud. See *In re Geopharma Inc., 399 F. Supp. 2d 432, 450 (S.D.N.Y. 2005)* ("[C]ourts in this Circuit have consistently held that allegations that a defendant was motivated to commit securities fraud by a desire to reduce its debt burden, or otherwise reduce borrowing costs, are insufficient to raise a scienter inference.") (citing *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Co., 75 F.3d 801, 814 (2d Cir. 1996)*). The Complaint alleges that the defendants misrepresented financial statements "to assure compliance with various financial covenants," (Compl. P 98) but defendants assert [*34] that this is insufficient to support scienter. *Caiafa v. Sea Containers Ltd., 525 F. Supp. 2d 398, 412-13 (S.D.N.Y. 2007)* (desire to maintain compliance with company loan agreement is "inadequate to support an allegation of intent to commit fraud.").

Fourth, the plaintiff argues that the Individual Defendants' compensation packages were linked to the price of Tarragon's common stock. (Mem. in Opp. to Tarragon at 17-18; Compl. P 99.) Plaintiff asserts that, cumulatively, these motivations "give rise to a strong inference of scienter." *Tellabs, 127 S.Ct. at 2509*. The Individual Defendants cite to Second Circuit precedent holding that a desire to maintain high share prices in order to increase officer compensation is an insufficient to support a strong inference of fraud. See *Kalnit, 264 F.3d at 141*; *Novak, 216 F.3d at 307-08*.

2. The Individual Defendants' Conduct Indicating Fraud or Recklessness.

Plaintiff also maintains that the Complaint alleges conscious disregard of known facts, or, in contrast, recklessness. In support of this argument, they note that the defendants were aware of Ansonia's operations, yet nevertheless failed to consolidate them into Tarragon's financial statements. [*35] This, they assert, is evidence that Tarragon's corporate officers failed to familiarize themselves with facts concerning core Company operations. (Mem. in Opp. to Tarragon at 19.) The Individual Defendants argue that the decisions not to consolidate and then subsequently to consolidate Ansonia were made in consultation with its outside accountants. When a company relies on the conclusions of licensed outside accounts, the Individual Defendants argue, its behavior, as a matter of law, is not reckless. *Pecarsky v. Galaxiworld.com, Ltd., 249 F.3d 167, 174 (2d Cir. 2001)* (reliance on accountant advice is "a complete defense" to a 10(b) and 10b-5 claim concerning consolidation status).

The plaintiff also argues that other decisions by the defendants -- including premature revenue recognition, insufficient deposits on Tarragon's One Hudson Place project, and Tarragon's $ 125 million impairment charge -- are evidence of reckless or intentional disregard of known facts. (Mem. in Opp. to Tarragon at 20-21.) The Individual Defendants argue that the Company's impairment charge was timely, and occurred early in the deterioration of the American real estate and credit markets, a development of which [*36] I am able to take judicial notice. *Fed. R. Evid. 201(b)*. The mere size of an improperly overstated value does not raise an inference of fraudulent or reckless intent, the defendants argue. See *Caiafa, 525 F. Supp. 2d at 413-14*. In addition, the defendants characterize the plaintiff's allegations about One Hudson Place as "an absurd contention" that places an onus on Tarragon to have foreseen a "cataclysm in the real estate and credit markets" and thereby require greater deposits from purchasers in the development. (Tarragon Reply Mem. at 9.)

3. The Complaint Does Not Set Forth Allegations That Raise a Strong Inference of Scienter.

In weighing plausible opposing inferences and considering the allegations collectively, *Tellabs, 127 S.Ct. at 2509,* I conclude that the Complaint falls below the threshold required to raise the "strong inference" of scienter necessary to satisfy the PSLRA.

The plaintiff repeatedly emphasizes *Tellabs's* admonition to weigh the allegations "collectively" and not weigh scienter based on allegations "scrutinized in isolation." *127 S. Ct. at 2509*. However, when examined in their totality, the Complaint's allegations fail to establish a "cogent and compelling" inference, [*37] one that "a reasonable person" would find "at least as compelling as any opposing inference one could draw from the facts alleged." *Id. at 2510*. Rather than a fraudulent scheme to artificially inflate the price of Tarragon shares, driven by a desire for personal profit at shareholder expense, the Complaint depicts a company's evolving judgment calls as to a relatively new accounting standard, and its apparently unsuccessful attempts to weather dramatic and sudden changes in the American real estate market.

