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**

LEAD PLAINTIFFS' OPPOSITION TO DEFENDANTS' MOTION TO DISMISS THE SECURITIES ACT CLAIMS

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The Alameda County Employees' Retirement Association, Government of Guam Retirement Fund, Northern Ireland Local Government Officers' Superannuation Committee, City of Edinburgh Council as Administering Authority of the Lothian Pension Fund, and Operating Engineers Local 3 Trust Fund ("Lead Plaintiffs" or "Plaintiffs"), respectfully submit this memorandum of law in opposition to Defendants' Joint Motion to Dismiss the Securities Act Claims.[1]

I. PRELIMINARY STATEMENT

On September 15, 2008, just months after having raised more than $47 billion through hundreds of Offerings of Lehman Brothers Holdings Inc.'s ("Lehman" or the "Company") preferred shares, bonds and equity between February 13, 2007 and September 15, 2008 ("Offerings Period"), Lehman petitioned for bankruptcy protection, shocking purchasers of Lehman's securities, and by many accounts triggering a global meltdown in the financial credit markets.[2] Plaintiffs filed this action on behalf of a class of investors who purchased the Offerings that Lehman registered and sold pursuant to false and misleading Offering Documents. By this action, Plaintiffs assert strict liability claims against the Securities Act Defendants, pursuant to Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 ("Securities Act").

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[1] For the purpose of this brief, "Defendants" refers to the Securities Act Individual Defendants identified in ¶244 and the Underwriter Defendants identified in ¶90 (together "Securities Act Defendants") of the Second Amended Consolidated Class Action Complaint For Violations Of The Federal Securities Laws, dated February 23, 2009 ("Complaint"). "¶__" refers to paragraphs in the Complaint.

[2] "Offerings" means the issuances of Lehman equity and debt securities pursuant to a shelf registration statement dated May 30, 2006, filed with the SEC on Form S-3 (the "Shelf Registration Statement"). The Shelf Registration Statement, together with the prospectuses, prospectus supplements, product supplements, and pricing supplements, as well as Securities and Exchange Commission ("SEC") filings incorporated therein, are collectively referred to herein as the "Offering Documents." The Offering Documents incorporated by reference are certain of Lehman's Forms 10-K, 10-Q and 8-K, as identified in the Complaint at Appendix A. ¶168. For example, on February 5, 2008, Lehman issued 75.9 million 7.95% noncumulative perpetual preferred depository shares at $25 per share pursuant to the Shelf Registration Statement, which incorporated by reference Lehman's 2006 and 2007 Forms 10-K, each of Lehman's 2007 quarterly reports, and various periodic reports filed with the SEC on Form 8-K. *See* Complaint & Appendix A, p.1.

Defendants seek to evade liability by attempting to persuade this Court to resolve a number of fact-intensive questions in their favor on a motion to dismiss. The motion must be denied.

Contrary to Defendants' assertions, Plaintiffs have standing to assert claims on behalf of investors who purchased securities in each of the Offerings set forth in Appendix A to the Complaint. Each Plaintiff alleges purchases of Lehman securities pursuant or traceable to at least one of the Offerings issued pursuant to the Shelf Registration Statement; thus, each Plaintiff has stated an individual claim against Defendants under Sections 11 and 12 of the Securities Act in accordance with both Article III of the United States Constitution and statutory standing requirements. Their ability to represent absent class members who purchased in the different Offerings is not, as Defendants erroneously contend, a question of standing but is merely a question of Rule 23 typicality.

Furthermore, the Complaint identifies each false and misleading statement in the Offering Documents, explains why each statement was false and misleading, and provides ample support for each allegation. Specifically, the Offering Documents included numerous material misstatements and omissions regarding Lehman's (1) significant and increasing concentration of mortgage-related risks; (2) failure to timely or adequately write down the value of its mortgage- and real estate-related assets as they became impaired; (3) high-risk residential mortgage lending programs; (4) risk mitigation and ability to directly hedge against losses in its residential mortgage-related portfolio; and (5) the Company's capitalization, liquidity and risks of bankruptcy.

Plaintiffs' allegations are well supported by, *inter alia*, testimony and internal documents that were only disclosed during congressional hearings in the aftermath of Lehman's collapse, comparisons with applicable market indices and observable market data during the Offerings Period, and accounts from percipient witnesses with first-hand knowledge about Lehman's

undisclosed high-risk lending practices and the overstated value of its real estate-related assets during the Offerings Period.

In moving to dismiss, Defendants ignore the Complaint's well pleaded allegations and attribute the Class's claims to a "destructive economic downturn" (Def. Br. 1),[3] which Defendants would have the Court conclude, at the pleading stage and as a matter of law, immunizes them from liability for the false statements and omissions in the Offering Documents.

Defendants' improper "economic downturn" defense is not grounds for dismissal. The Complaint demonstrates that, from the outset of the Offerings Period, Lehman not only accelerated the decline in the housing sector by issuing toxic "no documentation" and "stated income" mortgages without any verification of a borrower's ability to repay the loan, but Lehman acted inconsistently by, for example, issuing margin calls to floundering loan originators for devalued assets it had recently purchased while simultaneously leaving similar, if not identical, assets on its own books at full value. But one step that Lehman failed to take was to provide full and accurate information to the investors from whom it sought to obtain tens of billions of dollars. Hence this lawsuit.

Section 11 of the Securities Act imposes a "stringent standard of liability" and "places a relatively minimal burden on a plaintiff." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82, 103 S. Ct. 683, 686-87 (1983). Plaintiffs have met that burden, alleging reliable, contemporaneous facts that collectively demonstrate the falsity of the Offering Documents. Nothing more is required at the pleading stage, and Defendants' effort to evade that result by invoking the stricter pleading requirements of Rule 9(b) is without basis.

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[3] "Def. Br. __" refers to Defendants' Joint Motion To Dismiss The Securities Act Claims.

Accordingly, Defendants' Joint Motion to Dismiss the Securities Act Claims should be denied.

II. STATEMENT OF FACTS

Lehman's real estate- and mortgage-related businesses comprised the Company's largest reported revenue component during the Offering Period. ¶93 Lehman participated directly in all aspects of the residential and commercial mortgage markets, and despite the severe deterioration in the housing markets before and during the Offerings Period, Lehman amassed a portfolio of $90 billion in mortgage-related assets (including significant exposure to assets backed by Alt-A and subprime loans). ¶118. Lehman also increased its investment in commercial real estate, even as the commercial real estate market deteriorated during the Offering Period, acquiring more commercial holdings than any other firm as of March 2008. ¶¶123-29. Lehman exacerbated its exposure to losses from these assets risk by increasingly leveraging its position as Lehman expanded its portfolio, reaching a dangerous level of over thirty times shareholder equity by the end of the first quarter of 2008. ¶3.

Lehman, through its wholly owned subsidiaries BNC Mortgage LLC ("BNC") and Aurora Loan Services LLC ("Aurora"), originated and underwrote more than $60 billion and $47 billion in residential mortgages in 2006 and 2007, respectively. Lehman also securitized $145 billion and $100 billion in residential mortgage-backed securities ("RMBSs"), respectively, during those same years.[4] Accordingly, Lehman had substantial balance sheet exposure to residential mortgages and RMBSs, reporting $57.7 billion and $89.1 billion in "mortgages and mortgage-backed securities" at 2006 and 2007 fiscal year-end, respectively. ¶¶3, 94, 170, 197.

Unbeknownst to investors, however, Lehman's residential mortgage business was driven

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[4] ¶¶93, 97, 170, 323; *see also* 2007 Form 10-K at 104 (Declaration of Victor L. Hou, Ex. 8 hereinafter "Hou Ex. __"). RMBSs are securitized transactions formed by pooling hundreds of residential mortgages, which generate future payments to investors as borrowers of the underlying mortgages make their monthly mortgage payments.

by extremely high-risk lending programs that included, *inter alia*, "no documentation loans" (in which borrowers provided no documentation), "stated income loans" (in which borrowers stated their income without any verification), mortgages for 100% of a property's value to borrowers with low Fair Issac Corporation ("FICO") scores (in which borrowers had no equity in their home at the inception of the loan), and mortgages for homes that were geographically concentrated in California, Florida, and Nevada (housing markets suffering from alarming rates of mortgage defaults and home foreclosure throughout the Offerings Period). ¶¶98-101, 108.

In short, Lehman's lending business involved very risky practices. However, none of the risky lending programs was disclosed in ***any*** of the Offering Documents, even though they exposed Lehman (and its investors) to substantially elevated risks of borrower delinquencies and mortgage defaults – risks that were significantly heightened because the Offerings Period coincided with a steep decline in the United States housing market due to the type of "toxic" lending programs that fueled Lehman's business.[5]

The Offering Documents misstated and failed to disclose material facts about Lehman's financial exposure to that risk. For example, when Lehman reported its fiscal 2006 year-end results, it reported holding $57.7 billion in "mortgages and mortgage-backed securities" but failed to disclose that over 10% of this amount consisted of $6.8 billion in high-risk subprime loans, as well as additional (still untold) exposure to risky "Alt-A" loans.[6] Indeed, the word "subprime" appeared in the 2006 Form 10-K just twice, both times in passing, and the word "Alt-A" did not appear in either the 2006 or 2007 Forms 10-K. It was not until Lehman reported its 2008 first quarter results on April 8, 2008, that it reported ***any*** Alt-A exposure – and even that

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[5] Even Defendants characterized the Offerings Period as one of "unprecedented tumult." Def. Br. 27.

[6] Alt-A loans were experiencing alarming levels of mortgage defaults and were a substantially contributing factor to the then ongoing U.S. housing crisis and, thus, the failure to quantify exposures to these types of loans was also a material omission or misrepresentation.

disclosure was misleading because Lehman reported its Alt-A exposure with its ***prime*** mortgages in a single line item labeled "Alt-A/Prime" – even though the higher quality prime mortgages represented just a small fraction of the $14.6 billion line item.

In addition to misstatements and material omissions about Lehman's high-risk lending practices and the Company's financial exposure to that risk, the Offering Documents overstated the value of Lehman's commercial and residential real estate assets in violation of generally accepted accounting principles ("GAAP"). As Lehman careened towards bankruptcy in September 2008, and opened its books to suitors, representatives from Citigroup, Credit Suisse, Deutsche Bank and Goldman Sachs found that Lehman's $32.6 billion commercial mortgage and real estate portfolio was overvalued by as much as 35%. ¶¶10, 137. In fact, when Barclays PLC acquired certain of Lehman's assets post-bankruptcy, it specifically excluded the commercial mortgage and real estate portfolio because Barclays "did not feel the valuations were supportable." ¶139.

In addition to these facts, the Complaint provides substantial support for its allegations that Lehman had overvalued its commercial and residential real estate-related assets throughout the Offerings Period:

- In 2007, the ABX and CMBX indices – two observable market inputs under the key GAAP provision applicable to these assets (SFAS 157) – indicated unmistakably sharp increases in the risk of default for mortgages and mortgage-related assets directly comparable to billions of dollars in similar assets held by Lehman, in contrast to the modest and delayed Offerings Period write-downs that Lehman reported (¶¶126-27, 142, 149);
- Lehman's primary competitors with comparable types of residential and commercial mortgage-related exposures recognized much larger write-downs as a percentage of their portfolios than did Lehman (¶¶147-48);
- Credit performance data on loans Aurora originated between the end of 2005 and the spring of 2008 revealed a sharp deterioration, with the percent of loans delinquent for at least 30 days, in foreclosure or in bankruptcy rising from 2% to 11.9%, while many of the loans Aurora acquired from correspondent lenders defaulted immediately upon acquisition (¶¶105, 111);

- Data on the performance of residential mortgage-backed securities issued and sold by Lehman revealed that loans in Lehman's securitization pools had experienced substantially increased delinquencies and defaults throughout the Offerings Period (¶143);
- By late 2006 Lehman was increasingly required to satisfy repurchase requests under representations and warranties made in connection with its securitization transactions, often substituting delinquent or defaulted loans underlying such securities with more sound mortgages and retaining the credit and risk exposure of the swapped loan on its own books (¶¶109-116);
- By early 2007 Lehman had begun making margin calls on loan originators to whom it had extended credit lines, due to the decreased value of mortgage-related assets used as collateral underlying such credit lines (¶145);
- Beginning in the first quarter of 2007, the percentage of Lehman's mortgage inventory that did not qualify for sales treatment increased – meaning that Lehman was increasingly required to retain the risks of such assets on its books (¶¶144, 146);
- Confidential sources who worked in Lehman's Real Estate Group confirmed that Lehman failed to take necessary, material write-downs to its mortgage-related positions and real estate holdings (¶¶130-32);
- When Lehman finally recorded a substantial write-down on its residential mortgage assets in the second quarter of 2008, one that should have been taken in earlier quarters, Wachovia Capital Markets analyst Douglas Sipkin commented that "the Company did not have, and potentially still does not have, a complete grasp of its exposures" (¶153);
- One prominent market observer, David Einhorn of hedge fund Greenlight Capital Inc., told *Bloomberg News* that, given the more benign market environment during the 2008 second quarter, "most of [Lehman's 2Q08] losses [] were probably evident quarters ago" (¶152); and
- During the first quarter of 2008, Lehman wrote down its commercial mortgage portfolio by a mere 3%, despite the fact that the CMBX fell by more than three times as much (10%). (¶133).

Furthermore, up until Lehman filed for bankruptcy protection, the Offering Documents assured investors that, unlike other firms that announced significant write-downs, Lehman was, in effect, superior to its competition because of its "comprehensive" and "dynamic" risk management procedures and effective hedging strategies. ¶¶85, 156. In reality, and unbeknownst to investors, Lehman's supposedly superior hedging strategy actually exposed the Company to ***additional*** losses, which it realized in the 2008 second quarter. As Defendant

Lowitt finally acknowledged in a September 2008 conference call, Lehman had no meaningful hedge for the billions of dollars of problematic (and long-obscured) Alt-A assets that languished on Lehman's balance sheet. ¶¶157-59.

Attempting to stem investors' fears about Lehman's financial strength, on September 10, 2008, Lehman held a conference call to prerelease third quarter earnings, during which it announced plans to spin off its commercial real estate assets into a separate publicly traded company in order to remove them from Lehman's balance sheet. ¶¶8, 136. During the call Defendant Lowitt assured investors in the Offerings that, even then, Lehman's capital position remained "very strong." ¶9. Lowitt's assurance was just the latest in a long series of false and misleading statements to investors; five days later, Lehman filed for bankruptcy, citing a "liquidity crisis." ¶¶164, 321, 353, 366. The $47 billion in equity and debt that Lehman issued during the Offerings Period became virtually worthless. The extent to which Lehman misled the marketplace was later underscored by the explanation given by then-Treasury Secretary Henry Paulson as to why the government did not step in to try to save Lehman: "by law the Federal Reserve could bailout Lehman with a loan only if the bank had enough good assets to serve as collateral, ***which it did not***." ¶¶10, 138 (emphasis added).

III. NAMED PLAINTIFFS MAY REPRESENT ABSENT CLASS MEMBERS

"The class-action device was designed as an exception to the usual rule that litigation is conducted by and on behalf of the individual named parties only." *Gen. Tel. Co. of Sw. v. Falcon*, 457 U.S. 147, 155, 102 S. Ct. 147, 2369 (1982). Thus, when assessing a plaintiff's ability to represent absent parties in the class action context, the question is not one of "standing," but whether "the issues involved are common to the class as a whole" and whether they "turn on questions of law applicable in the same manner to each member of the class" in accordance with Rule 23. *Id.*; *see also* 1 ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON

CLASS ACTIONS, § 2.7, at 2-40-41 (4th ed. 2009) ("Whether or not the named plaintiff who meets individual standing requirements may assert the rights of absent class members is neither a standing issue nor an Article III case or controversy issue but depends rather on meeting the prerequisites of Rule 23 governing class actions.").

Here, each named plaintiff alleges purchases traceable to one of the Offerings issued pursuant to the Shelf Registration Statement and prospectus. At least one named plaintiff has a claim against all of the defendants named in this lawsuit. Therefore, the Plaintiffs have stated individual claims under Sections 11 and 12 in accordance with Article III and statutory standing requirements.

A. <u>Article III Does Not Bar Claims On Behalf Of Absent Plaintiffs</u>

To have Article III standing to advance a claim, the plaintiff "must have suffered an injury in fact − an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical." *Cent. States Se. & Sw. Areas Health & Welfare Fund v. Merck-Medco Managed Care, L.L.C.*, 433 F.3d 181, 198 (2d Cir. 2005) ("*Cent. States I*") (quotations omitted). By contrast, "typicality" under Rule 23 "is satisfied when each class member's claim arises from the same course of events, and each class member makes similar legal arguments to prove the defendant's liability." *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 291 (2d Cir. 1992).

