UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: LEHMAN BROTHERS SECURITIES AND ERISA LITIGATION This Document Applies to: *In re Lehman Brothers Equity/Debt Securities Litigation,* 08 Civ. 5523 (LAK)	Civil Action 09 MD 2017 (LAK) ECF CASE

MEMORANDUM OF LAW IN SUPPORT OF THE DIRECTOR DEFENDANTS' MOTION TO DISMISS THE THIRD AMENDED COMPLAINT

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The Director Defendants respectfully submit this memorandum in support of their motion, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, to dismiss the TAC insofar as it purports to assert claims against them.[1] In support of their motion, the Director Defendants incorporate by reference the arguments in Defendants' and E&Y's memoranda in support of their motions to dismiss the TAC, which show that (1) Plaintiffs lack standing to bring and are time-barred from bringing certain Section 11 claims, (2) Plaintiffs fail to allege the Offering Materials were false or misleading, and (3) the Securities Act Defendants are entitled to judgment as a matter of law to the extent Plaintiffs' claims are based on disclosures concerning Repo 105. Although Plaintiffs' claims against all of the Securities Act Defendants should be dismissed for these reasons, the TAC and other documents before the Court show that, in any event, the Director Defendants are entitled to dismissal of all of Plaintiffs' claims against them on the additional ground of the Section 11 due diligence defense.

PRELIMINARY STATEMENT

Plaintiffs allege the Director Defendants violated Section 11 by signing the Shelf Registration statement as well as the 2007 10-K. *See* TAC at ¶¶ 14, 50. Plaintiffs say nothing more of substance about the Director Defendants. Thus, the TAC rests entirely on the conclusory assertion that "[t]he Securities Act Defendants did not make a reasonable investigation or possess reasonable grounds to believe that the statements contained in the Shelf Registration Statement were true, were without omissions of any material facts, and were not misleading." *Id.* at ¶ 126.

In light of the documents the Court may consider in deciding this motion, particularly the Examiner's Report upon which the TAC is largely based, Plaintiffs' complaint against the

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1 Capitalized terms not otherwise defined herein are intended to have the meanings ascribed to them in the TAC or, if not defined therein, in Defendants' Joint Memorandum of Law in Support of Their Motion To Dismiss the Third Amended Complaint ("Defendants' Memorandum"). Unless otherwise noted, all referenced exhibits are attached to the accompanying Declaration of Kathleen N. Massey, dated June 4, 2010 ("Massey Ex."). References to "Chepiga Ex. __" are to exhibits attached to the Declaration of Michael J. Chepiga dated June 4, 2010, which accompanies Defendants' Memorandum.

Director Defendants should be dismissed because of the "due diligence" defense applicable to Section 11 claims. Indeed, having injected the Examiner's Report into their pleadings, Plaintiffs cannot "'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) (citation omitted). As the Supreme Court has noted, when a complaint cannot "raise a claim of entitlement to relief, 'this basic deficiency should ... be exposed at the point of minimum expenditure of time and money by the parties and the court.'" *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 558, 127 S. Ct. 1955, 1966 (2007) (citations omitted).

The Examiner's Report and other documents properly before the Court show that the Director Defendants conducted more than reasonable diligence regarding Lehman's business and had no reason to doubt the truth of the Offering Materials. The Director Defendants were outside directors who were extremely accomplished executives and were very familiar with Lehman as a result of their many years of service on the Board. The Examiner's Report shows that the Director Defendants received regular, detailed management reports on a variety of key issues relating to the financial condition of the Company; had a Finance and Risk Committee that met regularly to review risk-related issues; had an Audit Committee that met regularly to review SEC filings and other public disclosures; relied on internal audit and E&Y, both of whom monitored and reported to the Audit Committee on the Company's finances; and plainly implemented a sufficient reporting system and controls.

Plaintiffs have not alleged a single credible fact that the Director Defendants ignored red flags or had any reason to doubt the accuracy of the information presented to them. Nor could they: the Examiner's Report states explicitly that "[m]anagement's reports to the directors did not contain 'red flags' imposing on the directors a duty to inquire further" and the Director Defendants "were unaware of Lehman's Repo 105 program and transactions." ER at 56, 945.[2] Accordingly, under the unusual circumstances of this case, where the TAC incorporates the

[2] Defendants have provided the Court with an electronic copy of the Examiner's Report. Unless otherwise noted, references to "ER at _" are to the electronic copy. Where noted, certain references to the Examiner's Report are to pages included as part of Massey Ex. A.