Plaintiff does not, for instance, dispute the Individual Defendants' contention that they acquired shares of the Company throughout the class period, and that only Friedman sold shares of the Company during the same period -- transactions that arose solely in order to meet margin calls. The holding of *In re Worldcom, Inc. Securities Litigation, 294 F. Supp. 2d 392, 416-17 (S.D.N.Y. 2003)*, which is relied upon by the plaintiff, is distinguishable. There, Judge Cote found allegations sufficient to raise a strong inference of scienter because defendant Bernard Ebbers's personal financial incentives for maintaining a high share price were "unique and substantial." *Id. at 416*. Ebbers used [*38] a high share price to finance acquisition of hundreds of thousands of acres of

land at costs of hundreds of millions of dollars, and approximately $ 900 million in personal loans were secured by his stock ownership. Id. While the high share price also allowed Ebbers to avoid margin calls from lenders, that was one aspect of a dependency on high share prices that the opinion characterized as "enormous, unusual, personal and concrete," and pleaded in significant detail. *Id. at 416-17* ("Time and again the sources of the information and the information itself are described in detail, and time and again the information implicates Ebbers in the securities fraud."). Here, the Complaint alleges only that Tarragon stock "was used as collateral for personal loans," and that when Tarragon stock value declined, "the lenders began to sell Tarragon stock in order to meet the margin calls." (Compl. P 100.) Here, the Complaint does not allege what percentage of Friedman's shares in the Company were sold, or place a dollar value on the proceeds. One defendant's sale of shares in the final 48 hours of class period, made in order to satisfy margin calls, does not raise a "strong inference" of scienter. [*39] *Acito, 47 F.3d at 54* ("[T]he sale of stock by one outside director does not give rise to a strong inference of an intent to deceive the investing public").

Plaintiff's emphasis on Tarragon's use of stock to acquire assets and retire debt also fails to raise a plausible inference of scienter. Plaintiff cites three instances which it claims shows that the defendants "were motivated to misrepresent the true financial condition and state of affairs because they were using Tarragon common stock as currency to acquire assets and reduce debt ...." (Compl. P 98.) First, in April 2005, Tarragon acquired a 30 percent interest in a limited liability company in exchange for a $ 967,000 promissory note secured by common stock; in August 2005, Tarragon converted $ 54.25 million in senior convertible notes into common stock; and in September 2006, Tarragon issued stock to Rohdie LLC in connection with Rohdie's right to convert membership units in a Tarragon entity into Tarragon securities. (Compl. PP 25, 31, 46.) Plaintiff asserts that under Tellabs. these transactions should be "taken collectively" to raise an inference of scienter.

It is true that "in some circumstances, the artificial inflation of [*40] stock price in the acquisition context may be sufficient for securities fraud scienter." *Rothman, 220 F.3d at 93*. However, there must be "concrete benefits" and the alleged motivations for the acquisition must be "sufficiently particularized." Id. Here, the Complaint does not indicate any nefarious benefits or motivations behind the acquisitions. There is no basis to conclude that the defendants had an "intent to benefit themselves at the expense of the shareholders," or whether, alternatively, "the shareholders themselves would benefit from a superior transaction." *Kalnit. 264 F.3d at 140*; see also *In re DRDGOLD Ltd., 472 F. Supp. 2d at 571* (artificially high share price doesn't raise inference of scienter if shares alleged to fund acquisitions that would diversify company's holdings). The Complaint here simply does not support inferences as to how these acquisitions would have given a concrete benefit to the Company or the individual defendants at the expense of shareholders.

Similarly, the Complaint fails to set forth any allegations that invite an inference as to why the Company's desire to reduce debt conversion would support a strong inference of fraud. See *In re Geopharma, 399 F. Supp. 2d at 450*. [*41] The plaintiff's citation to authority from other circuits may provide some support for the proposition that the desire to avoid default on debt obligations supports an inference of scienter, but those authorities also acknowledge levels of specificity in the pleadings that are not present in the Complaint. *In re U.S. Aggregates, Inc. Securities Litigation, 235 F. Supp. 2d 1063, 1070-72 (N.D. Cal. 2002)*, concluded that scienter was adequately alleged when the complaint asserted that accounting irregularities were specifically motivated by a desire to maintain financial ratios required in loan agreements, and those allegations were based on confidential assertions by a former chief operating officer of the defendant, among other high-level executives. Another opinion relied upon by the plaintiff, *Wilson v. Bernstock. 195 F. Supp. 2d 619, 637 (D.N.J. 2002)*, concluded that allegations concerning debt level were insufficiently pleaded to raise an inference of scienter, and that "a company's desire to maintain a high bond or credit rating does not qualify as a sufficient motive for fraud." When taken in aggregate, as the plaintiff proposes, the allegations do not suggest any inference more [*42] damaging than a desire to limit company debt obligations.

Lastly, while linking bonus compensation to share performance may provide some evidence of scienter, the plaintiff sets forth nothing more than the type of speculative nexus that the Second Circuit has rejected. See *ECA. Local 134, 553 F.3d at 201* ("If scienter could be pleaded solely on the basis that defendants were motivated because an inflated stock price or improved corporate performance would increase their compensation, 'virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions. [I]ncentive compensation can hardly be the basis on which an allegation of fraud is predicated.'") (quoting *Acito, 47 F.3d at 54*).

Because the plaintiff has failed to plead scienter with the specificity required by *Tellabs* and the law of this Circuit, the Complaint is dismissed.