In a class action, a representative plaintiff's "standing" depends on whether that plaintiff personally has a claim against the defendants, irrespective of the class nature of the suit. If the named plaintiff has *individual* standing, inquiries regarding the plaintiff's ability to represent *other*, absent plaintiffs is examined under Rule 23 typicality. The Second Circuit explains:

> To establish Article III standing in a class action . . . for every named defendant there must be at least one named plaintiff who can assert a claim directly against that

> defendant, and at that point standing is satisfied and only then will the inquiry shift to a class action analysis.

Cent. States Se. & Sw. Areas Health & Welfare Fund v. Merck-Medco Managed Care, L.L.C., 504 F.3d 229, 241 (2d Cir. 2007) ("*Cent. States II*") (quoting 1 ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 2:6 n.3 (4th ed. 2002)). As one court explained:

> each of the Named Plaintiffs asserts a personal injury resulting from Defendants' allegedly wrongful marketing and sale of GTA under an inappropriate content rating. The relevant question, therefore, is not whether the Named Plaintiffs have standing to sue Defendants − they most certainly do − but whether their injuries are sufficiently similar to those of the purported Class to justify the prosecution of a nationwide class action. . . . This question is, at least in the first instance, appropriately answered through the class certification process.

In re Grand Theft Auto Video Game Consumer Litig. (No. II), No. MDL-1446, 2006 WL 3039993, at *3 (S.D.N.Y. Oct. 25, 2006) (citation omitted).[7]

Similarly, Federal Practice and Procedure says:

> Representative parties who have direct and substantial interest have standing; the question whether they may be allowed to present claims on behalf of others who have similar, but not identical, interests depends not on standing, but on an assessment of typicality and adequacy of representation.

7AA CHARLES A. WRIGHT, ARTHUR R. MILLER & MARY K. KANE, FEDERAL PRACTICE & PROCEDURE § 1785.1 (3d ed. 2005).[8]

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[7] The Fifth Circuit, as well, has explained that a representative plaintiff's "standing" is properly examined only when "the standing question would exist whether [the plaintiff] filed her claim alone or as part of a class." *Rivera v. Wyeth-Ayerst Labs*, 283 F.3d 315, 319 n.6 (5th Cir. 2002).

[8] *See also Grasty v. Amalgamated Clothing & Textile Workers Union*, 828 F.2d 123, 130 n.8 (3d Cir. 1987) ("[Defendants] confuse standing and the typicality requirement of Rule 23(a)(3). Each of the named plaintiffs has presented claims of injury to herself and has alleged facts which present a case or controversy."); *Mobley v. Acme Mkts., Inc*., 473 F. Supp. 851, 858-59 (D. Md. 1979) ("Defendant has confused standing with typicality . . . . [I]t is clear that plaintiff has standing in the constitutional sense . . . . Whether or not class certification is appropriate, however, raises entirely different concerns which need not and cannot be addressed [on a motion to dismiss]"); *Prater v. Ohio Educ. Ass'n*, No. C2-04-1077, 2008 WL 2566364, at *6 (S.D. Ohio June 26, 2008) (employees covered by 4 collective bargaining agreements may represent a class that includes 16 collective bargaining agreements; "[O]nce his standing has been established, whether a plaintiff will be able to represent the putative class, including absent class members, depends solely on whether he is able to meet the additional criteria encompassed in Rule 23. . . ." (*quoting Cooper v. Univ. of Tex. at Dallas*, 482 F. Supp. 187 (N.D. Tex. 1979)); *DeBoer v. Mellon Mortg. Co*., 64 F.3d 1171, 1174-75 (8th Cir. 1995) (plaintiffs who signed one form of mortgage

Courts in this district recognize that this approach does not change in the securities context. For example, in *In re Prudential Securities Inc. Ltd. Partnerships Litigation*, 163 F.R.D. 200 (S.D.N.Y. 1995) – which was explicitly approved by the Second Circuit in *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 82-83 (2d Cir. 2004) – a class action was brought against defendants who had committed frauds in connection with 700 different partnerships. Although the named plaintiffs had invested in a small subset of the partnerships, the court permitted them to serve as representatives for the class, employing an ordinary Rule 23 analysis. As the court explained, "[P]laintiffs are in the same position as absent Class Members, regardless of the specific . . . partnership in which they invested, because of the uniform course of improper conduct and standardized sales approach applied by defendants."[9] *Prudential*, 163 F.R.D. at 208.

Similarly, in *In re Dreyfus Aggressive Growth Mutual Fund Litigation*, No. 98 Civ. 4318(HB), 2000 WL 1357509 (S.D.N.Y. Sept. 20, 2000), the named plaintiffs were permitted to represent investors in two different mutual funds even though they had only invested in one of the funds. *See id.,* at *2. The court explained, "[C]lass representatives need not have invested in each security so long as the plaintiffs have alleged a single course of wrongful conduct with regard to each security. Courts have not addressed this concern vis-á-vis the doctrine of

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contract may represent a class that includes persons who signed different contracts); *Forbush v. J.C. Penney Co.*, 994 F.2d 1101, 1106 (5th Cir. 1993) (beneficiary of ERISA plan may sue on behalf of beneficiaries of multiple plans); *Elias v. Ungar's Food Prods.*, 252 F.R.D. 233, 244 (D.N.J. 2008) (named plaintiffs only purchased a subset of the products alleged to carry false nutritional information; because similar misrepresentations were included on a variety of products, "the named plaintiffs' claims are typical of the proposed class' claims and they have standing to pursue them").

[9] That the court reached this decision in the context of Rule 23 typicality, rather than a challenge to "standing," is irrelevant – plaintiffs must have standing to meet the typicality requirement. *See Piazza v. Ebsco Indus., Inc.*, 273 F.3d 1341, 1351 (11th Cir. 2001). Neither the *Prudential* court, nor the Second Circuit when citing *Prudential* with approval in *Hevesi*, saw any constitutional barrier to permitting a named plaintiff who had purchased one security to bring claims on behalf of a class of persons who had purchased other securities, so long as the other requirements for Rule 23 were met. In other words, the question is properly framed in terms of typicality, not standing.

standing, but rather have examined such concerns pursuant to Rule 23(a)(3)'s typicality requirement." *Id.*, at *3.[10]

Courts in other jurisdictions have also taken this approach.[11] In *In re Friedman's, Inc. Securities Litigation*, 385 F. Supp. 2d 1345 (N.D. Ga. 2005), the plaintiff had purchased securities in one offering, and brought Section 11 claims on behalf of a class that – just as in this case – included purchasers from other offerings derived from the same shelf registration. *See id.* at 1372-73. The court reasoned that because the plaintiff had standing to advance his own claims, the various offerings involved similar misstatements, and the defendant's involvement in each offering was similar, the issue of the plaintiff's "standing" to represent absent class members could be addressed "at a later stage." *Id.* at 1373.[12]

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[10] *See also Hicks v. Morgan Stanley & Co.*, No. 01 Civ. 10071(HB), 2003 WL 21672085, at *5 (S.D.N.Y. July 16, 2003) ("Because [the named plaintiff] is rightly in federal court for his Section 11 claim and because the Section 11 and Section 12 claims arise out of the same conduct and involve the same legal theories, the proper inquiry [as to whether he can represent the claims of the absent Section 12 plaintiffs] is typicality rather than standing."). *See In re Blech Sec. Litig.*, No. 94 Civ. 7696 (RWS), 2003 WL 1610775, at *17 (S.D.N.Y. Mar. 26, 2003) (seven named representatives could represent purchasers of all securities because "[t]here need not be a class representative for every Blech security, as long as all the securities are part of a common fraudulent or manipulative scheme"); *Berwecky v. Bear, Stearns & Co.*, 197 F.R.D. 65, 70-71 (S.D.N.Y. 2000); *Maywalt v. Parker & Parsley Petroleum Co.*, 147 F.R.D. 51, 56-57 (S.D.N.Y. 1993) (named plaintiffs who invested in two partnerships could represent those who had invested in a third partnership); *Tedesco v. Mishkin*, 689 F. Supp. 1327, 1335-36 (S.D.N.Y. 1988) ("to satisfy the typicality requirement, it is not necessary for the named plaintiffs to have invested in all of the investment vehicles [where] complaint alleges a single pattern of fraud").

[11] *See Mutchka v. Harris*, 373 F. Supp. 2d 1021, 1024 (C.D. Cal. 2005); *Hoxworth v. Blinder, Robinson & Co.*, 980 F.2d 912, 923 (3d Cir. 1992) (investors in 15 securities permitted to represent purchasers of 21 securities); *Eisenberg v. Gagnon*, 766 F.2d 770, 784 (3d Cir. 1985) (investors in two limited partnerships permitted to represent investors in three different partnerships); *In re MobileMedia Sec. Litig.*, 28 F. Supp. 2d 901, 911 n.7 (D.N.J. 1998) (plaintiffs have standing to bring their own Section 11 and 12 claims; "Concerns over whether stock purchasers should represent notes purchasers are better addressed at the time of class certification."); *In re DDi Corp. Sec. Litig.*, No. CV-03-7063 NM, 2005 WL 3090882, at *6 (C.D. Cal. July 21, 2005) (same).

[12] As Defendants point out, *Friedman*'s also dismissed a claim against an underwriter because the named plaintiff had not bought in the only offering in which the underwriter had participated. *Id.* at 1371-72. However, this was simply an ordinary application of the rule that "for every named defendant there must be at least one named plaintiff who can assert a claim directly against that defendant." *Cent. States II*, 504 F.3d at 241; *see In re Salomon Smith Barney Mut., Fund Fees Litig.*, 441 F. Supp. 2d 579, 606-08 (S.D.N.Y. 2006) (Def. Br. 10) (plaintiffs could not sue mutual funds that had not injured them; claims against advisors who served those funds *and had no other relationship with plaintiffs* were dismissed). Here, however, every Defendant is alleged to have harmed the named Plaintiffs; therefore, Plaintiffs have standing for their own claims, and any further inquiry concerns typicality.

Here, the named Plaintiffs allege that they purchased securities in an Offering based on the Shelf Registration Statement, that the Offering Documents were false and misleading, and that they were damaged, ¶¶17-22, 165, 169 & App. A; therefore, they have alleged "an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical." *Cent. States I*, 433 F.3d at 198. Whether they may represent a class of purchasers in *other* offerings must await a Rule 23 determination.

Defendants cite a number of cases for the unremarkable proposition that Article III requires a plaintiff, whether suing individually or on behalf of a class, to have personally suffered a redressable injury. *See, e.g.*, *W. R. Huff Asset Mgmt. Co., LLC v. Deloitte & Touche LLP*, 549 F.3d 100, 106 n.5 (2d Cir. 2008). The named Plaintiffs have alleged redressable injuries with respect to their own purchases. Their ability to represent a class of absent purchasers thus presents a Rule 23 question, not an Article III question.[13]

To be sure, there has been some confusion distinguishing Article III standing and Rule 23 typicality. In *Blum v. Yaretsky*, 457 U.S. 991, 102 S. Ct. 2777 (1982), the Supreme Court held that certain named plaintiffs did not have "standing" to represent a subset of absent class members because those class members suffered a different injury from that experienced by the named plaintiffs. *See id.* at 1001-02, 102 S. Ct. 2784-85. The same year, the Supreme Court used a Rule 23 typicality analysis to address the same issue. *Gen. Tel.*, 457 U.S. 147, 158-60, 102 S. Ct. 2364, 2371-72. For this reason, the Supreme Court recently acknowledged that "there is tension in our prior cases" regarding the distinction between typicality and standing. *Gratz v. Bollinger*, 539 U.S. 244, 263 n.15, 123 S. Ct. 2411, 2423 (2003) (citing *Blum* and *General*

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[13] In *Hoffman v. UBS-AG*, 591 F. Supp. 2d 522 (S.D.N.Y. 2008) the court correctly held that in most instances, standing must be examined before typicality, but failed to recognize that any consideration of plaintiffs' ability to represent *absent* plaintiffs (rather than bring claims based on their own purchases) did not concern Article III standing. *See* NEWBERG § 2.7, at 2-40-41.

Telephone). Without resolving the confusion, *Gratz* explained that whether characterized as Rule 23 or Article III, the question is whether the named plaintiff's injury "implicate[s] a significantly different set of concerns" than the class's injuries. *Id.* at 265, 123 S. Ct. 2424-25.[14]

For this reason, when the claims of the named plaintiffs facially bear little resemblance to the claims of absent class members, some courts have deemed the inquiry to be one of "standing." However, the inquiry is substantively the same as in *Gratz* and under Rule 23 – the court considers whether the named plaintiffs' individual claims employ similar factual and legal theories to the claims advanced on behalf of absent class members.[15] In other words, these courts consider whether the named plaintiffs' injuries "implicate a significantly different set of concerns" than absent class members' injuries. *Id*.

Because of the common course of misconduct alleged here, "[a] decision in favor of the plaintiffs will redress any injury suffered by [the absent class members]." *Beer v. XTO Energy, Inc.*, No. CIV-07-798-L, 2009 WL 764500, at *5 (W.D. Okla. Mar. 20, 2009). Thus, whether a question of Rule 23 typicality or the modified "standing" inquiry is used to assess the fitness of a plaintiff to represent absent class members, the named plaintiffs' claims do not "implicate a

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[14] Some courts use the term "standing" to refer to a named plaintiff's ability to represent absent class members, but always recognizing that the "standing" inquiry is governed by Rule 23, not Article III. *See, e.g.*, *Siegel v. Shell Oil Co.*, 480 F. Supp. 2d 1034, 1043 n.4 (N.D. Ill. 2007); *Brown v. Kelly*, 244 F.R.D. 222, 239 (S.D.N.Y. 2007) ("In a class action context, adequate representation and typicality of claims or defenses, as required by procedural due process and Rule 23 standards, serve as a substitute for application of normal standing requirements with respect to the relationship between absent class members and the party representing or opposing the class." (quoting *Marcera v. Chinlund*, 595 F.2d 1231 (2d Cir.), *vacated on other grounds*, 442 U.S. 915, 99 S. Ct. 2833 (1979)).

[15] *See*, *e.g.*, *In re Salomon Analyst Level 3 Litig.*, 350 F. Supp. 2d 477, 496-97 (S.D.N.Y. 2004) (equity purchasers may not represent debt purchasers and holders of retail accounts where the legal claims are entirely distinct, or where the fact patterns concerning reliance and causation are distinct); *In re Parmalat Sec. Litig.*, No. 04-MD-1653(LAK), 2008 WL 3895539, at *3 (S.D.N.Y. Aug. 21, 2008) (stockholders may not represent bondholders); *Congregation of Ezra Sholom v. Blockbuster, Inc.*, 504 F. Supp. 2d 151 (N.D. Tex. 2007) (Def. Br. 10) (plaintiffs who only have Section 10(b) claims may not represent a class of Section 11 claimants).

significantly different set of concerns" than those of absent class members. *Gratz*, 539 U.S. at 265, 123 S. Ct. 2424-25.[16]

B. The Securities Act Does Not Bar Claims On Behalf Of Absent Class Members

Defendants contend that the named plaintiffs lack statutory "standing" because Sections 11 and 12 – which permit claims by purchasers of "such securit[ies]" as were the subject of the false statements – forbid lawsuits based on securities other than the type purchased by the named plaintiffs. Def. Br. 6-7, 9-10. As "standing" refers only to the named plaintiffs' ability to advance their own claims individually, and the named plaintiffs here meet statutory requirements for bringing Section 11 and 12 claims on their own behalf, Defendants apparently mean that Sections 11 and 12 must be read to preclude the ordinary typicality inquiry under Rule 23. Defendants offer virtually no support for such a radical proposition.

Courts frequently apply ordinary Rule 23 principles to Section 11 and 12 claims, such as when the named plaintiffs bought in different offerings or purchased different securities,[17] or even when the named plaintiffs did not themselves have standing under Section 11 or 12 at all, so long as the claims they did have satisfied Rule 23.[18] Courts have also applied ordinary class

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[16] That purchasers in earlier Offerings were not adversely affected by misstatements incorporated into later Offering Documents is irrelevant. Plaintiffs may serve as class representatives based on a defendant's continuous course of conduct even if the plaintiff was only personally affected by a subset of that conduct. *See, e.g., In re VeriSign Sec. Litig.*, No. C-02-02270 JW(PVT), 2005 WL 88969, at *4 (N.D. Cal. Jan. 13, 2005) ("Simply because certain class members were injured by misrepresentations that came *after* the Lead Plaintiffs had already acquired VeriSign stock does not mean that the Lead Plaintiffs cannot represent the class. Defendants' argument conflates Article III's standing requirements with Fed. R. Civ. P. 23's class action requirements." (Emphasis in orginal)); *Adam v. Silicon Valley Bancshares*, No. C-93-20399 RMW(EAI), 1994 WL 374314, at *1 (N.D. Cal. Apr. 18, 1994) (plaintiffs may represent purchasers with claims based on statements issued after plaintiffs' own purchases; "If plaintiff's individual claim is typical, then . . . it is of no moment that the plaintiff lacks individual standing for each of the claims asserted by the class" (citing cases)).