Examiner's Report, dismissal of Plaintiffs' Section 11 claims against the Director Defendants pursuant to the due diligence defense is warranted.

ARGUMENT

The Examiner's Report conclusively establishes that the Director Defendants engaged in sufficient due diligence to defeat Plaintiffs' Section 11 claims. As an initial matter, the Court may consider both the Examiner's Report and the due diligence defense in connection with ruling on this motion to dismiss. And, based on the Director Defendants' extensive due diligence documented by the Examiner's Report, it is clear that Plaintiffs' claims against the Director Defendants should be dismissed.

I. IT IS APPROPRIATE TO APPLY THE DUE DILIGENCE DEFENSE IN THIS CASE

A. The Court May Properly Consider The Examiner's Report

It is well established that, in deciding motions to dismiss, courts may consider "statements or documents incorporated into the complaint by reference, legally required public disclosure documents filed with the SEC, and documents possessed by or known to the plaintiff and upon which it relied in bringing the suit." *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007).[3] "On a motion to dismiss, the court must assume that all factual allegations made in the complaint are true ... with 'complaint' defined to include any exhibits, any other written statements or documents attached to the complaint or incorporated by reference, and any document that is . . . 'integral' to the complaint." *Kalin v. Xanboo, Inc.*, 526 F. Supp. 2d 392, 398 (S.D.N.Y. 2007) (citations omitted). Where the allegations in the complaint conflict with the facts as presented in the incorporated documents, courts give

[3] *See also Staehr v. Hartford Fin. Servs. Group, Inc.*, 547 F.3d 406, 425 (2d Cir. 2008) (proper to take judicial notice of press coverage and regulatory filings).

preference to the documents. *See Barnum v. Millbrook Care Ltd. P'ship*, 850 F. Supp. 1227, 1232-33 (S.D.N.Y. 1994), *aff'd*, 43 F.3d 1458 (2d Cir. 1994).[4]

The Court may rely upon the Examiner's Report in dismissing claims against the Director Defendants because it is integral to Plaintiffs' complaint. For example, in *In re Polaroid Corp. Sec. Litig.*, plaintiffs claimed that defendants acted recklessly in failing to disclose substantial doubt about Polaroid's ability to continue as a going concern. 465 F. Supp. 2d 232, 239 (S.D.N.Y. 2006). However, the Court granted defendants' motion to dismiss plaintiffs' claim on the grounds that an examiner's report showed defendants had considered the issue and had reasonably determined Polaroid would likely be able to obtain the financing it needed to survive. *Id.* at 246-50; *see also In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610 (JFK), 1999 WL 178749, at *14 (S.D.N.Y. Mar. 31, 1999) (granting motion to dismiss claims against directors, noting that the "allegations, coupled with the Bankruptcy Examiner Report's assessment," did not plead conscious misbehavior).

Here, it is clear that the Examiner's Report is "integral" to Plaintiffs' TAC. This Court granted Plaintiffs leave to amend their complaint for the express purpose of modifying it to incorporate the Examiner's Report.[5] Not surprisingly, Plaintiffs not only repeatedly refer to the Examiner's Report, but explicitly state that their allegations are "based upon" the Examiner's Report and the documents collected by the Examiner. *See* TAC at p. 1.[6] Hence, consideration of

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[4] While the Court may assume facts are true for purposes of deciding a motion to dismiss, such facts "do not constitute findings of fact by the Court ... [and] are presumed to be true only for the purpose of deciding the" motion. *Barnum*, 850 F. Supp. at 1232.

[5] *See* Telephone Conference Tr. at 4-5, Mar. 17, 2010, *In re Lehman Bros. Equity/Debt Sec. Litig.*, No. 08 CV 5523 (LAK) (S.D.N.Y. 2010).