C. The Section 20(a) Claim is Dismissed.

Count II of the Complaint alleges that Friedman and Beachwold are separately liable as control persons under

Section 20(a) of the 1934 Act, *15 U.S.C. § 78t(a)*. "In order to establish a prima facie case of liability under § 20(a), a plaintiff must show: [*43] (1) a primary violation by a controlled person; (2) control of the primary violator by the defendant; and (3) that the controlling person was in some meaningful sense a culpable participant in the primary violation." *Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998)* (quotation marks omitted). "Control over a primary violator may be established by showing that the defendant possessed 'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." *SEC v. First Jersey Securities, Inc.. 101 F.3d 1450, 1472-73 (2d Cir. 1996)* (quoting SEC *Rule 12b-2*, *17 C.F.R. § 240.12b-2*), cert, denied, *522 U.S. 812, 118 S. Ct. 57, 139 L. Ed. 2d 21 (1997)*.

As an initial matter, because the Complaint fails to allege scienter, there is no viable claim for a primary violation of the securities laws, and the Section 20(a) claim against Beachwold and Friedman must be dismissed. See *Rombach v. Chang, 355 F.3d 164, 177-78 (2d Cir. 2004)* (dismissing section 20(a) claim for lack of underlying primary violation).

In addition, while the law in this Circuit may be unsettled as to whether a Section 20(a) claim must be pleaded with particularity, [*44] see *In re Global Crossings. Ltd. Securities Litigation, 322 F. Supp. 2d 319, 349 n.24 (S.D.N.Y. 2004)*, as to defendant Beachwold, the Complaint is devoid of allegations sufficient to state a claim for *Section 20(a)* liability even under the more liberal standard of *Rule 8, Fed. R. Civ. P.*, and the threshold of *Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 127 S. Ct. 1955, 1974, 167 L. Ed. 2d 929 (2007)*, which requires that a cause of action be pleaded with sufficient detail to be merely "plausible." Here, the Complaint identifies Beachwold only as a Texas limited partnership with an unspecified "ownership interest in Tarragon" and "other entangling business relationships with Tarragon." (Compl. P 12.) It otherwise asserts only the conclusory allegation that "Beachwold had the power and authority to cause Tarragon to engage in the wrongful conduct complained of herein." (Compl. P 121.) The Complaint is devoid of allegations that Beachwold wielded "control of the primary violator" and "was in some meaningful sense a culpable participant in the primary violation." *Boguslavsky, 159 F.3d at 720* (quotation marks omitted).

Plaintiff's Section 20(a) claim is dismissed.

II. Plaintiff's Claim Against Grant Thornton [*45] is Dismissed.

The Amended Class Action Complaint names Grant Thornton as a defendant based on (1) Grant Thornton's statements in the audit opinion letters filed with Tarragon's FY 2004 and FY 2005 Form 10-K filings and (2) Grant Thornton's review of unaudited interim filings prepared during the Class Period. (Compl. P 13.)

Plaintiff alleges that Grant Thornton's two audit opinion letters, dated March 15, 2005 and March 15, 2006, respectively, falsely represented that Grant Thornton had conducted its audits in accordance with Generally Accepted Auditing Standards ("GAAS") and falsely certified that Tarragon had reported its financial results in conformity with GAAP. (Compl. PP 24, 37, 102.) Plaintiff does not allege any express statements by Grant Thornton other than the content of these two letters. [2]

2 Plaintiff refers to Grant Thornton statements in the April 2, 2007 FY 2006 Form 10-K filing at page three of the Amended Complaint, but he does not allege any facts concerning the contents of those statements or how they might have been fraudulent elsewhere in the Complaint. Plaintiff makes no reference to the 2007 filing in his written opposition to Grant Thornton's motion. The Court [*46] will assume, for purposes of deciding Grant Thornton's motion, that plaintiff intends to base their audit opinion letter claims exclusively on the 2005 and 2006 letters that he quotes.

Plaintiff does not plead which GAAS principles Grant Thornton violated during its 2005 and 2006 audits. Instead, plaintiff simply asserts that "Grant Thornton's statements that it had conducted [its] audits of Tarragon's financial statements in accordance with GAAS were false." (Compl. P 102.) Plaintiff supports this assertion by quoting a July 17, 2007 Bloomberg article that reported on the Public Company Accounting Oversight Board ("PCAOB")'s 2006-2007 inspection of Grant Thornton. (Id.) The Bloomberg article notes that the PCAOB criticized Grant Thornton in its 2007 report for failing to obtain "sufficient competent evidential matter to support its audit opinion" and for failing to identify an accounting violation "that it should have identified and addressed before issuing its audit report" to an unidentified "Issuer A". (Id.) The Bloomberg article concludes that the PCAOB's criticism referred to Grant Thornton's 2006 Tarragon audit. (Id.) The article also notes that Grant Thornton filed a written [*47] response to the PCAOB report and that Grant Thornton claimed to have identified the issuer violation cited by the PCAOB during its audit. (Id.) Finally, the article concludes that the violation at issue involved Tarragon's failure to include "a certain 90 percent-owned partnership" on its company balance sheet. (Id.) As quoted in the Complaint, the Bloomberg article does not identify any basis for its conclusions that the PCAOB report referred to Grant Thorn-

ton's 2006 Tarragon audit and that the "accounting violation" cited by the PCAOB involved a consolidation decision. [3] The Bloomberg article also does not discuss any work by Grant Thornton other than the 2006 audit reviewed in the PCAOB report.