[17] *See Hoxworth*, 980 F.2d at 923; *Friedman's*, 385 F. Supp. 2d at 1372-73; *MobileMedia*, 28 F. Supp. 2d at 911 n.7; *DDi Corp*., 2005 WL 3090882; *Tedesco*, 689 F. Supp. at 1335-36; *Am. Cont'l Corp./Lincoln Sav. & Loan*, 794 F. Supp. 1424, 1461 (D. Ariz. 1992).

[18] *See Picard Chem. Profit Sharing Plan v. Perrigo Co.*, Nos. 1:95-cv-141, 1:95-cv-290, 1996 WL 739170, at *2 (W.D. Mich. Sept. 27, 1996); *In re Juniper Networks Sec. Litig.*, 542 F. Supp. 2d 1037, 1052 (N.D. Cal. 2008);

actions principles to ERISA claims, despite restrictive language of that statute. *See* 29 U.S.C. § 1132(a)(1)(B) (beneficiary may "recover benefits *due to him under the terms of his plan*, to *enforce his rights under the terms of the plan*, or to clarify *his rights to future benefits under the terms of the plan*.") (emphasis added). Despite this language, beneficiaries of one plan may represent a class that includes beneficiaries of other, similar plans.[19]

Unsurprisingly, then, Defendants offer minimal judicial support for their novel contention that the Securities Act, unique among federal statutes, mandates a more restrictive Rule 23 analysis, and that Congress communicated this intention by use of the phrase "such security." Section 11 was passed in 1933 – five years before the adoption of the Federal Rules of Civil Procedure in 1938, and thirty-three years before the typicality inquiry was added to the Rules in 1966. It can hardly be said that the 1933 Congress sought to bar the application of class action principles to Securities Act claims thirty-three years before such principles even existed.[20] Instead, Defendants cite to a variety of cases in which courts examined the standing requirements for *individual*, or named, plaintiffs to allege Section 11 and 12 claims based on their own securities purchases.[21] None of these cases even purport to address the conditions under which named plaintiffs who have individual standing may then represent a class of absent purchasers.

Hicks, 2003 WL 21672085, at *5. Courts differ as to whether equity purchasers may represent debt purchasers, or whether Section 10 claimants may represent Section 11 claimants, but the *analysis* merely requires the ordinary application of class action principles.

[19] *See, e.g., Cates v. Cooper Tire & Rubber Co*., 253 F.R.D. 422, 430 (N.D. Ohio 2008); *Smith v. United Healthcare Servs*., No. Civ-00-1163 ADM/AJB, 2002 WL 192565, at *4 (D. Minn. Feb. 5, 2002).

[20] If Congress did not want courts to use ordinary Rule 23 principles when considering Securities Act claims, it has had numerous opportunities to make its intentions clear. In 1995, Congress revamped securities litigation with the passage of the Private Securities Litigation Reform Act ("PSLRA"). *See* 15 U.S.C. § 77k; 15 U.S.C. § 77z-1. In 1998, Congress passed the Securities Litigation Uniform Standards Act, amending the Securities Act to preempt class action claims based on state law. *See* 15 U.S.C. § 77p. That Congress did not take these opportunities to alter the application of Rule 23 to Securities Act claims suggests that Congress endorsed the continued use of Rule 23 in the ordinary fashion. *Huddleston*, 459 U.S. 375, 385-86, 103 S. Ct. 683, 689.

[21] *See Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967); *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000); *DeMaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. 2003); *Ciresi v. Citicorp*, 782 F. Supp. 819 (S.D.N.Y. 1991);

Defendants' remaining cases interpreting the language of Sections 11 and 12 are nonbinding, unpersuasive, and go against the great weight of authority. For example, *In re Paracelsus Corp., Sec. Litig.*, 6 F. Supp. 2d 626 (S.D. Tex. 1998), cites no precedent for its conclusion that the language of Sections 11 and 12 bars named plaintiffs from representing absent investors who purchased different securities, and fails to consider Rule 23. *Ong v. Sears, Roebuck & Co.*, 388 F. Supp. 2d 871 (N.D. Ill. 2004), similarly cites no case law interpreting the statute in this manner, and misinterprets the precedent on which it relies.[22] *J & R Marketing, SEP v. Gen. Motors Corp.*, No. 06 Civ. 10201, 2007 WL 655291 (E.D. Mich. Feb. 27, 2007), simply follows *Ong*.

Finally, Defendants' interpretation would undermine the chief benefits of the class action. As exemplified by this case, numerous situations arise in which identical violations of Sections 11 and 12 occur in the context of multiple offerings. It would severely burden courts, and Plaintiffs if, for each one of these Offerings which present indistinguishable legal and factual issues, potentially hundreds of plaintiffs had to be named and, presumably, assume duties as class representatives. The statute should not be interpreted to require such an impractical result, particularly as Defendants have failed to identify any offsetting benefits.

C. The Offerings Took Place Pursuant To A Single Registration Statement For Standing Purposes

Even if purchasers of securities pursuant to one registration statement cannot represent absent plaintiffs who purchased pursuant to a different registration statement, all of the Offerings

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Akerman v. Oryx Commc'ns, Inc., 810 F.2d 336, 344 (2d Cir. 1987); *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 207 (S.D.N.Y. 2003).

[22] The *Ong* court relied on *In re WorldCom, Inc. Securities Litigation*, 294 F. Supp. 2d 392 (S.D.N.Y. 2003). However, in *Worldcom*, the named plaintiff had no standing to sue under Section 11 and 12 even on its own behalf; the court did not consider whether a named plaintiff with viable Section 11 and 12 claims could sue on behalf of a class of purchasers of other securities. *See id.* at 420-21.

were issued pursuant to a single, initial shelf registration. In *In re Countrywide Financial Corp. Securities Litigation*, 588 F. Supp. 2d 1132 (C.D. Cal. 2008), the court determined that the SEC regulations deeming each new Offering to have a new registration "effective date" did not control the concept of a "registration statement" as it appeared in the text of Section 11. *See id.* at 1165-66. Thus, purchasers of securities based on a single initial shelf registration statement could serve as representatives for purchasers from other offerings issued pursuant to the same shelf registration, so long as the offerings shared some false statements. *See id.*[23] The court observed that "[a] contrary rule would mean that someone who purchases before an amendment could not have standing to represent someone who happened to purchase after the most *de minimis* amendment, even if the only violation is common to both the original registration statement and the amended statement." *Id.* at 1166.

IV. NAMED PLAINTIFFS HAVE INDIVIDUAL STANDING TO ADVANCE CLAIMS ON THEIR OWN BEHALF

A. General Challenges To Named Plaintiffs' Standing

Defendants contend that the claims of any named plaintiff who did not file a PSLRA certification must be dismissed. Def. Br. 11-12. But *Greebel v. FTP Software*, 939 F. Supp. 57, 60 (D. Mass. 1996), cited by Defendants, only holds that a PSLRA class action may not be maintained unless the ***lead plaintiff*** files a certification; it does not require that every plaintiff named on the complaint file a certification at pleading. *See id.* at 61-62; *see also Carson v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 97 Civ. 5147, 1998 WL 34076402, at *6 n.3 (W.D. Ark. Mar. 30, 1998) (*Greebel* addressed the appointment of a lead plaintiff). Similarly, *In re Eaton Vance Corp. Securities Litigation*, 219 F.R.D. 38 (D. Mass. 2003) held that named

[23] The court did not consider, nor does it appear to have been argued, that the ability of a named plaintiff to represent absent purchasers is governed by Rule 23, not the text of the statute.

plaintiffs must file certifications to serve as class representatives *at the certification stage*, *see id.* at 41, but did not require that all plaintiffs file certifications as a condition to being included on the complaint.

Even if it was required in the first place, the issue is now moot, as Plaintiffs have submitted certifications with their briefing. Declaration of David Kessler ("Kessler Dec."), Ex. A; *see Carson*, 1998 WL 34076402, at *6 (plaintiffs may file belated certification). Moreover, these Plaintiffs have standing to sue on behalf of themselves, for their own purchases, *see* App. A, and Defendants do not argue otherwise. Thus, there is no basis for dismissing their individual claims. As for the *class* claims on behalf of *absent* purchasers, the remaining named plaintiffs may advance claims on behalf of those purchasers for the reasons given above.

Defendants next identify certain typographical errors in the Complaint's Appendix A. Def. Br. 12. Plaintiffs have submitted a Corrected Appendix A concurrently with this brief. *See* Kessler Dec., Ex. B. These minor errors are not a ground for dismissing valid claims.[24]

Finally, Defendants argue that named Plaintiff Grace Wang did not herself purchase any Lehman securities, and thus has no standing, citing *Huff*, 549 F.3d 100. Def. Br. 12. Defendants overlook that Ms. Wang is suing as trustee on behalf of the David J. Wang Inc. Pension Plan. Although the *Huff* court refused to allow *investment managers* to sue on behalf of their clients, the court expressly reaffirmed the right of *trustees* to sue on their trust behalf. *See Huff*, 549 F.3d at 109-10 (citing *Sprint Commc'ns Co., L.P. v. APCC Servs.*, 128 S. Ct. 2531, 2543, 171 L. Ed. 2d 424 (2008)).

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[24] As for Defendants' argument that certain securities were called or matured prior to Lehman's bankruptcy (Def. Br. 12), damages exist for purchasers who sold such securities at a loss prior to maturity or call and thus, it is entirely appropriate to bring Securities Act claims on their behalf.

B. <u>Challenges To Named Plaintiffs' Section 12 Standing</u>

Defendants also erroneously argue that the Complaint is deficient because, although it alleges that the named plaintiffs bought securities from the Underwriter Defendants, it does not particularly identify which named plaintiffs bought from which underwriters. Def. Br. 13-16. These details are not required at the pleading stage.[25]

Though Defendants cite cases holding that a plaintiff must prove at *trial* that he or she purchased from a particular underwriter, these cases do not address pleading requirements.[26] Defendants' citations to cases involving plaintiffs who admitted that they had not purchased from the defendants,[27] who never alleged that the defendants sold securities,[28] who never alleged that the defendants sold securities to the plaintiffs, or who never alleged that plaintiffs bought in the offering,[29] are also inapposite. The Complaint alleges that (1) the Underwriter Defendants transferred title to the named plaintiffs and solicited purchases, ¶258; (2) identifies which securities were bought by which Plaintiffs, and (3) lists all the Offerings involved in this litigation and the Underwriters who sold in each. *See* App. A, B. Further detail is not required under Rule 8.

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[25] *See In re Westinghouse Sec. Litig*., 90 F.3d 696, 718 n.22 (3d Cir. 1996); *In re Scottish Re Group Sec. Litig*., 524 F. Supp. 2d 370, 400 (S.D.N.Y. 2007); *Schoenhaut v. Am. Sensors*, 986 F. Supp. 785, 790 n.6 (S.D.N.Y. 1997); *DDi Corp*., 2005 WL 3090882, at *19.

[26] *See Capri v. Murphy*, 856 F.2d 473, 478-79 (2d Cir. 1988); *Akerman v. Oryx Commc'ns, Inc*., 609 F. Supp. 363, 374 (S.D.N.Y. 1984) (addressing the issue after "extensive discovery"); *Dartley v. ErgoBilt Inc*., No. Civ. A. 398CV1442M, 2001 WL 313964, at *2 (N.D. Tex. Mar. 29, 2001); *In re Enron Corp. Sec., Derivative & "ERISA" Litig*., No. MDL-1446, 2004 WL 405886, at *24 (S.D. Tex. Feb. 25, 2004).

[27] *See Griffin v. PaineWebber, Inc*., No. 99 CIV. 2292 (VM), 2001 WL 740764, at *1 (S.D.N.Y. June 29, 2001); *Jackson v. First Federal Sav., F.A*., 709 F. Supp. 863, 883 (E.D. Ark. 1988); *In re Activision Sec. Litig*., 621 F. Supp. 415, 426 (N.D. Cal. 1985). Notably, the *Activision* court certified a defendant class that included defendants who had sold to absent class members, but had not sold securities to the particular named plaintiffs. *See id.,* 621 F. Supp. at 432.

[28] *See Morin v. Trupin*, 747 F. Supp. 1051, 1063-64 (S.D.N.Y. 1990); *Klein v. Computer Devices, Inc*., 602 F. Supp. 837, 841-42 (S.D.N.Y. 1985).

[29] *See Dartley,* 2001 WL 313964, at *2; *In re WebSecure Sec. Litig*., 182 F.R.D. 364, 368-69 (D. Mass. 1998).

Defendants also contend that the Section 12 claims of certain named plaintiffs must be dismissed because, in Defendants' view, they purchased in the aftermarket. Def. Br. 15-16. Cases cited by Defendants confirm that at the pleading stage, plaintiffs need only allege that they purchased their securities in or traceable to the Offerings, as Plaintiffs have done here. ¶258.[30] Moreover, even if these few named Plaintiffs lack standing to sue under Section 12 on their own behalf, the remaining named plaintiffs' ability to represent absent class members who purchased those securities should by gauged by the standards of Rule 23.

V. THE COMPLAINT SUFFICIENTLY ALLEGES SECURITIES ACT CLAIMS

Securities Act claims are governed by the notice pleading standard set forth in Fed. R. Civ. P. 8(a). *In re NovaGold, Inc. Sec. Litig.*, No. 08 Civ. 7041 (DLC), 2009 WL 1575220, at *14-15 (S.D.N.Y. June 5, 2009). Under *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955 (2007), a pleader must "amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim plausible." A claim has facial plausibility "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, __ U.S. __, 129 S. Ct. 1937, 1949 (2009). The court must "accept[] all factual allegations in the complaint," *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007), and "draw on its judicial experience and common sense." *Iqbal*, 129 S. Ct. at 1950. Furthermore, on a Rule 12(b)(6) motion, "[t]he court is to draw all reasonable inferences in favor of the plaintiff." *Kassner v. 2nd Avenue Delicatessen, Inc.*, 496 F.3d 229, 237 (2d Cir. 2007).

Section 11 "places a relatively minimal [pleading] burden on a plaintiff." *Huddleston,*

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[30] *See*, *e.g.*, *In re Suprema Specialties, Inc. Sec. Litig*., 438 F.3d 256, 274 n.7 (3d Cir. 2006) (citing *Shapiro v. UJB Fin. Corp*., 964 F.2d 272, 287 n.16 (3d Cir. 1992); *Gargiulo v. Demartino*, 527 F. Supp. 2d 384, 392 (E.D. Pa. 2007); *Caiafa v. Sea Containers Ltd*., 525 F. Supp. 2d 398, 407-08 (S.D.N.Y. 2007); *In re Sterling Foster & Co*., 222 F. Supp. 2d 216, 246 (E.D.N.Y. 2002).

459 U.S. at 382, 103 S. Ct. at 687. The plaintiff need only "allege that he purchased the security and that the registration statement contains false or misleading statements concerning a material fact."[31] Here, Plaintiffs' allegations plainly satisfy Rule 8, and Defendants do not contend otherwise. Instead, they argue that the Securities Act claims must be evaluated under the more rigorous Fed. R. Civ. P. 9(b) pleading standards, because, according to Defendants, the claims "sound in fraud." Def. Br. 17. This boilerplate argument, routinely raised by defendants in Securities Act cases, has no application here.

A. <u>Rule 9(b) Does Not Apply To Plaintiffs' Securities Act Claims</u>

1. Plaintiffs' Securities Act Claims Do Not <u>Rely On Any Allegations Of Fraudulent Conduct</u>

Contrary to Defendants' argument, Plaintiffs' Securities Act claims do not "brim" with words associated with fraud. *See* Def. Br. 18, (citing *OSRecovery, Inc. v. One Group Int'l, Inc.*, 354 F. Supp. 2d 357, 380 n.165 (S.D.N.Y. 2005)). In the Securities Act portion of the Complaint, Plaintiffs expressly allege that Defendants acted negligently and failed to conduct reasonable investigations in connection with the Offerings, *see*, *e.g.*, ¶¶12, 92, 245, 249, 260, and do not include any allegations that Defendants acted with scienter. "[I]t is the intent requirement that distinguishes an action for securities fraud from an action for negligence . . . ." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1126 (7th Cir. 1990). As this Court stated at the conference on January 8, 2009, to sound in fraud a claim must include an allegation that a statement "was false or misleading ***and*** that the proponent of it knew it was at the time or acted in reckless disregard of its truth. That's where the line is between 9(b) and not 9(b)." Transcript of

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[31] *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 201 (E.D.N.Y. 2000) (internal citation omitted); *see In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610 (JFK), 2005 WL 2088406, at *1 (S.D.N.Y. Aug. 30, 2005); *In re WorldCom,* 294 F. Supp. 2d at 407-08 (finding it sufficient for purposes of pleading a Section 11 claim for plaintiff to allege that "'material facts have been omitted' from a registration statement or 'presented in such a way as to obscure or distort their significance'").