[6] Whereas Plaintiffs' Second Amended Complaint had no references whatsoever to Repo 105, the TAC is based largely upon Repo 105. *Compare* TAC ¶ 26-69; 147-157 *with* ER at 732-1053. In addition, the TAC incorporates substantial portions of the Examiner's Report insofar as it concerns other key issues. *Compare* TAC ¶ 72 *with* ER at 43-47 (discussing risk management); *compare* TAC ¶ 88 *with* ER at 16, 124, 150 (discussing liquidity); *compare* TAC ¶ 91 *with* ER at 356 (discussing commercial real estate); *compare* TAC ¶ 97 *with* ER at 312-13 (discussing valuation); *compare* TAC ¶ 108 *with* ER at 96-97 (discussing concentration of credit risk); *compare* TAC ¶ 94 *with* ER at 361-62 (discussing mortgage and real estate related assets).

the entire Examiner's Report is plainly appropriate in evaluating the Director Defendants' motion to dismiss.

B. The Court Can Dismiss Section 11 Claims Based On Affirmative Defenses, Including The Due Diligence Defense

Courts routinely consider – and grant – motions to dismiss based upon affirmative defenses when "the defense appears on the face of the complaint." *Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998). In the Section 11 context, in particular, courts in the Second Circuit have frequently granted motions to dismiss on the basis of affirmative defenses. *See, e.g., Blackmoss Invs. Inc. v. ACA Capital Holdings, Inc.*, No. 07 Civ. 10528, 2010 WL 148617, at *11 (S.D.N.Y. Jan. 14, 2010); *In re Openwave Sys. Sec. Litig.*, 528 F. Supp. 2d 236, 246-48 (S.D.N.Y. 2007). Here, because the facts establishing the due diligence defense are "definitively ascertainable from the complaint and other sources of information that are reviewable at this stage," dismissal of the claims against the Director Defendants is well warranted. *Ark. Pub. Employee Ret. Sys. v. GT Solar Int'l, Inc.*, No. 08-CV-312-JL, 2009 WL 3255225, at *6 (D.N.H. Oct. 7, 2009) (citation omitted); *see also Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Dynegy, Inc. (In re Dynegy, Inc. Sec. Litig.)*, 339 F. Supp. 2d 804, 871-74 (S.D. Tex. 2004).[7]

II. THE DIRECTOR DEFENDANTS ARE PROTECTED BY THE SECTION 11 DUE DILIGENCE DEFENSE

It is well established that non-issuer defendants may avoid liability for violations of Section 11 by "demonstrating due diligence." *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983). For non-expertised portions of a registration statement, non-issuer defendants are

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[7] In dicta, this Court and others have indicated that typically the due diligence defense to Section 11 may not be an appropriate issue for consideration on a motion to dismiss. *See, e.g., In re Lehman Bros. Sec. & ERISA Litig.*, 684 F. Supp. 2d 485, 493-94 (S.D.N.Y. 2010); *Lindsay v. Morgan Stanley (In re Morgan Stanley Info. Fund Sec. Litig.)*, 592 F.3d 347, 360 n.7 (2d Cir. 2010). But, none of the courts that have addressed a motion to dismiss on due diligence grounds has had the benefit of anything like the Examiner's Report, which the Court should consider in this unique case.

protected when, after a reasonable investigation, they had reasonable grounds to believe and did believe, at the time the statement became effective, that the statements therein were true. 15 U.S.C. § 77k(b)(3)(A). In this case, the Examiner's Report and other documents upon which the Court may rely show that the Director Defendants are protected by the due diligence defense. While what constitutes due diligence can vary depending upon the circumstances, the standard is certainly less stringent for outside directors than it is for insiders. *See* II(A). To the extent that Plaintiffs challenge non-expertised portions of the Offering Materials, the documents properly available to the Court show that the Director Defendants conducted a reasonable investigation and had reasonable grounds to believe the statements were accurate. *See* II(B).[8]

A. The Legal Standard For Determining Whether The Director Defendants' Diligence Was Reasonable Under The Circumstances

In considering the due diligence defense, Section 11 provides that what constitutes a "reasonable investigation" and "reasonable grounds to believe" is measured by the "prudent man" standard.[9] Courts have long held that reasonableness in the due diligence context can depend upon a variety of factors, including knowledge about the business of the company, directors' participation in board activities, review of relevant documents, reasonable reliance on information provided by management and other professionals, and the presence (or absence) of red flags of suspicious activities.