3 Plaintiff comments, in his Memorandum of Law in Opposition to Grant Thornton LLP's Motion to Dismiss the Amended Complaint, that "the facts related to Issuer A contained in the PCAOB Report are sufficiently unique that there exists no other public company (certainly not to [p]laintiff[s'] knowledge) which could possibly fit that description." (Lead Plaintiff Paul Berger's Memorandum of Law in Opposition to Grant Thornton LLP's Motion to Dismiss the Amended Complaint ("Pl. Opp."), at 4.) He [*48] also comments that "Grant Thornton does not deny that the *Bloomberg* reporter correctly identified Issuer A as Tarragon." (Id at 2.) The Court notes, however, that plaintiff, and not Grant Thornton, bears the burden of alleging facts sufficient to render his claim of auditor misstatements plausible. The Court also notes that Grant Thornton does respond at length to plaintiff's use of the Bloomberg article, and argues that: "[t]he Bloomberg columnist speculated that certain comments in the PCAOB's report, which had been redacted for public release in accordance with Sarbanes-Oxley's confidentiality requirements, referred to the Ansonia consolidation issue at Tarragon." (Memorandum of Law in Support of Grant Thornton LLP's Motion to Dismiss the Amended Complaint, at 10-11) (citations omitted).

Plaintiff also alleges that each of seven interim Form 10-Qs filed during the Class Period contained false representations -- by Tarragon -- that Tarragon's Consolidated Financial Statements had been prepared in accordance with GAAP. (Compl. PP 27(b), 30, 33, 39, 44, 48, 56.) Plaintiff further alleges that Tarragon cited consultations with Grant Thornton in its August 23, 2006 and April 2, 2007 Form [*49] 8-Ks, stating that the company's management and Audit Committee had "discussed" the restatements disclosed in those filings with Grant Thornton. (Compl, PP 42, 50 (citing discussion with "the Company's independent registered public accountants").) Other than quoting Tarragon's own statements about accountant review, plaintiff does not allege any facts to demonstrate that Grant Thornton participated in the preparation of these interim filings.

According to plaintiff, certain "true facts" were "known by defendants but concealed from the investing public during the Class Period," including that Tarragon had violated GAAP by (1) failing to consolidate Ansonia into its financial statements, (2) failing to properly classify its cash flows as operating, investing and financing activities, (3) failing to take timely property impairment charges and other write-downs, and (4) improperly recognizing revenue from its condominium developments under the percentage-of-completion method. (Compl. P 63.) Plaintiff alleges that these violations enabled Tarragon to overstate its income and inflate the price of Tarragon stock. (Compl. P 68, 72, 86.) Plaintiff does not distinguish between Grant Thornton [*50] and the Tarragon defendants in alleging defendants' collective knowledge of the alleged GAAP violations.

Plaintiff also alleges that deterioration in real estate credit markets and a "massive downturn" in Tarragon's business triggered liquidity issues for the company during the Class Period. (Compl. P 63(e)-(g).) According to the Complaint, the downturn jeopardized Tarragon's ability to comply with existing debt covenants and, by July 2007, increased volatility in the homebuilding industry and real estate credit markets had rendered Tarragon's 2007 projections reckless at best. (Id.)

Plaintiff asserts that Grant Thornton and the Tarragon defendants artificially inflated the share price by presenting "a misleading picture of [Tarragon's] business and prospects." (Compl. P 92.) "[I]nstead of truthfully disclosing during the Class Period that Tarragon's business was not as healthy as represented," plaintiff alleges, "Tarragon falsely reported its financial results and its actual business prospects going forward." (Id.) According to plaintiff, "[t]he Tarragon [d]efendants and Grant Thornton's false and misleading statements had the intended effect and caused Tarragon stock to trade at artificially [*51] inflated levels throughout the Class Period." (Compl. P 94.) When Tarragon postponed its earnings release in August 2006, and when it disclosed impairment charges and other write-downs in August 2007, the investing public discovered "the truth about Tarragon's overstatement of income and its actual business prospects." (Compl. PP 95-97.) This discovery prompted drops in Tarragon's stock price that "removed the inflation from Tarragon's stock price" and caused "real economic loss to investors who had purchased the stock during the Class Period." (Id.) Plaintiff does not distinguish between Grant Thornton and the Tarragon defendants in alleging this causal relationship.