January 8, 2009 hearing ("Tr. 1/08/09") at 24-25 (emphasis added).

Defendants contend that because Plaintiffs allege that information was "concealed" or "misrepresent[ed]," their claims sound in fraud. Def. Br. 18-19. But these allegations mirror the statutory language of the Securities Act.[32] At the January 8 hearing, as this Court observed, "[s]aying it's false and misleading doesn't mean it sounds in fraud." Tr. 1/08/09 at 24; *see also id*. at 25 ("Alleging that a document is false and misleading does not, in my court, sound in fraud"). Other courts agree.[33] Nor is this case anything like *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004), in which the Second Circuit held that Rule 9(b) would apply to Securities Act claims that sound in fraud. There, the Securities Act claims expressly incorporated paragraphs containing allegations of fraud. *See Rombach v. Chang*, No. 00 Civ. 0958 (SJ), 2002 WL 1396986, at *4 (E.D.N.Y. June 7, 2002), *aff'd*, 355 F.3d 164 (2d Cir. 2004). Moreover, the Securities Act claims in *Rombach* did "not assert any claim of negligence," *Rombach*, 2002 WL 1396986, at *4, and did not provide "any other basis for the claims" other than fraud. *Rombach*, 355 F.3d at 172. In this case, by contrast, the Securities Act claims in the Complaint – which are set forth in a section of the Complaint completely separate from the Exchange Act claims – clearly explain that they are based on Defendants' negligence and failure to conduct reasonable investigations.[34] Indeed, a large number of the Defendants are not charged at all with Exchange Act violations. *In re Parmalat Sec. Litig.*, 477 F. Supp. 2d 602, 610 n.57 (S.D.N.Y. 2007), cited

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[32] *See* 15 U.S.C. § 77k(a) (providing a claim where a registration statement "contained an untrue statement of a material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading.").

[33] *See*, *e.g.*, *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 631-32 (S.D.N.Y. 2007); *In re WRT Energy Sec. Litig*., No. 96 Civ. 3610 (JFK), 2005 WL 323729, at *6 (S.D.N.Y. Feb. 9, 2005); *In re Prestige Brands Holding, Inc*., No. 05 Civ. 06924, 2006 WL 2147719, at *8 (S.D.N.Y. July 10, 2006) ("A representation of fact in a prospectus may be material, false and misleading without regard to the motive or intent of the author.").

[34] *See In re NovaGold*, 2009 WL 1575220, at *14-15 (Rule 9(b) does not apply where Securities Act claims are in a separate section of the complaint, prefaced by a statement that they sound in negligence and charge negligent conduct). The fact that the Complaint pleads distinct Securities Act and Exchange Act claims in separate sections of the Complaint further supports a finding that the sounds-in-fraud doctrine does not apply here. *See, e.g., In re Refco*, 503 F. Supp. 2d at 632.

by defendants, is also distinguishable. In *Parmalat,* this Court made no determination of whether Rule 9(b) applies to Securities Act claims; instead, the issue was whether the *Wagoner* doctrine barred claims against certain third party professionals.[35]

At minimum, if the Court finds that certain of Plaintiffs' Securities Act allegations against the Executive Defendants sound in fraud, the same rationale should not be extended to the Underwriter and Director Defendants because Plaintiffs have expressly pled only negligence claims against these Defendants.[36]

2. Plaintiffs Adequately Plead Allegations Based On Confidential Sources

Defendants' argument that this Court must disregard allegations based on information provided by confidential sources depends entirely on their contention that Plaintiffs' Section 11 claims sound in fraud. Every one of the cases cited by Defendants is a Rule 10b-5 fraud case,[37] and in the one cited case that involved both Section 10(b) and Section 11 claims, *Chubb*, 394 F.3d 126, the court first found that all claims sounded in fraud before analyzing the confidential sources. Defendants cite no case holding that allegations as to confidential sources in Securities Act claims that do ***not*** sound in fraud must be pleaded with particularity. Because Plaintiffs'

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[35] The *Wagoner* doctrine "derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation." *Wight v. BankAmerica Corp*., 219 F.3d 79, 86 (2d Cir. 2000).

[36] *See Rombach*, 355 F.3d at 178 (finding allegations that "each of the Underwriter Defendants owed to [investors] . . . the duty to make a reasonable and diligent investigation of the statements contained in the Prospectus," sounded in negligence); *see also Suprema*, 438 F.3d at 273 ("As to its claims against the Outside Directors and Underwriters in particular, there are no allegations of fraud or reckless misconduct whatsoever in any count of [Plaintiffs' Complaint]; ordinary negligence is all that is pled"); *NovaGold*, 2009 WL 1575220, at *5, (finding that the Securities Act allegations did not sound in fraud because "[e]ach group of defendants had different incentives in the secondary offering, and each served a different function. The complaint could not uniformly plead fraudulent conduct against all defendants given these distinctions; more specific conduct would need to be alleged.").

[37] *Higginbotham v. Baxter Int'l Inc*., 495 F.3d 753 (7th Cir. 2007); *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp*., 394 F.3d 126 (3d Cir. 2004); *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000); *In re Elan Corp. Sec. Litig*., 543 F. Supp. 2d 187 (S.D.N.Y. 2008); *In re Am. Express Co. Sec. Litig*., No. 02 Civ. 5533 (WHP), 2008 WL 4501928 (S.D.N.Y. Sept. 26, 2008); *In re Bausch & Lomb, Inc. Sec. Litig*., 592 F. Supp. 2d 323 (W.D.N.Y. 2008); *Malin v. XL Capital Ltd*., 499 F. Supp. 2d 117 (D. Conn. 2007), *aff'd*, 312 Fed. Appx. 400 (2d. Cir. 2009); *Freed v. Universal Health Servs., Inc*., No. Civ. A 04-1233, 2005 WL 1030195 (E.D. Pa. May 3, 2005).

Securities Act claims do not sound in fraud, none of Defendants' attacks on the allegations attributable to the confidential sources has any merit.

Even if Rule 9(b) applied, the Complaint describes the confidential sources "with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged." *Novak v. Kasaks*, 216 F.3d at 314. Under this standard, courts test the information provided by the source against the complaint's description of the source. If it is plausible that a person meeting the description would possess the information supplied, then the source has been sufficiently described.[38]

Plaintiffs detail the basis for each confidential source's knowledge, including specific job titles, the divisions in which they worked, and the dates of employment. The information provided by each source is tied directly to the source's position with the Company and period of service, and Defendants have no basis to suggest that CW2, CW3 or any other confidential source is unreliable or does not possess the information asserted.[39] Thus, Plaintiffs have alleged ample information supporting the confidential sources' personal knowledge of the facts they

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[38] *See, e.g., Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982 (9th Cir. 2008) (sources sufficiently described because it was "plausible that 'engineers or technical editors' would know, or could reasonably deduce that the company had suffered [certain problems]").

[39] *See, e.g.,* ¶98 (describing CW14, "an underwriter in Aurora's correspondent division from late 2006 until April 2008"); ¶99 (describing CW15, "a Credit Policy Coordinator at Aurora from 2004 until the beginning of 2008"; and CW2 "a Vice President of Credit Policy at Aurora from 2005 until January 2008"); ¶100 (describing CW16, "a Vice President of Credit Policy for Aurora from late 2004 to the fall of 2007"); ¶103 (describing CW3, "a Vice President of Aurora from 2002 through the fall of 2007" and CW4, "who worked for Aurora from the fall of 2005 until April 2008 as a Transactions Analyst"); ¶104 (describing CW5 and CW22, "investigators in Aurora's Special Investigations Unit from 2005 until 2008"; CW18, a mortgage fraud analyst for Aurora from 2007 to January 2008"; and CW11, "a High Risk Specialist/Mortgage Fraud Investigator for Aurora from late 2004 to March 2008); ¶106 (describing CW6, "BNC's COO from January 2006 through 2007"); ¶111 (describing CW9, "a contract administrator and repurchase coordinator at Aurora from the fall of 2004 to the fall of 2006"); ¶114 (describing CW12, "a managing director in Lehman's contract finance department from 1987 to early 2008"); ¶116 (describing CW10, "a due diligence underwriter who worked almost exclusively with repurchase requests from loan investors while employed at BNC from mid 2005 to October 2007").

provided.[40] While the Defendants cite cases outside this Circuit for the proposition that post-*Tellabs*, allegations from confidential sources should be somehow discounted, post-*Tellabs* cases in this Circuit continue to consider statements by confidential sources without applying any such discount.[41]

Finally, Defendants' argument that none of the confidential sources "makes particularized allegations that establish any Defendant acted fraudulently" or "asserts that any particular Defendant was aware of any material undisclosed facts in Lehman's Offering Documents" is a red herring. Def. Br. 23. Even if the Securities Act claims sounded in fraud, which they do not, application of Rule 9(b) would merely mean that the elements of those claims would need to be pleaded with particularity; it would not require the pleading of new elements – such as scienter – that are not required to state a Securities Act claim. *See Friedman's*, 385 F. Supp. 2d at 1367 ("[W]hile Rule 9(b) requires the circumstances of the fraud be pleaded with particularity, it does not require scienter to plead Section 11 and 12 claims") (citing *In re HealthSouth Corp. Sec. Litig.*, No. CV-98-J-2634-S, 2000 WL 34211319, at *19 (N.D. Ala. Dec. 13, 2000)); *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 503 (S.D.N.Y. 2004) (even under Rule 9(b), plaintiffs need only plead with particularity that the registration statement was false).

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[40] Defendants cite *Higginbotham*, 495 F.3d 753, for the proposition that confidential sources must be distrusted because they may "be lying" or "may not even exist." Def. Br. 21, n.23. *Higginbotham's* analysis is in direct contrast to the Supreme Court's instruction in *Tellabs* that allegations in a complaint must be taken as true. *Tellabs*, 551 U.S. at 323, 127 S. Ct. at 2509. Indeed, just six months after *Higginbotham* was decided, the Seventh Circuit retreated from that position and adopted the *Novak* standard. *See Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 712 (7th Cir. 2008) ("*Tellabs II*"); *see also N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc.*, 537 F.3d 35, 51-52 (1st Cir. 2008) (*Tellabs* did not change the standard for evaluating confidential sources). Courts within the Second Circuit continue to apply the *Novak* standard.

[41] *See*, *e.g.*, *In re PXRE Group, Ltd. Sec. Litig.*, 600 F. Supp. 2d 510, 526 n.18 (S.D.N.Y. 2009) (declining to follow the approach of discounting allegations from confidential sources adopted by the Seventh Circuit in *Higginbotham,* 495 F.3d at 757) (citations omitted); *City of Brockton Ret. Sys. v. Shaw Group, Inc.*, 540 F. Supp. 2d 464, 474 (S.D.N.Y. 2008); *Hall v. The Children's Place Retail Stores, Inc.*, No. 07 Civ. 8252, 2008 WL 2791526, at *9-10 (S.D.N.Y. July 18, 2008); *In re Xethanol Corp. Sec. Litig.*, No. 06 Civ. 10234 (HB), 2007 WL 2572088, at *3 n.3 (S.D.N.Y. Sept. 7, 2007).

Even if Rule 9(b) is applied to any of the Securities Act claims, the Complaint still easily satisfies the Rule's particularity requirements. Rule 9(b) requires only that the Complaint "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) states where and when the statements were made, and (4) explain why the statements were fraudulent." *Novak*, 216 F.3d at 306; *Suprema*, 438 F.3d at 277. The Complaint satisfies this standard with respect to each type of alleged material omission and misstatement.

VI. THE COMPLAINT ADEQUATELY ALLEGES THAT THE OFFERING DOCUMENTS CONTAINED MATERIALLY UNTRUE STATEMENTS AND MATERIAL OMISSIONS

Section 11 forbids registrants from making misstatements in their registration statements and requires such information "as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77k. Additionally, Regulation S-X, 17 C.F.R. § 210.4-01, in conjunction with SFAS 107, *Disclosures About Fair Value of Financial Instruments*, as amended by SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (together, "SFAS 107"), requires disclosure of "significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties." Further, Item 303 of Regulation S-K, 17 C.F.R. § 229.303(a)(1), 229.303(2)(ii), 229.303(3)(i)-(ii) ("Item 303"), requires disclosure of (1) known trends, events or uncertainties that are reasonably likely to affect the registrant's liquidity; (2) trends in capital resources; or (3) unusual events that the registrant reasonably expects to affect net sales, revenues or income from continuing operations. These regulations impose an independent "duty to disclose upon those involved in an offering," the violation of which satisfies the element of falsity in a claim under the securities laws. *See, e.g.*, *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 70-71 (2d Cir. 2001); *see also Gallagher v. Abbott Labs.*, 269 F.3d 806, 808-809 (7th Cir. 2001); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202-03 (1st Cir.

1996). As set forth below, the Offering Documents violated each of these disclosure requirements.

A. The Offering Documents Failed To Disclose Lehman's Exposure To Subprime And Alt-A Mortgages

The Securities Act "was designed to provide investors with full disclosure of material information concerning public offerings." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S. Ct. 1375, 1382 (1976); *see also Pinter v. Dahl*, 486 U.S. 622, 646, 108 S. Ct. 2063, 2078 (1988) (the very purpose of the Securities Act is "to promote full and fair disclosure of information to the public in the sales of securities"). Indeed, "the primary innovation of the 1933 Act was the creation of federal duties – for the most part, registration and disclosure obligations – in connection with public offerings." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 571, 115 S. Ct. 1061, 1063 (1995).

The Offering Documents did not contain anything resembling a "full disclosure of material information." In 2006 and 2007, Lehman originated and underwrote $60 billion and $47 billion in residential mortgages, respectively, and securitized $145 billion and $100 billion in RMBSs.[42] At its 2006 fiscal year-end, Lehman held approximately $57.7 billion in mortgages and mortgage-backed securities on its balance sheet, a material exposure that increased to over $88 billion by the 2007 third quarter.[43] As a leading originator and underwriter of residential mortgages and RMBSs, information concerning Lehman's "underwriting practices would be among the most important information looked to by investors." *In re Dynex Capital, Inc. Sec. Litig.*, No. 05 Civ. 1897 (HB), 2006 WL 314524, at *10 (S.D.N.Y. Feb. 10, 2006), *rev'd on other grounds sub. nom., Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531

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[42] *See* 2007 Form 10-K at 104, 111 (Hou Ex. 8).

[43] S*ee* 2006 Form 10-K at 90 (Hou Ex. 3); 2007 Form 3Q Rep. at 17 (Hou Ex. 7).

F.3d 190 (2d Cir. 2008).[44] Nonetheless, and despite SFAS 107, which requires companies to disclose "***all*** significant concentrations of credit risk from ***all*** financial instruments" (emphasis added), the Offering Documents failed to disclose Lehman's true exposure to extremely high-risk subprime and Alt-A mortgages that Lehman originated and that remained on Lehman's balance sheet. *See*, *e.g.*, ¶120. Because Lehman failed to disclose its exposure to high-risk subprime and Alt-A loans, the Offering Documents also failed to provide material information on any known trends regarding these particularly risky assets, thereby running afoul of Item 303, which requires companies to disclose known trends that either have affected their business or could reasonably be expected to affect their operations. ¶176. *See In re Initial Pub. Offering Sec. Litig*., 358 F. Supp. 2d 189, 211 (S.D.N.Y. 2004) ("An omission of fact 'required to be stated' under Item 303 will generally produce liability under section 11.").

Ignoring the dictates of SFAS 107 and Item 303, the 2006 Form 10-K reported merely that Lehman held $57.7 billion in "mortgages and mortgage-backed positions" at 2006 year end, but failed to disclose the extent to which these positions were concentrated in subprime or Alt-A loans, residential or commercial loans, or whole loans or mortgage-backed securities.[45] Similarly, in reports filed with the SEC during the first three quarters of 2007, Lehman reported holding $72.9 billion, $79.6 billion, and $88 billion, respectively, in "mortgages and mortgage-backed positions," but again omitted any material information about the extent to which these assets were concentrated in subprime and Alt-A loans, even though the U.S. housing market was

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[44] *See also Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc*., No. 05 Civ. 1898 (SAS), 2005 WL 2148919, at *12 (S.D.N.Y. Sept. 6, 2005) (misrepresentations regarding company's underwriting practices sufficient to state a claim); *Atlas v. Accredited Home Lenders Holding Co*., 556 F. Supp. 2d 1142, 1154-55 (S.D. Cal. 2008) (plaintiffs alleged actionable false and misleading statements regarding underwriting practices); *In re PMA Capital Corp. Sec. Litig*., No. 03-6121, 2005 WL 1806503, at *10 (E.D. Pa. July 27, 2005) (misrepresentations regarding a company's underwriting practices are actionable); *Ong*, 388 F. Supp. at 898-99 (misrepresentations regarding underwriting standards along with other misrepresentations regarding portfolio quality and loan loss reserve was sufficient to withstand dismissal).