Ordinarily, outside directors are not expected to conduct their own review of the company and its financial status. As the Court explained in *Weinberger v. Jackson*, an outside

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[8] To the extent Plaintiffs challenge the expertised portions of the Offering Materials, the Director Defendants are further protected by their reliance on E&Y. *See* Defendants' Memorandum at 10-13.

[9] *See* 15 U.S.C. § 77k(c); *see also* 17 C.F.R. § 230.176 (identifying some of the relevant factors a court may consider in determining reasonableness as: "the type of issuer," "the type of person," "reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing)," and "whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated").

director is "not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement . . . [and can] rely upon the reasonable representations of management, if his own conduct and level of inquiry [are] reasonable under the circumstances," as well as the fact that "the prospectus statements were consistent with the knowledge of the company which he had reasonably acquired in his position as director." No. C-89-2301-CAL, 1990 WL 260676, at *4 (N.D. Cal. Oct. 11, 1990); *see also Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971). In the absence of "red flags," what is required of an outside director is essentially a good faith effort to familiarize oneself with the company through board meetings and discussions with management and other professionals. For example, in *In re Avant-Garde Computing Inc. Sec. Litig.*, the Court held that an outside director did adequate due diligence by, among other things, "'participat[ing] in four Board meetings prior to the offering and several independent conversations with other Board members' in which the proposed public offering of [the company] was discussed" and familiarizing himself with the company in discussions with company personnel. No. Civ. 85-4149 (AET), 1989 WL 103625, at *8-9 (D.N.J. Sept. 5, 1989) (citation omitted). And, in *Laven v. Flanagan*, the Court held the outside directors were protected by the due diligence defense because, among other things, they had reasonably relied on the representations of management and the outside auditor. 695 F. Supp. 800, 811-12 (D.N.J. 1988).

Application of these principles to this case compels the conclusion that the TAC should be dismissed as to the Director Defendants. In particular, the documents of record the Court may consider conclusively demonstrate that the Director Defendants conducted reasonable investigations, reasonably relied on management and E&Y and had no reason to question the accuracy of the Offering Materials.

B. The Director Defendants Are Not Liable For Any Alleged Misrepresentations In The Offering Materials Because They Conducted Reasonable Due Diligence Concerning The Relevant Issues

Plaintiffs base their claims against the Director Defendants on purported misrepresentations and omissions in the Offering Materials concerning Repo 105, leverage, risk management, liquidity, valuation of commercial real estate assets, concentration of credit risk in mortgage and other real estate related assets and related issues.[10] The Director Defendants are protected from liability relating to these statements pursuant to the due diligence defense. The Examiner's Report and Lehman's SEC filings make plain that the Director Defendants' diligence was extensive. The Director Defendants regularly and actively participated in Board meetings over a lengthy period of time, received comprehensive management reports on various aspects of Lehman's plans and operations, specifically reviewed financial and risk issues at both the Board and Board Committee levels, and received regular assurances from E&Y about the propriety of Lehman's accounting.

As Lehman's SEC filings make clear, the Director Defendants are not only highly accomplished professionals with deep and varied experience, but also, at the time of the bankruptcy filing, they had served on the Lehman Board for between three and twenty-three years and were deeply familiar with the Company's business.

- Michael L. Ainslie, former President, Chief Executive Officer ("CEO") and Director of Sotheby's Holdings, became a director of Lehman in 1996 and served on the Board's Audit Committee. *See* Lehman Proxy Statement at 6 (Mar. 5, 2008) ("2008 Proxy") (Massey Ex. B).
- John F. Akers, the former Chairman of the Board of Directors of International Business Machines Corporation, joined the Lehman Board in 1996 and served as the Chairman of the Compensation and Benefits Committee and as a member of the Finance and Risk Committee. *Id.* He is also a director of W.R. Grace & Co. *Id.*
- Roger S. Berlind, who founded the brokerage firm Carter, Berlind, Potoma and Weill, became a member of Lehman's maiden Board in 1985, and served as a Chairman and a

[10] *See generally* TAC at ¶¶ 40, 70, 88, 93, 105.