A. Accountant Liability under Section 10(b) and *Rule 10b-5*

The section 10(b) implied private right of action does not extend to aiders and abettors; conduct by a secondary actor must satisfy each of the elements or preconditions for liability, namely: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a

connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. See [*52] *Stoneridge.128 S.Ct, at 768-69*. "Accordingly, to state a § 10(b) claim against an issuer's accountant, a plaintiff must allege a misstatement that is attributed to the accountant 'at the time of dissemination,' and cannot rely on the accountant's alleged assistance in the drafting or compilation of a filing." *Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 153 (2d Cir. 2007)* (citing *Wright v. Ernst & Young LLP, 152 F.3d 169, 174 (2d Cir. 1998)*). "Conduct itself can be deceptive, and so liability under § 10(b) or *Rule 10b-5* does not require a specific oral or written statement." *United States v. Finnerty, 533 F.3d 143, 148 (2d Cir. 2008)* (citing *Stoneridge, 128 S.Ct, at 769*) (internal quotation marks omitted). But, "broad as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." Id. "Public understanding that an accountant is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the accountant. Unless the public's understanding is based on the accountant's articulated statement, the source for that understanding -- whether it be a regulation, an accounting practice, [*53] or something else -- does not matter." *Id. at 150* (quoting and approving *Lattanzio. 476 F.3d at 155*). [4]

4 Accountants may also be held liable under section 10(b) and *Rule 10b-5* where they fail to correct prior certified statements that were false when made. See *Overton v. Todman & Co. CPAs. P.C., 478 F.3d 479, 486-87 (2d Cir. 2007)*. Plaintiff's allegations do not assert this theory of liability.

A plaintiff alleging securities fraud by an accountant must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2)*. As noted above, scienter may be pleaded by alleging (1) facts to show that a defendant had both motive and opportunity to commit the alleged fraud, or (2) facts constituting strong circumstantial evidence that the defendant consciously misbehaved or acted recklessly. *ATSI, 493 F.3d at 99*. "[F]ailure ... to identify problems with [a] defendant-company's internal controls and accounting practices does not constitute reckless conduct sufficient for § 10(b) liability." *In re Doral Fin. Corp. Sec. Litig., 563 F. Supp. 2d 461, 464 (S.D.N.Y. 2008)* (citing *Novak, 216 F.3d at 309*). Similarly, [*54] "[a]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.... Only where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." *ECA, Local 134, 553 F.3d at 200* (citing *Novak, 216 F.3d at 309*). For recklessness on the part of a non-fiduciary accountant to satisfy securities fraud scienter requirements, the accountant's recklessness must amount to "conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care. It must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." *Rothman, 220 F.3d at 98* (citations and internal quotation marks omitted).

Finally, a plaintiff suing under section 10(b) on the basis of auditor misstatements or omissions must allege that the auditor's misstatements or omissions proximately caused his loss. *Lattanzio, 476 F.3d at 157* ("Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff. ... A misstatement is the proximate cause of an investment loss if the risk that caused the loss was within [*55] the zone of risk concealed by the misrepresentations . . . alleged by a disappointed investor.") (citations and internal quotation marks omitted); see also *In re AOL Time Warner, Inc. Securities Litigation. 503 F. Supp. 2d at 677* (citing *Lentell v. Merrill Lynch & Co.. 396 F.3d 161, 173-76 (2d Cir. 2005)*) ("[L]oss causation requires a plaintiff to allege not only that its loss was foreseeable, but also that the alleged misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. In its simplest form, this may be achieved by alleging that the market reacted negatively to a corrective disclosure, which revealed an alleged misstatement's falsity or disclosed that allegedly material information had been omitted. Loss causation may also be pleaded by allegations that a defendant's misstatements or omissions concealed a risk that later materialized to cause the plaintiff's loss.") (internal citations and quotation marks omitted).

As in any securities fraud action, the PSLRA imposes "exacting pleading requirements," and it requires a plaintiff alleging auditor fraud to state with particularity both the facts constituting [*56] the accountant's alleged section 10(b) violation and the facts evidencing scienter, i.e., the accountant's intention to "deceive, manipulate or defraud." See *Tellabs, 127 S.Ct, at 2504*.

B. Plaintiff Fails to State A Claim as to Grant Thornton.

1. The Audit Opinion Letters Do Not Support a Securities Fraud Claim.

Plaintiff's complaint alleges only two express statements by Grant Thornton during the Class Period: the March 15, 2005 and March 15, 2006 audit opinion letters filed with Tarragon's FY 2004 and FY 2005 Form 10-Ks. Plaintiff alleges that these letters falsely stated that Grant Thornton had complied with GAAS and falsely certified

that Tarragon had reported its financials in accordance with GAAP.

Plaintiff alleges that the following four GAAP violations committed during the Class Period rendered as false Grant Thornton's statements of 2005 and 2006: (1) Tarragon's failure to consolidate Ansonia into its financial statements, (2) Tarragon's failure to properly classify its cash flows as operating, investing and financing activities, (3) Tarragon's failure to take timely property impairment charges and other write-downs, and (4) Tarragon's improper recognition of revenue from the [*57] One Hudson Park development under a percentage-of-completion accounting method. (Compl. P 63.) [5] Plaintiff details three of these alleged violations in paragraphs seventy-two to eighty-seven of the Amended Complaint, under the heading "Tarragon's False Financial Reporting During the Class Period." Plaintiff does not mention Grant Thornton anywhere in this review and does not allege any facts connecting the alleged violations to Grant Thornton's work in 2005 and 2006. Plaintiff does not specifically allege that Grant Thornton knew of the alleged violations when it issued its 2005 and 2006 letters. Plaintiff's allegations also indicate that one of the alleged violations -- improper recognition of revenue from One Hudson Park under the percentage-of-completion method -- began in mid-2006, after Grant Thornton completed its FY 2005 audit and after the firm issued the second of its two audit opinion letters. See Compl. P 45. [6]