[45] *See* ¶¶94, 170; *see also* 2006 Form 10-K at 65, 90 (Hou Ex. 3).

then in the midst of an unprecedented collapse characterized by steeply rising delinquencies and defaults by subprime and Alt-A borrowers.[46] Defendants also failed to disclose in the Offering Documents that there was a trend of increased repurchase requests due to defaults by borrowers who could not even make the first or second mortgage payments, and a trend of decreased ability by Lehman to qualify its securitizations as sales rather than financings, indicating that Lehman's mortgage related assets had becoming increasingly illiquid and had deteriorated in value.[47] Defendants' failure to include this information, in the midst of obvious signs of market turmoil, made it impossible for investors to assess these "trends" or their likely impact on Lehman's business, in violation of Item 303.

It was not until January 29, 2008, when Lehman filed its 2007 Form 10-K that the Offering Documents gave any hints of Lehman's true subprime exposure.[48] Specifically, the Company reported for the first time that Lehman's $57.7 billion of "mortgages and mortgage-backed positions" at 2006 year end included $18.7 billion of residential whole loans and $7.9 billion of residential asset-backed securities, that $6.84 billion of this exposure consisted of subprime loans (in whole loans and retained interest in securitizations), and that Lehman also held $5.27 billion in subprime exposure at 2007 year end.[49] Even this belated report was itself inadequate because it revealed nothing about Lehman's high-risk subprime and Alt-A lending practices, discussed *infra*, and it failed to break out the amount of Lehman's exposure to Alt-A mortgages, even though these mortgages had many of the same characteristics as Lehman's

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[46] *See* ¶¶185, 190; *see also* 2007 1Q Rep. at 15, 2007; 2Q Rep. at 17, 2007; 3Q Rep. at 17 (Hou Ex. 4, 5, 7).

[47] *See* ¶¶109-116; 144.

[48] While Defendant O'Meara revealed for the first time during the Company's 2007 third quarter earnings conference call that Lehman possessed approximately $6.3 billion in subprime exposure at the end of the 2007 third quarter, that disclosure did not appear within the Offering Documents.

[49] *See* 2007 Form 10-K at 104-05 (Hou Ex. 8).

subprime exposure. In fact, the word "Alt-A" did not appear within the 2007 Form 10-K, even though Lehman had approximately $12.7 billion in exposure to "Alt-A/Prime" at the 2007 third quarter, *see* 2007 3Q Rep. at 56 (Hou Ex. 7), and $13.6 billion in Alt-A exposure by the first quarter of 2008. Defendants' meager report of subprime exposure – while omitting any mention of the billions of subprime-like Alt-A exposure – violated Item 303 and materially misled investors by understating Lehman's exposure to these "toxic" assets, particularly during the worst housing crisis in U.S. history.

Lehman's disclosures for the first quarter of 2008 were similarly misleading. The Company reported holding $11.9 billion in residential whole loans and $18.2 billion in residential asset-backed securities, of which $4.0 billion consisted of subprime loans.[50] However, when breaking out the remainder of its residential mortgage exposure, Lehman lumped its Alt-A and prime loan exposure together into a single line item, reporting that it possessed $14.6 billion of "Alt-A/Prime" mortgage assets, and thereby failing to disclose that over $13.6 billion of the portfolio consisted of high-risk Alt-A mortgages with many subprime characteristics. *Id*. at 56; *see also* ¶119. Defendants' description of a segment that was over 93% Alt-A as "Alt-A/Prime," as well as their failure to disclose that Lehman's Alt-A assets were akin to subprime and were similarly impaired, materially misled reasonable investors about Lehman's true Alt-A exposure. In fact, Defendants are unable to cite to any statement in any Offering Document that would have fully apprised investors of the true risks associated with Lehman's multibillion exposure to Alt-A mortgage-related assets. *See Ong,* 388 F. Supp. 2d at 894 (disclosure of two loan segments as a single, combined portfolio found to mislead investors when the segments had dissimilar characteristics).

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[50] *See* 2008 1Q Rep. at 20 (Hou Ex. 9).

Thus, Defendants' contention that they were under no legal duty to break out the specific risk concentrations posed by the subprime and Alt-A exposure in Lehman's mortgage-related portfolio, despite the worsening U.S. housing crisis, is irrelevant. Def. Br. 38. Where, as here, Defendants made certain limited disclosures but omitted other material facts necessary to render their disclosures not false or misleading, they had a duty to disclose those facts under the Securities Act. *See Caiola*, 295 F.3d at 331 (once defendant chooses to discuss an issue, "it had a duty to be both accurate and complete.").

To support their contention that they were not required to disclose their Alt-A exposure, Defendants resort to an SEC "Sample Letter" dated March 27, 2008, a document outside the Complaint and not appropriately considered on a motion to dismiss, which Defendants misinterpret because it says nothing about disclosing risk concentrations or known trends and does nothing to insulate Defendants from the disclosure requirements of SFAS 107, as amended by SFAS 133, and Item 303.[51] Rather, the SEC Sample Letter was directed at disclosure requirements related to providing further transparency in the proper valuation of assets under SFAS 157. (*See id.,* Hou Ex. 33, "In this letter, we highlight some disclosure matters relating to SFAS 157 that you may wish to consider as you prepare your Form 10-Q."). Even if this document is considered, it does nothing to negate the fact that Defendants misled investors by failing to disclose the trend of rising repurchase requests and decreasing ability to qualify Lehman's securitizations as sales rather than financings throughout the Offerings Period, and by mischaracterizing an overwhelmingly Alt-A segment as "Alt-A/Prime." *Caiola*, 295 F.3d at 331.

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[51] In doing so, Defendants are asking this Court to resolve a factual dispute, namely, whether Lehman's disclosures were adequate. The Sample Letter was not attached to or incorporated by reference in the Complaint, and it is not integral to Plaintiffs' allegations. Therefore, consistent with *ATSI Commc'ns Inc*., 493 F.3d at 98, the Court should strike this document.

B. The Offering Documents Failed To Disclose The True Nature Of Lehman's Mortgage Origination And Underwriting Practices

Notwithstanding the fact that GAAP required the Offering Documents to disclose Lehman's "significant concentrations of credit risk arising from all financial instruments," *see* SFAS 107, the Offering Documents failed to disclose that Lehman had adopted extraordinarily risky subprime and Alt-A lending programs throughout the Offerings Period, including "no documentation loans" and "stated income loans," which resulted in an amplified risk of elevated levels of borrower default – a risk that materialized as the U.S. housing markets collapsed.

Ten confidential sources with first-hand knowledge of Lehman's high-risk lending programs, corroborated by internal documents identified in the Complaint, evidence how the Company abandoned lending standards so that inherently risky loan programs became commonplace. ¶¶96-108. These statements also confirm that the Offering Documents provided materially false and misleading information about the quality of Lehman's residential mortgage-related assets. The fact that several of the witnesses who provided this information were employed at Lehman's "non-New York subsidiaries" that were closed or downsized before the end of the Offerings Period does nothing to undermine their credibility, as Defendants contend.[52] Def. Br. 22-23. The subsidiaries, BNC and Aurora, were wholly-owned by Lehman and many of the confidential sources who worked at these subsidiaries were directly involved in Lehman's high-risk lending practices. Consequently, the confidential sources are reliable.

Defendants' contention that Plaintiffs' confidential sources are unreliable because eight sources make allegations that pre-date the Class Period and another three do not reveal the

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[52] *See*, *e.g*., *Tellabs II*, 513 F.3d at 711-12 (on remand from the Supreme Court, holding that the confidential sources referred to in the complaint supported allegations of falsity); *see also In re Scottish Re Group*, 524 F. Supp. 2d at 392-93 (finding that unnamed former employees provided an adequate basis for finding defendants' statements were false post-*Tellabs*, where the complaint identified positions occupied by the former employees that "would have allowed for relevant hands-on experience in various parts of the Company"); *In re Xethanol Corp.,* 2007 WL 2572088, at *3 n.3.

relevant time period for their allegations, should also be rejected. Defendants overlook specific references in the Complaint to Offerings Period activity involving these sources.[53]

The first quarter 2008 Form 10-Q stated that Lehman "generally defines U.S. Alt-A residential mortgage loans as those associated with borrowers who may have creditworthiness of 'prime' quality." (Hou Ex. 9, p.56.) To the contrary, CW3, Vice President of Aurora from 2002 through the fall of 2007, responsible for buying bulk pools of loans form correspondent lenders, and CW14, an underwriter in Aurora's correspondent division from late 2006 until April 2008, characterized over half of Aurora's Alt-A mortgage originations by early 2007 as having been "high risk" and better described as "Alt-B." ¶¶98-101, 103. CW15, a credit policy coordinator at Aurora from 2004 until 2008, described Aurora's Alt-A loans as being more comparable to subprime loans issued with lax restrictions and minimal documentation requirements – even borrowers who had a FICO score in the 500s. ¶99. Furthermore, CW14 said that up to 80% of the mortgages s/he underwrote were "stated income loans" for which Lehman did not verify the borrower's ability to repay the mortgage. ¶98. CW15 and CW2 similarly indicated that Lehman underwrote "stated income loans" for borrowers with FICO scores as low as 560 or 580 and who had blemished credit histories, including recent bankruptcies. ¶¶99, 100.[54]

Documents also show that Aurora's guidelines allowed for loans for 100% of the value of a property to borrowers with FICO scores in the low 600s, and loans for 95% of the property

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[53] *See* ¶110 (CW15 referring to conduct "[d]uring the last half of 2007"); ¶106 (CW6, BNC's COO, describing BNC's high-risk lending practices in originating subprime loans leading to first-payment defaults "throughout 2006 and into 2007"); ¶112 (CW4 stating that Aurora started to see loans default in the beginning of 2007 and "[i]t seemed to just get worse after that"); ¶331 (CW11 stating that in the six to eight months preceding his March 2008 departure from Aurora, "Lehman demanded that Aurora purchase a large pool of loans from Lehman."). Each of the witnesses describes activity that "started" or "began" prior to the Offerings Period, and the Complaint is replete with allegations that these problems continued into the Offerings Period.

[54] Similarly, CW2, Vice President of Credit Policy at Aurora from 2005 until January 2008, explained that Aurora started producing "Alt-B" products in late 2005, accepting FICO scores as low as 540, and that Lehman would underwrite stated income loans for borrowers with FICO scores as low as 560 and blemished credit histories or recent bankruptcies. ¶99-100.

value with no documentation and FICO scores of 620. ¶101. These "no money down" loans carried a heightened risk because the borrower was dependent on increasing home values to build equity in the home.

The Offering Documents failed to disclose these high-risk lending practices, even though this information would have been important to allow investors to assess current trends and concentrations of risk. Nor did the Offering Documents disclose (1) the rising tide of mortgage defaults that severely jeopardized the value of those assets (¶¶105-06, 109-114, 145); (2) the increasing impairment of the assets from an unprecedented tumult in the housing market (¶¶107, 125-130, 142-44, 147-48); (3) Lehman's balance sheet exposure to more than $89.1 billion in mortgages and mortgage-related assets by the 2007 year end (¶¶94, 118, 197); and (4) that these assets were highly leveraged, such that "a mere 3.3% drop in the value of assets wipes out the entire value of equity and makes the Company insolvent." ¶¶5, 162.

Furthermore, the Offering Documents misled investors by touting the adequacy of Lehman's disclosure controls and "comprehensive" risk management procedures, including that Lehman "continue[d] to actively risk manage [its] mortgage related positions" through "dynamic" risk management strategies, and the "effectiveness" of the Company's hedging strategies.[55] Defendant Lowitt admitted on September 10, 2008, that there was no "direct hedge for Alt-A" mortgage assets (*see* Sept. 10, 2008 earnings conference call transcript, Kessler Dec. C, p.8), directly contradicting statements in the Offering Documents. Courts regularly find similar statements regarding a company's risk management policies actionable where, as here, a company elected to make certain disclosures, but omitted other material information about such

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[55] ¶¶156, 185, 224, 226. *See also* 2006 Form 10-K at 57, 60, 93 (Hou Ex. 3); 1Q07 Form 10-Q at 66, 71 (Hou Ex. 4); 2Q07 Form 10-Q at 53, 70 (Hou Ex. 5); 3Q07 Form 10-Q at 73, 78 (Hou Ex. 7); 2007 10-K at 69 (Hou Ex. 8); 1Q08 Form 10-Q at 77 (Hou Ex. 9); 2Q08 Form 10-Q at 93 (Hou Ex. 10).

policies.[56] By putting the topic of Lehman's hedges and risk management into play, Defendants were obligated to ensure that all material information regarding Lehman's risk management activities was fully disclosed, including, *inter alia*: (1) the fact that Lehman had no direct hedge for Alt-A; and (2) that its hedging activities could actually increase losses on mortgage-related assets, as opposed to mitigate them. As a result of these false statements and omissions, investors suffered when Lehman's "economic hedges" *increased* the Company's losses by an additional $700 million dollars in the second quarter of 2008. ¶158.

C. Lehman's Financial Statements Violated GAAP

Financial statements that violate GAAP are presumed to be false and misleading. 17 C.F.R. § 210.4-01(a)(1).[57] The Complaint alleges that Lehman's financial statements materially overstated the value of Lehman's residential and commercial mortgage-related exposure with reliable and mutually-corroborating evidence, including:

a. According to former employees, the Company failed to take timely, necessary, and material write-downs as its mortgage-related positions and real estate holdings became impaired (¶¶130-32);

b. Lehman failed to write down its assets despite movements of the ABX and CMBX indices, two observable market inputs under SFAS 157 that indicated unmistakably sharp increases in the risk of default for mortgage-related assets (¶¶126-27, 142, 149);

c. Lehman experienced unsustainably high default rates for entire vintages of its mortgages due to dangerous lending practices and lax underwriting standards, disrupting Lehman's lucrative mortgage-securitization operations (¶¶96-116);

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[56] *See, e.g., Caiola*, 295 F.3d at 330-31 ("Once Citibank chose to discuss its hedging strategy, it had a duty to be both accurate and complete") (citing *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 267-68 (6th Cir. 1998)); *Ackerman v. Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991); *Robbins v. Moore Med. Corp.*, 788 F. Supp. 179, 184 (S.D.N.Y. 1992); *South Ferry LP #2 v. Killinger*, 399 F. Supp. 2d 1121, 1136-38 (W.D. Wash. 2005), *vacated and remanded on other grounds*, 542 F.3d 776 (9th Cir. 2008).

[57] Whether Plaintiffs have stated a claim for GAAP violation is a fact-specific question that cannot be resolved on a motion to dismiss. *SEC v. Caserta*, 75 F. Supp. 2d 79, 90 (E.D.N.Y. 1999).

d. Lehman's write-downs were miniscule compared to the write-downs taken by Lehman's competitors on similar holdings (¶¶147-48); and

e. Internal presentations and actions leading up to, and following, Lehman's September 15, 2008 bankruptcy indicated that Lehman's commercial real estate and mortgage-related holdings were materially overvalued (¶¶137-39).

These allegations plainly satisfy the "plausibility" pleading standard set forth in *Twombly* and *Iqbal*. Plaintiffs further allege that, as a result, the Offering Documents left investors unable to evaluate the true risks associated with the mortgage-related assets on Lehman's balance sheet and the Company's full exposure to the deteriorating residential and commercial mortgage and real estate markets. With respect to the Securities Act claims, Plaintiffs need allege nothing further at the pleading stage.

Defendants' contention that Plaintiffs' allegations lack "any quantification or detail" regarding the appropriate level of write-downs is without support. Def. Br. 29. Even assuming Rule 9(b) applies, which it does not, Defendants disregard allegations that, by the end of the Offerings Period, Lehman's commercial portfolio was overvalued by at least 35%, or $12 billion. *See* ¶¶137-39. Defendants also fail to address allegations that Lehman's 3% gross write-down on its commercial mortgage assets during the first quarter of 2008 was three times less than the 10% decline in the relevant benchmark CMBX index. ¶133. Likewise, Plaintiffs set forth that, beginning with the Company's 2006 Form 10-K, Lehman's mortgage-related positions were materially overvalued (*see* ¶170), thus discrediting Defendants' suggestion that the Complaint does not allege when Lehman should have recognized larger write-downs. *See* Def. Br. 26.

1. GAAP Required Lehman To Report Its <u>Mortgage And Mortgage-Related Assets At Fair Value</u>

Lehman represented in its quarterly and annual filings that, in accordance with SFAS No. 115, it measured its "Financial instruments and other inventory positions owned, excluding Real

estate held for sale, and Financial instruments and other inventory positions sold but not yet purchased at fair value." *See* 2007 Form 10-K at 40 (Hou Ex. 8). The Company accounted for its real estate held for sale "at the lower of its carrying amount or fair value less cost to sell." *Id.* In addition, beginning in the first quarter of 2007, the Company adopted SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), issued by the Financial Accounting Standards Board in September 2006. SFAS 157 was enacted to address "the need for increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements." *See* SFAS 157 at 2 (Kessler Dec. Ex. D).