member of the Audit Committee and a member of the Finance and Risk Committee. *Id.* at 7.[11]

- Thomas H. Cruikshank joined the Lehman Board in 1996, shortly after he retired as Chairman and CEO of Halliburton Company. 2008 Proxy at 7. Mr. Cruikshank became Chairman of the Audit Committee in 2004 and served as a member of the Nominating and Corporate Governance Committee. *Id.*[12]

- Marsha Johnson Evans, a retired Rear Admiral in the U.S. Navy and former President and CEO of the American Red Cross, became a director of Lehman in 2004 and served as the Chairman of the Nominating and Corporate Governance Committee and as a member of the Compensation and Benefits Committee and the Finance and Risk Committee. 2008 Proxy at 7.

- Sir Christopher Gent, former CEO and Director of Vodafone and current Non-Executive Chairman of GlaxoSmithKline plc, joined the Lehman Board in 2003 and served as a member of the Audit Committee and Compensation and Benefits Committee. *Id.* at 8.

- Roland A. Hernandez became a director of Lehman in 2005 and served as a member of the Finance and Risk Committee. *Id.* Mr. Hernandez was the Chairman and CEO of Telemundo Group, Inc., and has also served as a director of MGM Mirage and Wal-Mart Stores, Inc. *Id.*

- Henry Kaufman became a director of Lehman in 1995 and served as the Chairman of the Finance and Risk Committee. *Id.* at 8-9. Dr. Kaufman is President of Henry Kaufman & Company, Inc., and previously spent 26 years with Salomon Brothers Inc. as a Managing Director and Member of the Executive Committee. *Id.* at 8.

- John D. Macomber joined the Lehman Board in 1994 and served as a member of the Executive Committee, Compensation and Benefits Committee and Nominating and Corporate Governance Committee. *Id.* at 9. Mr. Macomber was also Chairman and President of the Export-Import Bank of the United States and Chairman and CEO of Celanese Corporation. *Id.*

The Director Defendants' lengthy experience with Lehman – its business, management and culture – justified their trust in management and gave them a strong understanding of the Firm, one far greater than the knowledge gleaned in the course of several months by the director-defendants in *Laven* and *In re Avant-Garde*, which the courts found adequate.

In addition to being long-standing members of the Lehman Board, the Director Defendants regularly attended Board and Committee meetings. Overall director attendance at Board and Committee meetings in the 2007 fiscal year was 96%, which greatly exceeded the

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11 *See also* Bill Atkinson, *Man of the big deal*, Baltimore Sun, Apr. 12, 1998, at D1 (Massey Ex. I); Lehman Proxy Statement at 6 (Feb. 28, 2003) (Massey Ex. G).

12 *See also* Lehman Proxy Statement at 6 (Feb. 26, 2004) (Massey Ex. F).

75% attendance requirement. *See* 2008 Proxy at 13 (Massey Ex. B); s*ee also* Lehman Proxy Statement at 11 (Feb. 26, 2007) (noting that overall director attendance was 100% in fiscal year 2006) (Massey Ex. C); Lehman Proxy Statement at 10-11 (Feb. 27, 2006) (noting that overall director attendance was 98% in fiscal year 2005) (Massey Ex. D). In 2007, the Board held eight meetings and, collectively, the Board Committees met 25 times. *See* 2008 Proxy at 9-13 (Massey Ex. B). As markets deteriorated in 2008, the Board more than tripled its number of meetings, meeting more than 25 times before the Company filed for bankruptcy on September 15, 2008.[13] Indeed, in July 2008, the Board met six days in a row. *See* ER at 617 n.2176.

At these meetings, the Board received reports from management and others relating to all of the relevant issues. As the Examiner's Report demonstrates,

> Lehman's management gave the Board regular reports concerning the state of the Firm's business, including reports containing quantitative risk, balance sheet, revenue, and other metrics. Lehman's management also discussed market conditions and their potential impact on the Firm with the Board.