5 Plaintiff appears to abandon his allegation concerning Tarragon's cash-flow classifications in his Opposition to Grant Thornton's Motion to Dismiss. See Pl. Opp. at 13 n.6 ("Grant Thornton also argues that the cash flow restatement was not the cause of any damages. [*58] Plaintiff concedes this point as it was not his intention to allege loss causation stemming from that restatement since the Complaint does not allege that this particular disclosure of falsity in the Company's prior public statements had any identifiable impact on the price of Tarragon's stock."). The Court has included the allegation in this Memorandum and Order for purposes of completeness but has disregarded the allegation during its consideration of Grant Thornton's motion in light of plaintiff's concession.

6 In his discussion of revenue-recognition violations, plaintiff alleges that, "at projects such as One Hudson Park, Tarragon recognized revenue despite the fact that relatively small deposits of 10% or less were put down on the units with no reasonable expectation that full payment would be made...." (Compl. P 86.) (emphasis added). Plaintiff's allegation implies that Tarragon committed this particular GAAP violation on numerous occasions, but plaintiff does not identify any other examples of such reporting in his complaint.

In addition to alleging general knowledge of Tarragon's alleged GAAP violations, plaintiff relies on the 2007 PCAOB report -- and Bloomberg's interpretation [*59] of that report -- to allege that Grant Thornton "failed to obtain sufficient competent evidential matter to support its audit opinion" during the 2005 and 2006 audits. (See Compl. P 102; Pl. Opp. at 3-4, 6-7.) These materials do not provide meaningful support for plaintiffs allegations. Neither the PCAOB report nor the Bloomberg article discusses Grant Thornton's work prior to 2006. The PCAOB report, as publicly disseminated and as quoted in plaintiffs' supporting affidavit, deliberately refrains from disclosing the identity of the audit client cited in its review. The PCAOB's own preamble to its 2007 report states that "[a]ny references in [the] report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which [the] report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability." (Abraham Aff, Ex. C, at 5.) The report also contains a written response from Grant Thornton contesting the PCAOB's conclusion. Id. at 26 ("[T]he manner in which the [PCAOB] inspection team [*60] describes the issue [in Grant Thornton's unidentified audit] fails to capture the extent and complexity of the professional judgments that were required under the relevant accounting literature which includes, but is not limited to, FIN 46(R). The comments are also misleading in that they imply that the [Grant Thornton] engagement team failed to identify the issue. This was not the case."). Plaintiff does not supplement his reference to the Bloomberg article or the underlying PCAOB report with any independent allegations specific to Grant Thornton's 2005 and 2006 audit work for Tarragon.

In sum, plaintiff asserts in conclusory fashion that Tarragon violated GAAP and that Grant Thornton failed to identify Tarragon's violations. Plaintiff then relies on a single 2007 news article, and its unsupported conclusions about the contents of a 2007 PCAOB report, to allege that (1) Grant Thornton's work during the FY 2004 and FY 2005 audits did not follow GAAS and that (2) Grant Thornton misrepresented this work in 2005 and 2006 audit opinion letters. Without more, these conclusions do not amount to a plausible allegation that Grant Thornton's March 2005 and March 2006 certifications were false.

Assuming, [*61] however, that plaintiff had alleged facts sufficient to demonstrate a material misstatement or

omission in the audit opinion letters, plaintiff fails to adequately allege that Grant Thornton issued the letters with scienter. According to plaintiff, "it is obvious that the Complaint properly alleges fraud. Grant Thornton clearly had access to the relevant information and clearly disregarded its importance in preparing its public statements.... This blatant disregard of GAAP by an accounting firm is sufficient to support a strong inference of scienter." (Pl. Opp. at 6-7.) Plaintiff's argument ignores the Second Circuit's precedent regarding the sufficiency of using GAAP violations as a stand-alone basis for alleging scienter, and it fails to identify any independent evidence of fraudulent intent. See *In re Doral. 563 F. Supp. 2d at 466* ("None of these allegations shows anything more than that [defendant] was Doral's auditor, a fact which is wholly insufficient to show [defendant's] scienter."). Plaintiff attempts to explain this pleading defect by describing Grant Thornton's "disregard" of the alleged GAAP violations as "blatant," but such a conclusory statement cannot overcome the PSLRA's [*62] requirement that a plaintiff "state with particularity ... the facts evidencing scienter." *Tellabs, 127 S.Ct, at 2504*. Plaintiff does not allege any facts to show that Grant Thornton had both motive and opportunity to commit fraud through its audit opinion letters, and he does not allege any facts constituting strong circumstantial evidence that Grant Thornton consciously misbehaved or acted recklessly during its 2004 and 2005 audits. Plaintiff ascribes no motive, fraudulent or otherwise, to Grant Thornton, and he does not allege facts suggesting that Grant Thornton's work during 2005 and 2006 was "highly unreasonable" or an "extreme departure from standards of ordinary care." Plaintiff also concedes that Tarragon's decision to consolidate Ansonia under FIN 46(R) would have considered numerous factors other than strict voting control (Compl. P 73) and that Tarragon's eventual reclassification of the cash flow's reported in 2004 and 2005 had "no identifiable impact on the price of Tarragon stock" (Pl. Opp. at 13 n.6). Plaintiffs scienter allegations do not satisfy the PSLRA -- measured against "*all* of the facts alleged, taken collectively," they do not give rise to an inference of scienter [*63] that is "more than merely plausible or reasonable" and "at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, 127 S.Ct, at 2509, 2504-05* (emphasis in original).