In addition to defining "fair value" as the amount at which financial instruments could be exchanged in a current transaction between willing parties, SFAS 157 established a three-tiered hierarchy of valuation inputs – Levels I, II and III – that Lehman was required to follow in order to determine the fair value of its assets. *Id.* at ¶22. Level I inputs are derived from the observed market prices of the particular asset being valued – *i.e*., actual sale prices of identical assets. *Id.* at ¶24. Level II inputs under SFAS 157 are derived by correlation, that is, by review of observable market data, such as market transactions in similar (though not identical) assets, or proxies like the ABX and CMBX,[58] which are accepted as Level II inputs for subprime and commercial mortgage-backed securities, respectively. *Id.* at ¶28.[59] Finally, Level III inputs consist of non-observable, internal model-driven inputs. *See id.* at ¶30. Although Level III

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[58] As set forth herein, the ABX and CMBX indices were created by Markit Group and several large financial institutions, including Lehman, to track the pricing of mortgage-backed securities. Specifically, the ABX Index measures the cost of purchasing default insurance in connection with subprime residential mortgage-backed securities, while the CMBX tracks the same costs associated with commercial mortgage-backed securities. Pricing for the ABX and CMBX indices is determined by referencing a basket of 15-20 securities considered to be the most liquid.

[59] The American Institute of Certified Public Accountants' Center for Audit Quality has specifically opined that "the pricing indicated by the ABX credit derivative index for subprime mortgage bonds may be a Level 2 input when used as an input to the valuation of a security backed by subprime mortgage loans." *See* Kessler Ex. E.

contemplates a degree of management judgment, SFAS 157 requires that companies maximize the use of observable market inputs in determining an asset's fair value. Accordingly, during the Offerings Period, Level III inputs were supposed to be used by Lehman only "to the extent that observable inputs [we]re not available." Further, consistent with its emphasis that fair value "is a market-based measurement, not an entity-specific measurement," SFAS 157 also regulates the types of nonobservable inputs that can be considered when valuing Level III assets, stating that the inputs must reflect "assumptions that ***market participants*** would use in pricing the asset or liability." *See id.* Thus, not only was Lehman required to report its mortgage assets at fair value during the Offerings Period, but it was also required to follow SFAS 157 to determine the fair value of those positions.

Defendants urge this Court to hold that SFAS 157 provided Lehman with virtually unrestrained discretion to value its assets as it saw fit. *See* Def. Br. 30 (suggesting that Lehman was merely "set[ting] out" its own "opinion" as to the "valu[e] of its mortgage assets"). Their contention is entirely misplaced and inappropriate at this stage. Defendants' argument that Lehman's financial statements were prepared in accordance with GAAP is an issue of fact that should not be resolved on a motion to dismiss. After a record is developed, the Court will have the benefit of factual and expert evidence concerning the propriety of Lehman's accounting.[60]

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[60] *See, e.g., In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1421 (3d Cir. 1997) (whether accounting practices were consistent with GAAP is a factual question that should not be addressed on a motion to dismiss); *In re RAIT Fin. Trust Sec. Litig.*, 2008 WL 5378164, at *7 (E.D. Pa. Dec. 22, 2008) ("[I]t is a factual question whether [a company's] accounting practices were consistent with GAAP, and thus, we cannot determine this issue on a motion to dismiss"); *Refco*, 503 F. Supp. 2d at 656-57 ("Although the question of whether GAAP has been violated might appear to be a legal determination, the element of what is 'generally accepted' makes this difficult to decide as a matter of law. At the motion to dismiss stage, the plaintiffs' assertion that certain practices were not generally accepted 'must be taken as true.'") (citation omitted); *In re WorldCom Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 494 n.30 (the extent to which financial statements were GAAP compliant is an issue of fact); *Nappier v. PricewaterhouseCoopers, LLP*, 227 F. Supp. 2d 263, 276 (D.N.J. 2002) ("the determination of 'what accounting practices comprise GAAP is a question of fact best addressed through expert testimony and thus inappropriate for resolution on a motion to dismiss.'") (citation omitted).

Although Defendants cite various Rule 10b-5 cases, including *Fraternity Fund Ltd. v. Beacon Hill Asset Management, LLC*, 376 F. Supp. 2d 385 (S.D.N.Y. 2005) and *In re Salomon Analyst Level 3 Litigation*, 373 F. Supp. 2d 248 (S.D.N.Y. 2005), for the proposition that Lehman's valuations were merely "opinions" or "judgments" regarding an asset's fair value, each case was decided prior to the enactment of SFAS 157.[61] As noted above, SFAS 157 formalized the valuation process, implemented a defined hierarchy of inputs that Defendants were required to follow in valuing their securities, and required the maximum use of observable market inputs, thus taking as much of the subjective judgment out of the valuation process as possible. ¶149.[62] Moreover, courts routinely hold that GAAP violations are actionable where, as here, contemporaneous facts existed which contradicted the judgments made by reporting entities. *See RAIT*, 2008 WL 537164, at *6-8 (sustaining claims that company failed to properly value the assets collateralizing its CDOs); *In re New Century*, 588 F. Supp. 2d 1206, 1210, 1215, 1226-27, 1239 (C.D. Cal. 2008) (rejecting argument that misstatements of value of residual RMBS interests were judgmental and sustaining Section 11 claim for those misstatements). As such, the cases cited by Defendants are inapposite.[63]

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[61] Defendants' reliance on *Salomon* also reflects a fundamental misunderstanding of the valuation issue. *Salomon* did not involve a company valuing its own assets, but instead involved a securities analyst's estimate, made in the context of a research report to investors, as to the value of an outside company he was assigned to cover. 373 F. Supp. 2d at 250. Thus, while the analyst in *Salomon* was merely setting out his opinion as to the value of the company and may have had the choice of whether to use a discounted cash flow method or a market-based method, Defendants possessed no such luxury; under SFAS 157, they were required to maximize the use of market-based inputs in arriving at fair value, and could only use non-market based inputs to the extent observable inputs were unavailable. As Plaintiffs have adequately pled the existence of observable inputs that the Company should have used to value its assets, they have met their burden at this stage in the proceedings.

[62] In addition, Defendants' contention that Lehman made "pointed disclosures" in its 2006 Form 10-K regarding the use of management estimates in valuing its mortgages and mortgage-related securities is unavailing. The cited passage appeared prior to the enactment of FAS 157, which, as set forth above, significantly curtailed the use of management estimates in arriving at fair value.

[63] Similarly, Defendants' argument that "lack of clairvoyance" is not securities fraud must be rejected as it is dependent upon Defendants' theory that valuations are almost entirely judgment-based opinions. Def. Br. 36. Moreover, Plaintiffs have not alleged that Defendants were required to anticipate potential future defaults and other

(a) Lehman's Residential Mortgage-Related Assets Were Not Marked To Fair Value

Lehman possessed tens of billions of dollars in high-risk residential mortgage-related assets during the Offerings Period, including approximately $5.3 billion in subprime mortgages and RMBSs at year end November 30, 2007 (*see* Hou Ex. 8, at 105), and $13.6 billion in similarly risky Alt-A mortgages as of February 29, 2008. *See* ¶119. These assets, however, were materially overvalued throughout the Offerings Period due to Lehman's failure to timely and adequately write them down as they became impaired. Indeed, the U.S. housing crisis began in 2006 and continued for more than a year before Lehman recorded any write-downs to its portfolio of residential mortgages and mortgage-related assets. That Lehman's subprime and Alt-A whole loans and RMBSs suffered significant deteriorations in value as a result of the mortgage market decline during 2006 and the first half of 2007, and that Lehman's first mortgage-related write-down in the 2007 third quarter was unquestionably belated, is evidenced by (1) statements from confidential sources; (2) rapidly increasing repurchase requests and margin calls; and (3) early and substantial decreases in relevant indices.

As alleged in the Complaint, Plaintiffs' confidential sources explained that, well before Lehman recorded any write-downs in its residential mortgage-related portfolio, BNC and Aurora experienced a substantial increase in loan defaults and a corresponding sharp rise in repurchase requests made by, and to, Lehman ***beginning in 2006***, underscoring the low-quality, and deteriorating value, of Lehman's inventory of subprime and Alt-A mortgage and mortgage-related positions.[64] For example, CW3, a vice president at Aurora from 2002 until the fall of

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losses in connection with its mortgage-related positions, but only that Lehman was required to value its mortgage assets to reflect market losses that ***had already materialized***.

[64] Repurchase requests, made pursuant to representations and warranties regarding loan quality, were typically made when mortgage loans went into first payment default or early payment default, meaning the borrower failed to make the first or second monthly mortgage payments within thirty days of the due date. ¶109.

2007, noted that, as a result of the increasing defaults, repurchase requests made by Aurora to its correspondent lenders increased during the Offerings Period, so much so that the business unit handling these requests was "buried" with work ***beginning in the fall of 2006***. ¶113. In addition, CW9, a repurchase coordinator at Aurora from 2004 to ***the fall of 2006***, stated that many loans Aurora acquired went into default immediately after being purchased, while CW4 stated that by 2007, Aurora "started to see a lot of loans default." ¶¶111-12. CW4, CW9, CW12, CW15 and CW20 echoed these sentiments. *See* ¶¶109-16. These witnesses further noted that Lehman's correspondent lenders became increasingly unable to honor such requests, often going out of business or declaring bankruptcy without repurchasing the troubled assets from Lehman. ¶¶110, 145.

The marked increase in defaults on BNC and Aurora loans also supports the allegation that the subprime and Alt-A loans that Lehman held on its balance sheet, and the securities backed by those loans, suffered sharp declines in value prior to Lehman's first reported write-down in the third quarter of 2007. *See* ¶105 (the percent of Aurora loans delinquent 30 days or more, in foreclosure or bankruptcy doubled from 2% in 2005 to 4.2% in 2006, and spiked to 9.5% in 2007). Further, in March 2007, several months before Lehman disclosed its first write-down, Lehman made a margin call on American Home Mortgage because the value of the collateral for Lehman's line of credit had declined abruptly. *Id.* Lehman also made margin calls on Accredited Home Lenders, and halted a $1.5 billion line of credit to subprime originator Option One Mortgage Corporation due to the decreasing value of the collateral underlying Lehman's lines of credit to these mortgage lenders. *Id.*

That Lehman's first reported residential mortgage write-downs in the third quarter of 2007 were untimely is also supported by the fact that Lehman itself became "bombarded" with an increasing number of repurchase requests from investors like GMAC and Citigroup

beginning in 2006 and continuing into 2007, as the mortgages in which GMAC, Citigroup and others invested, including those underlying Lehman's securitizations, became delinquent or defaulted. ¶¶111, 116. Confidential sources, including CW10 and CW13, also noted that Lehman faced increasing difficulty selling its mortgage loans beginning in the first or second quarter of 2007. ¶¶116, 146.

Even when Lehman finally began disclosing mortgage-related write-downs to investors the marks it took on these positions were insufficient to reflect their true market value. During the third quarter, the Company disclosed only a $700 million net write-down. Further, at the end of fiscal year 2007, Lehman disclosed $830 million in net write-downs for the fourth quarter and gross residential mortgage-related write-downs of $4.7 billion for the full year. Finally, for the first two quarters of 2008, the Company reported gross write-downs of $3.0 billion and $2.4 billion, respectively, to its portfolio of residential mortgage and mortgage-related assets. These write-downs were extremely small and inadequate, however, in comparison to the rapidly deteriorating nature of its residential mortgage portfolio. This is demonstrated by, among other things, market indices showing steepening declines in the value of residential mortgage assets prior to Lehman's write-downs, and comparatively larger and earlier write-downs recorded by Lehman's peers holding similar assets.

Specifically, the ABX index, created by several commercial and investment banks (including Lehman) to gauge the market value of subprime RMBSs by tracking the cost of insurance for those securities, served as an observable market input that Lehman was required to consider in valuing its positions. In fact, the American Institute of Certified Public Accountants Center for Audit Quality, in a white paper titled *Measurements of Fair Value in Illiquid (or Less Liquid) Markets*, stated that "the pricing indicated by the ABX credit derivative index for subprime mortgage bonds may be a Level 2 input when used as an input to the valuation of a

security backed by subprime mortgage loans." *See* Kessler Dec. Ex. F. Beginning in January 2007, and continuing throughout the Offerings Period, the ABX indices began a steep decline as an unprecedented number of subprime borrowers defaulted on their mortgages. For example, on February 28, 2007, the ABX.HE.BBB 06-2 Index was trading at around 75 cents on the dollar, a sharp decline from 95 cents on the dollar, where it traded on January 17, 2007. *See* ¶142 (graph of ABX.HE.BBB 06-2 Index from January 17, 2007 and August 15, 2007). Notwithstanding a 21% decline in this relevant market index during the first quarter of 2007, Lehman did not report ***any*** mortgage-related write-downs for that period.

Likewise, performance data on RMBSs that Lehman packaged from 2005 to 2007 demonstrates the inadequacy of Lehman's Offerings Period write-downs. Loans originated by Lehman and its correspondent lenders in 2006 experienced significantly higher default rates compared to RMBSs originated in 2005, and 2007 vintage loans were faring even worse than the 2006 vintage. ¶143. By 2007, loans Lehman packaged into RMBSs defaulted nearly ***three times*** as quickly as those packaged in 2005, meaning that the risks associated with the RMBSs issued and sold by Lehman in 2007 were far greater than those originated during earlier periods. *Id.* Compounding matters, as the mortgage crisis worsened, Lehman became increasingly unable to sell the RMBSs it structured from these troubled loans. ¶144. The increased default rate of packaged loans demonstrates that billions of dollars in comparable loans that Lehman held on its books (and could not sell into the secondary market in the form of RMBSs), had suffered significant declines in value during the Offerings Period that required substantial write-downs in accordance with GAAP. Lehman's increased inability to sell these troubled mortgages and RMBSs is evidenced by the declining amount of its securitizations that qualified for sales treatment because Lehman was unable to unload the requisite amount of the risk associated with those assets. *Id*. As a result, Lehman was forced to carry more high-risk mortgages and

mortgage-related assets on its balance sheet, positions that it had to record at fair value and was required to write-down as the U.S. mortgage market continued its "unprecedented tumult" prior to and throughout the Offerings Period.

Lehman's peers recorded multi-billion dollar gross write-downs that, as a percentage of holdings, were much greater than Lehman's write-downs. For example, during the fourth quarter of 2007, Citigroup wrote down its $54.4 billion subprime mortgage portfolio by $17.4 billion, or 32%. ¶148. Likewise, Merrill Lynch recorded net write downs of $9.9 billion on its $14.7 billion portfolio of asset-backed CDOs, including a $1.6 billion net write-down of its U.S. subprime residential mortgage exposures, leaving it with $2.7 billion of those assets at year end. *Id.*[65] During the same period, Lehman, despite holding $6.3 billion in subprime exposure and $13.6 billion in Alt-A exposure (as of the first quarter of 2008), recorded only a $700 million, or less than 1%, net write down, and did not even disclose whether all of it was related to the Company's mortgage positions. Likewise, Lehman disclosed in the fourth quarter that, ***during all of 2007***, it wrote down its $32 billion residential mortgage portfolio by a mere $1.3 net billion, whereas competitors like Citigroup and Merrill Lynch each wrote down their subprime mortgage exposures by at least 30% in the fourth quarter alone. ¶148; 2007 Form 10-K at 49 (Hou Ex. 8). The plainly insufficient write-downs Lehman recorded in 2007, and its failure to break out the gross amount of its write-downs before filing its 2007 Form 10-K or to identify the asset types that were written down, overstated Lehman's financial results and left investors

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[65] While Defendants suggest that Lehman's write-downs cannot be compared to those taken at Merrill Lynch, Citigroup and UBS, Plaintiffs have alleged that, like Lehman, each of these companies possessed multibillion dollar portfolios of residential and/or commercial mortgage and mortgage-related assets that had to be reported at fair value. At this stage in the proceedings, Plaintiffs need not plead any further allegations, as they have satisfied the standard set forth in *Twombly*.

without material information about Lehman's assets and the extent of its exposure to the deteriorating mortgage market.