Id. at 184.[14] The Board and its Committees also received numerous presentations about such important topics as Lehman's risk management, leverage, liquidity, commercial real estate, valuation, and mortgage and real-estate related assets. These presentations included:

- Lehman's Risk Management, April 15, 2008 (*id.* at 66 n.185);
- Lehman's Liquidity, Leveraged Loan Commitments and Mortgage Positions, September 11, 2007 (*id.* at 146 n.555);
- Liquidity and the Market, March 25, 2008 (*id.* at 633 n.2269);
- Lehman's Commercial Real Estate, March 25, 2008 (*id.* at 836 n.3213);
- Lehman's Subprime Mortgage Origination Business, March 20, 2007 (*id.* at 90); and

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[13] The Examiner's Report cites to 26 of the Board's meetings that occurred before Lehman's bankruptcy in 2008. *See* ER at 16 n.57, 155 n.594, 614 n.2159, 617 n.2176, 619-20 n.2191, 621 n.2202, 633 n.2269, 639 n.2309, 655 n.2388, 680 n.2541, 714 n.2766, 947 n.3653, App. 13 at 16 n.73.

[14] *See also id.* at App. 8 at 21 n.104 (citing to Board presentations on monthly and quarterly financial information).

- Lehman's Valuations, July 22, 2008 (*id.* at 226 n.784).[15]

Thus, as the Examiner's Report concludes, the Director Defendants "plainly implemented a sufficient reporting system and controls." *Id.* at 194 (Massey Ex. A).

Lehman viewed risk management as one of its core competencies, and Lehman's risk management function was widely regarded as the best in the industry. *Id.* at App. 8 at 1-2. Accordingly, "[t]he directors received reports concerning … the level and nature of [Lehman's] risk-taking at every Board meeting." *Id.* at 55 (Massey Ex. A). During the second half of 2007, the Director Defendants were informed about the conservative nature of both the Firm's liquidity pool and its approach to funding its balance sheet, which had been lauded by the credit rating agencies. *Id.* at 148-49. The Board was also told that Lehman's leverage was in line with its peers. *Id.* at 803. In late 2007 and 2008, the Board received numerous presentations about balance sheet reduction and leverage, which indicated that the Firm had set aggressive targets for reducing balance sheet, cash capital usage, leverage and liquidity risk. *Id.* at 947 (Massey Ex. A). After the collapse of Bear Stearns in March of 2008, the Director Defendants received a presentation dedicated to distinguishing Lehman from Bear Stearns. *Id.* at 633. That presentation emphasized that Lehman had the strongest liquidity position of all of the brokers and that its funding framework was significantly different from that of Bear Stearns. *Id.*

The Board's Finance and Risk Committee reviewed even more detailed information about risk management. For example, the Committee received detailed reports on the Firm's risk management processes (*id.* at 76 n.233, 193-94),[16] which included an executive risk committee and a global risk management group. *Id.* at 71, App. 8 at 1-3. Also, between September 2007 and September 2008, the Committee received numerous detailed presentations about risk, liquidity, capital and the balance sheet. *See, e.g., id.* at 67 n.190, 947 n.3653,[17] 1460 n.5633.

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[15] *See also id.* at 155 n.596 (2008 financial plan); *id.* at 836 n.3215 (fixed income); *id.* at 960 n.3716 (balance sheet and related issues); *id.* at App. 13 at 33 (strategic alternatives).

[16] *See* Massey Ex. A.

[17] *See* Massey Ex. A.

The Board also ensured that its Audit Committee monitored the quality and integrity of Lehman's financial statements by reviewing the Firm's disclosures and reporting on its review to the full Board. *See* 2008 Proxy at 9 (Massey Ex. B); Audit Committee Charter, Lehman Proxy Statement at A-1 - A-6 (Mar. 1, 2005) ("2005 Proxy") (Massey Ex. E). The Audit Committee, in turn, relied upon E&Y, who reviewed Lehman's financial statements for GAAP compliance. The TAC acknowledges that E&Y issued an unqualified audit opinion for Lehman's 2007 10-K, certifying that Lehman's financial statements presented fairly, in all material respects, Lehman's financial condition and operations in conformity with GAAP. *See* TAC ¶ 224. E&Y's analysis included (i) an examination "on a test basis, [of] evidence supporting the amounts and disclosures in the financial statements," (ii) an assessment of "the accounting principles used and significant estimates made by management," and (iii) an evaluation of "the overall financial statement presentation." 2007 10-K at 83 (Chepiga Ex. 7).