Plaintiff also fails to adequately allege that Grant Thornton's audit opinion letters caused his loss. Plaintiff states that "[t]he Tarragon [d]efendants and Grant Thornton's false and misleading statements had the intended effect and caused Tarragon stock to trade at artificially inflated levels throughout the Class Period," but his allegations concerning the creation and exposure of that artificial inflation do not refer to Grant Thornton or to the GAAP and GAAS certifications in Grant Thornton's 2005 and 2006 letters. For example, plaintiff alleges that, on January 5, 2005, Tarragon issued a press release affirming its 2004 guidance and forecasting 2005 results. (Compl. PP 20-21.) This release triggered "a 22% [stock price] increase over the previous day's close." (Compl. P 21.) Plaintiff then alleges that, on August 9, 2006, five months after Grant Thornton issued the second of its letters, Tarragon postponed its Q2 2006 earnings release and thereby prompted a stock price decline of more than [*64] one dollar per share. (Compl. P 95.) Next, plaintiff alleges that "adverse information concerning the viability of [Tarragon]'s One Hudson Park project" began to leak to the investing public in July 2007, triggering a "steep descent" in the company's stock price. (Id) Finally, plaintiff alleges that Tarragon's August 9, 2007 disclosure, almost seventeen months after Grant Thornton issued the second of its letters -- that it would take "property impairment charges and other write-downs" and that "serious liquidity issues" existed at the company -- caused the stock price to drop to $ 1.88 per share. (Compl, P 96.) Plaintiff characterizes these "admissions" as "public revelations regarding the truth about Tarragon's overstatements of income and its actual business prospects," but he does not indicate how such "revelations " relate to Grant Thornton's 2005 and 2006 certifications or how those certifications "concealed something from the market that, when disclosed, negatively affected the value of the security." As the Supreme Court has explained, "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss" in a typical fraud-on-the-market case. [*65] *Dura, 544 U.S. at 342*. "When the purchaser subsequently resells [shares bought at an inflated price], even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." *Id. at 342-43*. To survive a motion to dismiss, plaintiff must provide Grant Thornton with some indication of the causal connection between his loss and Grant Thornton's alleged misrepresentations in 2005 and 2006. *Id. at 347*. Plaintiff's conclusory allegations that Grant Thornton falsely certified GAAP and GAAS compliance, taken together with his allegations that (1) deterioration in real estate credit markets and a "massive downturn" in Tarragon's business triggered liquidity issues for the company, and that (2) and increased volatility in the homebuilding industry and real estate credit markets undermined Tarragon's 2007 results projections, fail to state a plausible theory of proximate causation connecting Grant Thornton's 2005 and 2006 audit opinion letters to such loss.

2. [*66] The Complaint Fails to Allege Fraud by Grant Thornton as to Tarragon's Form 10-Q and Form 8-K Filings.

Plaintiff also alleges that each of seven interim Form 10-Qs filed during the Class Period contained false assertions by Tarragon's that the Company's consolidated financial statements had been prepared in accordance with GAAP. Plaintiff does not indicate how these statements could be attributed to Grant Thornton for purposes of stating a plausible fraud claim or how those statements demonstrate actionable fraudulent conduct by Grant Thornton. In fact, plaintiff does not allege any specific facts to indicate that Grant Thornton contributed to the preparation of Tarragon's unaudited Form 10-Qs.

In opposition to Grant Thornton's motion, plaintiff cites the Supreme Court's comment in *Stoneridge* that "conduct itself can be deceptive" to argue that Grant Thornton's position as an outside auditor triggers primary liability for Tarragon's alleged "materially false or misleading statements ... in the ... financial statements filed with the SEC." (Pl. Opp. at 5-6.)

Plaintiff's argument overstates the holding of Stoneridge decision, which addressed "when, if ever, an injured investor may rely upon [*67] § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b)." *Stoneridge, 128 S.Ct, at 767*. In *Stoneridge*, the Supreme Court emphasized that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action." *Id. at 769*. This requirement, the Court continued, "ensures that, for liability to arise, the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability." *Id.* (citations omitted). The Court explained that a rebuttable presumption of reliance will arise in two different circumstances: (1) where there is an omission of material fact by one with a duty to disclose, and (2) where deceptive statements by a defendant become public and may thereby be assumed to have been incorporated into the security's market price. *Id.* Here, as in *Stoneridge,* neither presumption applies: plaintiff has not alleged any acts or omissions by Grant Thornton during the preparation of Tarragon's Form 10-Q filings, let alone any omission that might violate a duty to disclose. Similarly, [*68] plaintiff has not alleged a deceptive act by Grant Thornton that was disclosed to and relied upon by the investing public.