(b) **Lehman's Commercial Real Estate And Commercial Mortgage Exposures Were Not Marked To Fair Value**

As alleged in the Complaint, Lehman was involved in all aspects of the commercial real estate markets during the Offerings Period, holding substantial interests in both commercial real estate and CMBSs. ¶123. By March 2008, in addition to significant foreign commercial exposure, Lehman held more U.S. commercial real estate and mortgage exposure than any other investment bank. *Id.* Under GAAP, Lehman was required to report each of these positions at fair value. However, as the commercial mortgage market deteriorated throughout 2007 and 2008, Lehman's commercial mortgage assets were not recorded at fair value; instead, they were overvalued by at least 35%, or $12 billion, by September 2008. *See*, *e.g.*, ¶¶130-33, 135-37. As a result, the Offering Documents materially overstated the value of Lehman's assets and failed to provide investors with a true picture of Lehman's financial condition.[66]

The Complaint provides ample support for allegations that Lehman's commercial mortgage and real estate exposures were overvalued. During the Offerings Period the CMBX index tracked value and pricing information on CMBSs by monitoring the cost of insuring against their default. ¶126. Beginning as early as March 2007, the spreads on the CMBX indicated that the risk of default on these bonds had increased markedly and that, as a result, their fair value had declined. ¶¶126-27. The CMBX index was an observable market input indispensible to the valuation of Lehman's commercial mortgage-related exposures – a fact that Lehman expressly recognized in its 2008 first quarter Form 10-Q. *See* 2008 1Q10Q at 54 (Hou

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[66] That Lehman's commercial assets were overvalued by $12 billion was particularly material because of Lehman's enormous leverage of more than 30 times shareholder equity, and a small drop in value could render the Company insolvent. *See* ¶¶5, 214.

Ex. 9) (noting that "[t]he valuation methodologies used for mortgage-related assets incorporate a variety of inputs including . . . ABX, CMBX and similar indices that track the performance of a series of credit default swaps based upon specific types of mortgages . . ."). However, when compared to the marked declines in the CMBX index, Lehman's write-downs during the Offerings Period were insufficient, resulting in inflated asset values.

For example, during the 2008 first quarter, the value of the AAA-rated CMBS tracked by the CMBX index declined in value by 10%, with the lower-rated tranches falling much more. ¶133. Nonetheless, at the end of the 2008 first quarter, Lehman's gross write-down related to its $49 billion commercial real estate and mortgage exposures was just $1.4 billion, or less than 3%. *Id*. The inexplicably large disparity between the fall in the CMBX index and the modest commercial real estate and mortgage-related write-downs taken by Lehman is further evidence that Lehman's commercial mortgage assets were not presented to investors at their fair value during the Offerings Period.

Confidential sources also confirmed the inadequacy of Lehman's commercial mortgage-related write-downs. For example, CW7, who was directly involved in the Company's commercial real estate operations, and CW23, a Product Controller in Lehman's Real Estate Group from late 2007 until the fall of 2008, confirmed that the write-downs taken by Lehman during the Offerings Period were insufficient. CW7 stated definitively, based on first-hand observation as an employee in Lehman's Bridge Equity Program, that Lehman's commercial real estate and mortgage-related assets were not marked down to their fair value during his/her tenure with the Company. ¶¶130-31. Likewise, CW23 stated that, since s/he joined the Company in late 2007, the inadequacy of Lehman's commercial mortgage and real estate write-downs extended not only to Lehman's CMBS positions, but to Lehman's real estate investment trust exposures and its private commercial real estate holdings. *Id*.

Additionally, events leading to Lehman's September 15, 2008 bankruptcy filing further substantiate Plaintiffs' allegation that the Company's commercial real estate and mortgage holdings were overvalued during the Offerings Period. *See In re Scholastic Corp.*, 252 F.3d at 72 (2d Cir. 2001) ("Any information that sheds light on whether class period statements were false or materially misleading is relevant," including post-class period data and pre-class period data); *In re Vivendi Universal, S.A. Sec. Litig*., 381 F. Supp. 2d 158, 181 (S.D.N.Y. 2003) (permitting the use of post-class period data to confirm circumstances that existed during the class period). As alleged in the Complaint, in the days prior to Lehman seeking bankruptcy protection, it frantically attempted to sell its $32.6 billion commercial mortgage and real estate portfolio in a last ditch effort to remain solvent. ¶137. It was unable to find a buyer for those assets, however, because, as reported in a December 15, 2008 *Fortune* article, experts from Citigroup, Credit Suisse, Deutsche Bank and Goldman Sachs determined that the Company's commercial mortgage and real estate portfolio was overvalued by approximately $12 billion. *Id.* Likewise, when Barclays PLC agreed to acquire $1.54 billion in Lehman assets following its bankruptcy, it expressly excluded the Company's commercial mortgage and real estate portfolio because Barclays "did not feel the valuations were supportable." ¶139. These post-Offerings Period developments are undoubtedly relevant and further support Plaintiffs' allegations of overvaluation.

At November 30, 2007, Lehman purported to possess approximately $38.9 billion in commercial mortgage-related positions, and carried more exposure to commercial real estate and mortgage assets than any other investment bank. Nevertheless, its write-downs on those positions were, on a percentage basis, inexplicably small. As Lehman reported for the first time in its 2007 Form 10-K, its commercial mortgage portfolio was written down by a gross amount of just $1.2 billion, or approximately 3%, during fiscal 2007. ¶199. Further, during the first and

second quarters of 2008 leading up to its bankruptcy filing, Lehman wrote down its commercial real estate and mortgage-related assets by gross amounts of just $1.4 billion and $900 million, respectively. The Company's first quarter 2008 write-down, which included a mere $1.1 billion, or 3%, write-down to its commercial mortgage portfolio, was particularly insufficient given that, during the same quarter, the CMBX index for ***the highest rated CMBS*** fell by 10%.

Reactions of industry analysts and other market participants lend additional support to Plaintiffs' allegations that Lehman's commercial real estate and mortgage-related exposures were overvalued. For example, analysts questioned the Company's mortgage-related write-down for the first quarter of 2008. Notably, a March 20, 2008 *Conde Nast Portfolio* article stated that Lehman's mortgage write-downs seemed "tiny" and noted that Lehman took a mere 3% write-down on its $87 billion real estate portfolio, while "indexes and publicly traded instruments and companies that serve as proxies for these securities generally fell more than that in the quarter." ¶150. Analysts met the Company's write-downs for the second quarter of 2008 with similar skepticism. Despite a calmer economic climate during the quarter, on June 9, 2008, Lehman announced one of its largest mortgage-related write-downs to date. Given the more stable environment and Lehman's unexpectedly large write-down, industry experts and analysts questioned the adequacy of prior write-downs, and called upon Lehman to increase transparency so that investors could properly assess the Company's true mortgage-related risks. Notably, David Einhorn, president of Greenlight Capital, Inc., stated, "The credit market did not really deteriorate between February and May. Most of these losses are losses that were probably evident quarters ago," and he implored Lehman to be "much more forthcoming and transparent in their disclosures and discussion and analysis of the high risk assets." ¶152. Likewise, Wachovia analyst Douglas Sipkin downgraded Lehman after it announced its 2008 second

quarter write-downs, stating that he had "underestimated how poorly marked [Lehman's] assets were." ¶153.

Collectively, the Complaint's allegations that Lehman's commercial assets were overvalued during the Offerings Period are more than sufficient to allege a Section 11 claim.

2. Inadequacy Of Lehman's Real Estate And Mortgage-Related Write-Downs Caused Other Financial Metrics To Be Materially Misstated

As set forth in the Complaint, the inadequate mark-to-market write-downs taken by Lehman on its mortgage-related positions caused many of Lehman's remaining financial metrics to be materially overstated during the Offerings Period. Specifically, the failure to properly record mortgage-related write-downs rendered materially false and misleading the Company's financial instruments and inventory positions owned, and total assets metrics for each of the quarters during the Offerings Period. In addition, because the mortgage-related write-downs also flowed through to the Company's income statement, the insufficient write-downs caused Lehman's net revenues, net income, and earnings per share figures to be similarly overstated. *See, e.g.*, ¶186.

D. Lehman's False And Misleading Statements Regarding Its Real Estate And Mortgage-Related Exposures Were Material To Investors

Disputing materiality, Defendants contend that the Complaint purportedly does not address "how many of the supposedly overvalued loans were commercial or residential" and whether the overvaluations "would be material relative to the $503.4 billion worth of assets on Lehman's balance sheet as of its year-end in November 2006, or at the time of any relevant offering." Def. Br. 32. Assessments of materiality are questions of fact that ordinarily are inappropriate for resolution by motion to dismiss.[67] Furthermore, Defendants' formulaic

[67] *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) ("a complaint may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant

analysis of materiality is of the type that the Second Circuit has time and again rejected. Def. Br. 32. Notably, in *Ganino*, 228 F.3d at 162, the Second Circuit expressly rejected the application of a numerical or percentage benchmark in order to determine the materiality of a company's financial misstatement, instead holding that materiality must be assessed in context, and both quantitative and qualitative factors must be analyzed in order to determine materiality of financial misstatements. *Id.* at 162-163.[68]

In this respect, to truly assess the materiality of the Company's overvalued mortgage assets in context, this Court must consider the size of the mortgage portfolio in relation to the Company's *extreme use of leverage* during the Offerings Period. As of the first quarter of 2008, Lehman had $786 billion of assets and approximately $25 billion of capital – a ratio of about 32 to 1, which left the Company relatively little cushion to absorb losses. ¶161. Given Lehman's high leverage, "a mere 3.3% drop in the value of assets wipes out the entire value of equity and makes the company insolvent." ¶162. Moreover, Lehman's mortgage related business

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to a reasonable investor that reasonable minds could not differ on the question of their importance.") (*quoting Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985)); *In re Union Carbide Class Action Sec. Litig.*, 648 F. Supp. 1322, 1326 (S.D.N.Y. 1986) ("Courts should be particularly hesitant to dismiss a securities complaint on grounds of materiality.").

[68] *See also In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 657-58 (S.D.N.Y. 2004) (material facts may "include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities") (citations omitted); *Akerman v. Arotech, Corp.*, No. 07 Civ. 1838 (RJD), 2009 WL 840380, at *8-9 (E.D.N.Y. Mar. 30, 2009) (denying motion to dismiss, and stating: "In [SAB 99], the SEC urges that both quantitative and qualitative factors be considered in assessing a statement's or omission's materiality, and in the Circuit's view, courts "[should] consider the factors it sets forth in determining whether [a] misstatement significantly altered the 'total mix' of information available to investors") (*quoting ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JPMorgan Chase Co.*, 553 F.3d 187, 198 (2d Cir. 2009)); *Goldman*, 754 F.2d at 1067 ("Materiality is a mixed question of law and fact . . . and a complaint may not properly be dismissed pursuant to Rule 12(b)(6) (or even pursuant to Rule 56) on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance") (citing *TSC Indus.*, 426 U.S. at 450) (*questioned on other grounds* in *Kramer v. Time Warner Inc.*, 937 F.2d 767, 774 (2d Cir. 1991)); *SEC v. Biovail Corp.*, No. 08 Civ. 2979 (LAK), 2009 WL 361997, at *1 (S.D.N.Y. Feb. 10, 2009) (Kaplan, J.) (denying motion to dismiss, holding: "[Defendant's] claim that his alleged misstatements were immaterial as a matter of law is similarly unavailing. Materiality is a mixed question of fact and law, and here the Court cannot say that [Defendant's] alleged misstatements were 'so obviously unimportant . . . that reasonable minds could not differ on the question of their importance.'").

compromised the Company's largest revenue component, and Lehman amassed nearly $90 billion in mortgage related holding – more than four times its shareholder equity. ¶328. When assessed in the context of the Company's delicate capital structure – and Lehman's bankruptcy following its mortgage-related write-downs – the materiality of the overvaluations cannot seriously be disputed.[69]

Further, in assessing materiality, the *Ganino* court found SAB 99, which contains a list of qualitative factors that may cause misstatements to be material, to be "persuasive guidance for evaluating the materiality of an alleged misrepresentation."[70] One factor the SEC listed in SAB No. 99, "whether the misstatement masks a change in earnings or other trends," weighs in favor of a finding of materiality under these circumstances. Here, and as set forth above, the overvaluation of the Company's mortgages and mortgage-related positions masked the Company's true exposure to the worsening real estate and mortgage markets and suggested that Lehman's assets were not subject to the same risks and devaluations plaguing other banking institutions. Had these assets been properly marked at their fair market values, investors in the Offerings would have been able to understand that Lehman was extremely vulnerable to the real estate and mortgage market crisis throughout 2007, before its bankruptcy filing in 2008. *See Interpublic Group of Cos. v. Fratarcangelo*, No. 00 Civ. 3323 (SHS), 2002 WL 31682389, at *11 (S.D.N.Y. Nov. 26, 2002) (holding that materiality could not be decided as a matter of law

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[69] Given the Company's excessive use of leverage and, accordingly, its razor-thin margin of error with respect to valuing its $89 billion portfolio of high-risk mortgage-related positions, the representations regarding its capital adequacy and liquidity (specifically, that it maintained a liquidity pool sufficient to cover expected cash flows for twelve months in a stressed environment) in the Offering Documents were also materially false and misleading. *See* ¶¶230-31.

[70] *Ganino*, 228 F.3d at 163; *see also Akerman,* 2009 WL 840380, at *8-9 (noting that courts should "consider the factors [SAB No. 99] sets forth in determining whether [a] misstatement significantly altered the 'total mix' of information available to investors"). SAB No. 99 states: "[i]n the context of a misstatement of a financial statement item, while the 'total mix' includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item."

where allegations suggested that an alleged overstatement of revenues by only $55,086 masked a change in earnings trends).

Given the overvaluations in the proper context of Lehman's highly leveraged risk level, and under the SEC's SAB 99 guidance on qualitative factors regarding materiality determinations, Defendants' suggestion that a comparison of the amount of overvalued mortgage-related assets compared to Lehman's total asset levels renders the overstatement immaterial as a matter of law rings hollow.[71]

VII. NEITHER THE "BESPEAKS CAUTION" DOCTRINE NOR THE PSLRA'S SAFE HARBOR PROVISIONS APPLY, AND DEFENDANTS' SUPPOSED WARNINGS WERE INADEQUATE TO APPRISE INVESTORS OF THE REAL RISKS

A. The Alleged Misrepresentations And Omissions Are Not Forward-Looking

The false and misleading statements and material omissions in the Offering Documents concern misstatements of present and historical facts. Nevertheless, Defendants contend that the Complaint is based on forward-looking statements, and therefore, Plaintiffs must allege that Defendants had actual knowledge that such statements were false and misleading. A "forward-looking statement" is a "statement containing a projection of revenues, income (including income loss) . . . or other financial items"; "a statement of the plans and objectives of management for future operations"; "a statement of future economic performance"; and "any statement of the assumption underlying or relating to any [of these] statement[s]."[72] Thus,

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[71] As *Ganino* instructs, to the extent that the magnitude even needs to be measured, the financial metric in question "should be compared to like items on the corporate financial statement." 228 F.3d at 165. With that in mind, it is clear that a comparison of mortgage-related assets to Lehman's "financial instruments and other inventory positions owned" is more appropriate, as the exposure comprised over 28% of this category of assets as of November 30, 2007. In fact, at the end of 2007, the Company possessed $89.1 billion in mortgage-related assets compared to $691.3 billion of total assets.

[72] 15 U.S.C. § 77z–2(i)(1).

"[f]orward-looking statements are contingent statements as to future events."[73]

Here, Plaintiffs' Securities Act claims are predicated not on projections about the future but on misstatements of historical and current fact. Indeed, the very paragraphs to which Defendants point (Def. Br. 20 n.22) contain statements regarding the Company's ***present*** condition and performance, and thus are not forward-looking. *See*, *e.g.*, ¶156 (Lehman stated it "actively managed" its mortgage-related positions; a comprehensive risk management structure "existed" with several risk control processes in place; the Company "measured" quantifiable risks using methodologies and models based on "tested" assumptions; Lehman "identified" emerging risks through monitoring; Lehman "reviewed" risk exposures; and Lehman "allocate[d] the usage of capital to each of [its] businesses and establishes trading and credit limits for counterparties."); ¶230 (Lehman represented that the Company "was" well capitalized and "possessed" capital in excess of all applicable minimum capital requirements established by regulatory bodies and rating agencies); ¶224 (Lehman stated that management "evaluated [the Company's] disclosure controls and procedures as of the end of the fiscal quarter" and, based on that evaluation, "found" Lehman's disclosure controls and procedures effective)).

Because these statements contain omissions or misrepresentations of current facts, they do not qualify for the PSLRA's safe harbor.[74] Even if some aspect of a challenged statement "has both a forward-looking aspect and an aspect that encompasses a representation of present

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[73] *Credit Suisse First Boston Corp. v. ARM Fin. Group, Inc.*, No. 99 Civ. 12046 (WHP), 2001 WL 300733, at *5 (S.D.N.Y. Mar. 28, 2001).