Also, even though E&Y did not certify Lehman's quarterly 10-Qs, Plaintiffs concede that E&Y reviewed them and stated in the review reports filed with the 10-Qs that it was not aware of any material modifications that should be made to the financial statements for them to be in conformity with GAAP. *See* TAC ¶ 40(d). Indeed, E&Y asserted that its review of the 10-Qs had been conducted in accordance with the standards of the PCAOB and that it had applied analytical procedures and made inquiries of persons responsible for financial and accounting matters. *See, e.g.*, 2007 1Q Rep. at 40 (Chepiga Ex. 4); 2007 2Q Rep. at 43 (Chepiga Ex. 5); 2007 3Q Rep. at 44 (Chepiga Ex. 6); 2008 1Q Rep. at 42 (Chepiga Ex. 8); 2008 2Q Rep. at 52 (Chepiga Ex. 9). Given that E&Y had served as Lehman's independent auditor for well over ten years (*see, e.g.*, Lehman Brothers Annual Report (Form 10-K) at F-2, Ex. 23 (Mar. 31, 1994) (Massey Ex. H)), the Committee's reliance on E&Y was amply justified. *See Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993), *superseded on other grounds by statute as stated in Louros v. Kreicas*, 367 F. Supp. 2d 572 (S.D.N.Y. 2005).

In addition to relying on management, internal audit and E&Y, the Director Defendants could take additional comfort in the layers of oversight provided by government regulators, who monitored Lehman with increasing scrutiny throughout 2008. Even before the financial crisis, Lehman voluntarily subjected itself to the scrutiny of the SEC as a part of that agency's Consolidated Supervised Entity ("CSE") Program. *See* ER at 1484-87; App. 8 at 22-23. Indeed, as the administrator of the CSE program recently testified, CSE participants (which included Lehman), "had to provide the Commission on an ongoing basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk." SEC Regulation of Investment Banks: Testimony Before the Financial Crisis Inquiry Commission, May 5, 2010 (Statement of Erik R. Sirri, Former Director of Trading and Markets at the SEC) at 7 (Chepiga Ex. 43). And, as the financial crisis deepened, both the SEC and the Federal Reserve Bank of New York ("FRBNY") worked intimately with Lehman, even installing teams in Lehman's offices to conduct daily monitoring, with the FRBNY receiving real-time data regarding the liquidity and capital position of the Firm. *See* ER at 8, 1488, 1495-96. Thus, the Outside Directors could take further assurance that any issues needing to be brought to the Board's attention would surface under the intense scrutiny of the SEC and FRBNY.

Relying on the Examiner's Report, the TAC focuses heavily on so-called Repo 105 issues. In particular, as the TAC explicitly confirms, the Examiner's Report makes clear that the Director Defendants had absolutely no reason to suspect there was anything wrong involving Repo 105. *See* TAC at ¶ 231. Rather, the Examiner found that the Director Defendants "were unaware of Lehman's Repo 105 program and transactions." ER at 945 (Massey Ex. A); *see also id.* at 7-8, 739, 959-60, 991-92, 1035-36.

Likewise, with regard to more general warnings, "[t]he directors were not presented with 'red flags'" relating to management's "decisions concerning the amount of risk that Lehman assumed and their management of that risk." *Id.* at 195 (Massey Ex. A). Moreover,

management's reports to the directors did not contain "red flags" imposing on the directors a duty to inquire further. *Id.* at 55-56 (Massey Ex. A). In light of the foregoing, the Examiner's Report states that "in monitoring risk issues, the Board justifiably relied entirely on information provided by management." *Id.* at 195 (Massey Ex. A). Accordingly, dismissal of the claims against the Director Defendants is warranted given that the documents the Court may consider demonstrate that the Director Defendants conducted a reasonable investigation into Lehman's business operations and had no reason to doubt the accuracy of the Offering Materials.

CONCLUSION

For the foregoing reasons, as well as those set forth in Defendants' and E&Y's memoranda in support of their motions to dismiss, Plaintiffs' claims against the Director Defendants should be dismissed with prejudice.

Dated: New York, New York
June 4, 2010

Respectfully submitted,

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