Plaintiff argues that Grant Thornton should be liable for Tarragon's statements because (1) federal regulations required Grant Thornton to review Tarragon's quarterly statements and (2) the investing public knew of these requirements and (3) learned of unspecified "deceptive acts" through Tarragon's quarterly filings. (Pl. Opp. at 5-6.) [7] But *Stoneridge* did not eliminate the requirement that a secondary actor's alleged misstatements or omissions independently satisfy each of the prerequisites to liability under section 10(b) and *Rule 10b-5*. *128 S.Ct, at 769*. Nor did it overrule the Second Circuit's conclusion in *Lattanzio* that "[a]bsent an audit opinion, the existence of a[n auditor's] duty to correct cannot by itself translate [auditor] silence regarding ... 10-Qs into an actionable misstatement." *476 F.3d at 154*. See *Finnerty. 533 F.3d at 149-50* (citing Lattanzio and affirming judgment of acquittal where government argued that defendant's violation of NYSE rules deceived customers familiar with NYSE requirements) ("In essence, the government seeks to impose criminal [*69] liability based on a background assumption of compliance with NYSE rules.... [W]e rejected a similar argument (made by civil claimants) in a statement case decided last term, *Lattanzio v. Deloitte & Touche LLP* .... The claim was that 'an investor (understanding Deloitte's regulatory obligation) would construe Deloitte's silence as its imprimatur' on the quarterly statements in question. . . . This argument failed because in a statement case like *Lattanzio,* 'a party can incur liability [under § 10(b)] only if a misstatement is attributed to it at the time of dissemination.' It may be that 'a requirement that an issuer's accountant review interim financial statements supports an understanding among the investing public that such reviews are in fact conducted.' But that was not enough to ground § 10(b) liability in *Lattanzio*. . . . The government's argument fails for much the same reason.") (internal citations omitted); see also *In re Refco, Inc. Sec. Litig., 609 F. Supp. 2d 304, 2009 WL 693628, at *6 (S.D.N.Y. 2009)* (dismissing §§ 10(b) and 20(a) claims against brokerage's outside counsel where allegations failed to show that counsel "made" the alleged material misstatements or omissions and that plaintiffs [*70] relied on counsel's misrepresentation) ("To rise to the level of a primary violation, the secondary actor must not only make material a misstatement or omission, but the misrepresentation must be attributed to the specific actor at the time of public dissemination, such as in advance of the investment decision, so as not to undermine the element of reliance required for § 10(b) liability. Allegations of'assisting,' 'participating in,' 'complicity in' and similar synonyms ... all fall within the prohibitive bar of Central Bank. Nor can silence or mere association be construed as nonetheless conveying an actor's 'imprimatur.'") (internal citations and quotation marks omitted). Plaintiffs' allegations concerning the Tarragon 10-Qs fail to plausibly allege a misstatement or omission by Grant Thornton.

7 Plaintiffs argument, at pages five and six of his Opposition brief, does not indicate what "the deceptive acts" that he refers to involved. As written, the argument appears to describe allegedly deceptive acts by Tarragon, not Grant Thornton.

Plaintiff's passing reference to Tarragon statements in the August 23, 2006 and April 2, 2007 Form 8-K filings is similarly insufficient to allege an actionable [*71] misstatement or omission by Grant Thornton.

Because plaintiff fails to indicate any actionable misstatement or omission by Grant Thornton in connection with the preparation of Tarragon's Form 10-Q and Form 8-K filings, the Court need not consider the application of scienter and loss causation requirements to those filings in evaluating Grant Thornton's motion.

III. Leave to Amend is Granted.

Plaintiff asserts that in the event that this Court grants the defendants' motions, he should be granted leave to amend the Complaint to cure any pleading defects. The defendants do not address the plaintiff's request for leave to amend. The promotion conference is waived for any motion to amend filed by plaintiff prior to May 8, 2009. See *Teamster Local 445, 531 F.3d at 197* (while PSLRA required dismissal of complaint for failure to plead scienter, the district court appropriately granted leave to amend); *ATSI, 493 F.3d at 108* ("District courts typically grant plaintiffs at least one opportunity to plead fraud with greater specificity when they dismiss under *9(b)*.").

CONCLUSION

The motions to dismiss filed by Friedman, Rothenberg, Pickens, Beachwold and Grant Thornton are granted.

Pursuant to *11 U.S.C. § 362*, [*72] this action is stayed as to Tarragon.

Plaintiff may move to amend the Complaint, provided the motion is filed by May 8, 2009.

SO ORDERED.

/s/ P. Kevin Castel

P. Kevin Castel

United States District Judge

Dated: New York, New York

March 27, 2009

5:35 pm