[74] *In re Regeneron Pharm., Inc. Sec. Litig.*, No. 03 Civ. 3111 (RWS), 2005 WL 225288, at *13 (S.D.N.Y. Feb. 1, 2005) (citing *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314, 340 (S.D.N.Y. 2001)); *see P. Stolz Fam. P'ship L.P. v. Daum*, 355 F.3d 92, 96-97 (2d Cir. 2004); *ABF Capital Mgmt. v. Askin Capital Mgmt.*, 957 F. Supp. 1308, 1324 (S.D.N.Y. 1997); *City of Sterling Heights Police & Fire Ret. Sys. v. Abbey National, PLC*, 423 F. Supp. 2d 348, 360 (S.D.N.Y. 2006) (statements directed at then-existing financial condition were not protected by safe-harbor) (citing *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706, 721 (D. Del. 2000) (statements about "then-present" financial state of company not protected)).

fact, the safe harbor provision of the PSLRA does not apply."[75]

B. <u>The Bespeaks Caution Doctrine Is Inapplicable</u>

The Defendants contend that certain disclosures in the Offering Documents nullified the falsity of their statements because they adequately warned of the risks Plaintiffs allege were omitted from the Offering Documents. This contention evokes the "bespeaks caution" doctrine, which only renders ***forward-looking*** "misrepresentations in a stock offering . . . immaterial as a matter of law [if] it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same offering."[76] However, the doctrine does ***not*** render immaterial either omissions or statements of historical fact.[77] Further, for the doctrine to apply, "the cautionary language must be examined in the context of the representations to determine whether the language warns of the specific contingency that lies at the heart of the alleged misrepresentation." *Id.* at 97 (citing *Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 729 (2d Cir. 1998)).[78]

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[75] *Schottenfeld Qualified Assocs., L.P. v. Workstream, Inc.*, No. 05 Civ. 7092 (CLB), 2006 WL 4472318, at *3 (S.D.N.Y. May 4, 2006) (internal quotation marks omitted); *see In re KeySpan Corp. Sec. Litig.*, No. 01 Civ. 5852, 2003 WL 21981806, at *18 (E.D.N.Y. July 30, 2003); *In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 757 (S.D.N.Y. 2001) abrogated by *Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003); *see also In re Ashanti Goldfields Sec. Litig.*, 184 F. Supp. 2d 247, 267 (E.D.N.Y. 2002) (the fact that a complaint may refer to some statements that "may well be seen as forward-looking" does not matter where the claims are grounded in misstatements of current fact).

[76] *P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 96 (2d Cir. 2004) (*quoting Halperin v. Ebanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002)); *see also Faulkner v. Beer*, 463 F.3d 130, 133-35 (2d Cir. 2006) (vacating court's application of bespeaks caution doctrine where cautionary statements were in materials most investors did not received).

[77] *Stoltz Family P'ship*, 355 F.3d at 96-97. In adopting a limited application of this doctrine to forward-looking statements only, the Second Circuit followed the guidance of its sister circuits and district courts within this Circuit. *Stolz Family P'ship*, 355 F.3d at 96-97 (citing *EP Medsystems, Inc. v. EchoCath, Inc.*, 235 F.3d 865, 874 (3d Cir. 2000) ("By its terms, the 'bespeaks caution' doctrine . . . is directed only to forward-looking statements.") *In re Complete Mgmt. Inc.*, 153 F. Supp. 2d at 340 (noting that the "bespeaks caution" doctrine applies "to forward-looking statements *only*, and not to material omissions or misstatements of historical fact." (Emphasis in original.)

[78] *See also In re Flag Telecom Holdings, Ltd. Sec. Litig.*, No. 02 Civ. 3400 (WCC), 2009 WL 1181293, at *8 (S.D.N.Y. Mar. 23, 2009) (cautionary language must be specific, prominent and must directly address the specific risk that plaintiffs claim was not disclosed, especially considering that most, if not all securities offerings contain

The "bespeaks caution" doctrine is inapplicable here. The Offering Documents contained misrepresentations and omissions material facts regarding Lehman's financial results, high-risk lending practices, mortgage-related portfolio, risk mitigation practices and hedging, significant concentrations of credit risk, and capitalization and liquidity. These statements of then-current or historical facts are not shielded by the "bespeaks caution" doctrine.[79] Additionally, the statements regarding Lehman's "comprehensive" risk management procedures or the "effectiveness" of hedging strategies failed to bespeak caution in light of the material omission that there was no direct hedge for Lehman's multi-billion dollar Alt-A portfolio or that Lehman's hedges could actually increase rather than mitigate losses, resulting in an additional loss of $700 million in the 2008 second quarter. ¶¶158-59.

C. <u>Warnings Were Insufficiently Tailored To Known, Materializing Risks</u>

Even if the "bespeaks caution" were to apply to these statements and omissions, the disclosures cited by the Defendants are not sufficiently tailored to the risks about which investors were misled – namely, the true extent of Lehman's exposure to the mortgage market, its inability to adequately hedge against losses on, *inter alia*, its undisclosed portfolio of Alt-A mortgage assets, or the fact that its hedging strategy actually exposed Lehman to substantial additional losses.[80] General warnings, such as Lehman's "businesses are materially affected by conditions

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cautionary language) (citing *Olkey v. Hyperion 1999 Term Trust, Inc*., 98 F.3d 2, 5-6 (2d Cir. 1996)); *Miller v. Lazard, Ltd*., 473 F. Supp. 2d 571, 579 (S.D.N.Y. 2007).

[79] *Credit Suisse,* 2001 WL 300733, at *8-9 (warnings of specific risks are insufficient to shelter a defendant from liability where they fail to disclose specific facts necessary to appreciate the magnitude of the risk).

[80] *Halperin v. eBanker USA.com, Inc*., 295 F.3d 352, 357, cited by Defendants, *see* Def. Br. at 46, is not apposite. *Halperin* merely affirms the above-cited principal that cautionary language must be sufficiently specific in order to render an undisclosed risk immaterial and found that the precise risk about which investors alleged they were misled was expressly disclosed to investors. *Id*., 295 F.3d at 360. Here, Defendants do not dispute that Lehman's Offering Documents made no specific disclosure about its inability to directly hedge Alt-A mortgage-assets, or that, in addition to being ineffective at mitigating losses, Lehman's hedging strategy could actually expose the Company to additional losses. *See id.* at 359 (affirming that cautionary language is insufficient if it leads "a reasonable investor to conclude that the only risk was in the effectiveness of hedging, not in its availability").

in the financial markets and economic conditions generally" (Def. Br. 24-25) are insufficient to trigger any protection. *See*, *e.g.*, *Provenz v. Miller*, 102 F.3d 1478, 1494 (9th Cir. 1996) (warning that company was "living in an uncertain economic environment" was too general to trigger protection).

For example, Defendants rely upon the following purported warnings to suggest that they were relieved of the obligation to provide detailed information regarding, *inter alia*, the specific concentrations of subprime and Alt-A assets within Lehman's mortgage-related portfolio: (1) the residential real estate market "experienced a downturn due to declining real estate values"; (2) "[f]urther declines" could "further reduce our level of mortgage loan originations and could also reduce our level of securitizations"; and (3) a "substantial portion" of Lehman's securities transactions are collateralized and executed with, and on behalf of, financial institutions and that it was exposed to the nonperformance of these counterparties. None of these "warnings" was sufficient.

The first purported cautionary statement merely discussed the historical condition of the residential real estate market and, thus, did not warn investors of anything.[81]

The second statement is also not sufficiently tailored to any specific risk, as it addressed only Lehman's mortgage origination volume and securitization activity. To warn that a slowdown in originations and securitizations *may reduce revenues* is insufficient when Lehman *had already* amassed billions in undisclosed concentrations of subprime and Alt-A mortgage-related assets. Reasonable investors could not have understood from this disclosure that Lehman was already experiencing slowdowns in securitizations, and left unspoken was the material fact

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[81] *See In re New Century*, 588 F. Supp. 2d at 1226 (bespeaks caution doctrine did not apply to "generalized cautionary language regarding the sub-prime industry [which] appear[ed] largely unrelated to whether the alleged statements here were false and misleading"); *In re BankAmerica Corp. Sec. Litig*., 78 F. Supp. 2d 976, 997 n.10 (E.D. Mo. 1999) (bespeaks caution doctrine did not apply to boilerplate disclosures of market volatility, which did not alert investors of risky trading practices).

that Lehman became increasingly unable to sell off interest in its MBSs and was increasingly required to retain the risk associated with those assets on its balance sheet. Furthermore, the deteriorating value of these assets had a substantial and material impact on the Company's balance sheet, capitalization, and liquidity – financial impacts that this purported warning did not address at all.

The third statement is also insufficient to alert investors to the rising levels of repurchase requests that Lehman had already received as well as those it unsuccessfully pursued against its correspondent lenders. *See*, *e.g*., ¶¶109-16. Nor is the "warning" sufficiently tailored to alert investors to the rising credit and liquidity risk that resulted from the deteriorating value of Lehman's mortgage-related assets.

With respect the Defendants' argument about statements regarding Lehman's hedging strategies, Defendants ignore the fact that the court in *In re Initial Public Offering Securities Litigation*, 358 F. Supp. 2d 189, 212, also held that "[g]eneralized disclosures of amorphous risks will not shield defendants from liability as the cautionary language must be 'too prominent and specific to be disregarded' and must 'warn investors of exactly the risk that plaintiffs claim was not disclosed.'"[82]

Considered in light of the total mix of information available to investors, nothing in the Offering Documents sufficiently disclosed to investors the risks inherent in Lehman's mortgage-related assets.

D. The 10-K "Risk Disclosures" Are Themselves Misleading

Defendants' effort to immunize themselves from liability rests on a faulty premise that

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[82] *See also Hunt*, 159 F.3d at 724-25 (finding that defendants' extensive discussion of hedging would have led prospectors to believe that such mechanisms were available and that language implying a present ability to hedge against exchange rate fluctuations would have led a reasonable investor to conclude that the only risk was in the effectiveness of hedging, not in its availability).

the 2006 10-K disclosed "the types and amounts of mortgage related-assets held by Lehman and the risk that further real estate market declines could impact those asset levels." Def. Br. 37. To the contrary, the 2006 10-K provided nothing of the sort, and the four statements Defendants reference provide merely that:

- Lehman was a leading residential mortgage loan originator and underwriter of residential mortgage- and asset-backed securities. 2006 10-K at 5 (Hou Ex. 3).
- Lehman's revenues from residential mortgage and "securitization businesses decreased overall" and that this decrease was "primarily attributable to a softer housing market and lower margins." *Id*. at 41.
- Lehman had $2.0 billion of noninvestment grade interests (primarily junior securitization interests) from securitization of residential mortgages. *Id*. at 92.
- Lehman owned approximately $57.7 billion worth of mortgages and mortgage-backed positions, including mortgage loans (both residential and commercial) and nonagency mortgage-backed securities. *Id*. at 90.

See Def. Br. 37. These threadbare statements reveal nothing about the true risks associated with the types and amounts of Lehman's balance sheet exposure to residential and commercial real estate assets, subprime or Alt-A mortgage risk, and the extent to which the assets were comprised of whole loans versus mortgage-backed positions, and thus they are plainly inadequate.[83] Moreover, Defendants' bald contention that the 2006 10-K "disclose[d] [Lehman's] exposure to subprime and Alt-A residential loans and the risks of 'no documentation' loans and borrowers with credit problems" is pure fiction. *See* Def. Br. 41. The words "Alt-A" or "no documentation loans" are plainly absent from the 2006 10-K, and thus it strains credulity to contend that the 2006 10-K disclosed risks associated with such loans.

[83] *See, e.g., Credit Suisse*, 2001 WL 300733, at *8 (defendants are not sheltered from liability if they "fail to disclose hard facts critical to appreciating the magnitude of the risks described"); *see also In re Prudential Sec. Ltd. P'ships. Litig*., 930 F. Supp. 68, 72 (S.D.N.Y. 1996) (disclosures of risk provide no protection to "someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away") (citations omitted).

Further, the word "subprime" appears in the 2006 10-K just twice, but both times in passing.[84] As the Second Circuit has cautioned, "it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1297 (2d Cir. 1973); *see also Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 566 (E.D.N.Y. 1971) ("the prospectus must not slight the less experienced. They are entitled to have within the four corners of the document an intelligible description of the transaction."). Even if, like the omissions in *Feit*, the information Plaintiffs claim was misleading had been disclosed in a way that was "probably technically accurate," it was "hardly calculated to apprise the owner of shares" of the actual risks. *Id.* at 565.

E. Boilerplate Corporate Disclosures Buried Within Hundreds Of Pages Of SEC Filings By The BNC Trusts Do Not Immunize Defendants

Without any real disclosure in the Offering Documents about Lehman's high-risk lending programs and its large exposure to subprime and Alt-A mortgages, Defendants resort to arguing that the relevant disclosures were contained *not* in the Offering Documents, but instead appeared in the SEC filings of BNC Mortgage Loan Trust 2006-2 and BNC Mortgage Loan Trust 2007-4 (together, "BNC Trusts"), separate legal entities formed as common law trusts under the laws of the State of New York. These filings were not provided to Lehman investors because they were filed under the BNC name and pursuant to a separate SEC index number not referenced or incorporated into the Offering Documents. *See*, *e.g*., 11/26/07 BNC Mortgage Loan Trust 2007-4 Prospectus Supplement at S-5 (Hou Ex. 13).

The first flaw in Defendants' argument is that Section 11 claims, unlike claims brought

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[84] The first involved a lawsuit against First Alliance Mortgage Company, a "subprime" mortgage lender. *See* 2006 Form 10-K at 22 (Hou Ex. 3). The second, in Note 11 to Lehman's financial statements, made generic statements about representations and warranties regarding subprime loans in securitized transactions. ¶174; *see*, 2006 Form 10-K at 103 (Hou Ex. 3). Neither of these references was sufficient to warn investors of Lehman's exposure to risky subprime and Alt-A loans.

under Section 10(b), are not premised on the fraud-on-the-market doctrine, because Section 11 claims do not have a reliance element. Thus, the fraud-on-the-market argument is irrelevant to this motion; it has no bearing on whether the Offering Documents themselves – which are the only subject of a Section 11 claim – were false and misleading. In addition, even if the Court were inclined to review the BNC Trusts' MBS prospectuses, those documents actually bolster Plaintiffs' allegations that the Offering Documents omitted material information about Lehman's high-risk subprime and Alt-A loans lending programs and their impact on Lehman's balance sheet. The following statements in the BNC prospectuses reflect the type of disclosures about Lehman's high-risk lending practices that are conspicuously missing from the Offering Documents:

- **"No documentation loans"** offered to borrowers without any documentation regarding the borrowers' income or employment or verification of the borrowers' assets, and thus no information about the borrower's ability to repay the loan. *See* 1/8/2008 BNC Trust Prospectus at S-36 (Hou Ex. 13).

- **"Stated income loans"** that increased the risk that the borrowers would not have sufficient income or assets or may have overstated their income and assets and would be unable to make monthly mortgage loan payments, thereby increasing the risks of payments delinquencies and loan defaults. *Id*.

- **"Interest only loans"** that were particularly high-risk because, for an extended time period including up to ten years, borrowers paid no principal on the loan, just interest, thus were entirely dependent on rising home values to build equity in their homes. *Id*. at S-39.

- **"80/20 loans"** in which borrowers financed 100% of their home by obtaining a first lien loan with a maximum loan-to-value ratio of 80% in combination with a second lien loan with a maximum loan-to-value ratio of 20%. Under this program, borrowers had no equity in the homes at the inception of the two mortgages, and were exposed to a greater risk of being "underwater" or "upside-down" in the mortgages in the event home values decreased. *Id*. at S-71.

- **"Geographically concentrated mortgages"** in California, Florida, and Nevada, which were subject to higher rates of delinquencies, defaults and

> losses on mortgages throughout the Offerings Period because unfavorable housing conditions in those states were resulting in a disproportionate number of mortgage delinquencies and default. *Id*. at S-40.

Even had they appeared, however, they still would not have corrected the deficiencies in the Offering Documents because the prospectuses are silent regarding Lehman's true exposure to the risky subprime and Alt-A assets on Lehman's balance sheet, as they do not speak to the quantity of these risky assets to which Lehman was then exposed.

Moreover, even if it were relevant to a Section 11 claim what the "market" knew, the market cannot be deemed to have been on notice of the risk based on separate filings by a distinct legal entity. The Court in *Countrywide*, 588 F. Supp. 2d at 1159-60, rejected a similar argument regarding other SEC filings that were not part of or referenced in a registration statement filed *by the same issuer* ("Countrywide's MBS were complex instruments and the prospectuses are very large documents; it is perfectly reasonable to infer that this complexity, coupled with Countrywide's alleged public misrepresentations, would blunt the effect of any disclosures in MBS' prospectuses.") In the instant matter, Defendants are one step removed from the issuer in Countrywide, as they attempt to rely on documents filed by an entirely separate issuer.

In fact, Defendants' preoccupation with filings by the BNC Trusts completely undermines the very purpose of the Securities Act, which "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce . . . and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." *In re WorldCom*, 294 F. Supp. 2d 392, 407 (quoting *Ernst & Ernst*, 425 U.S. 185, 195, 96 S. Ct. 1375). Tabular presentations of borrower or loan statistics or other disclosures, buried among hundreds pages of the BNC Trusts' MBS prospectuses filed not by Lehman but by separate legal entities, fall far short of full and fair

disclosure of the risks associated with Lehman's high-risk subprime and Alt-A lending practices. Furthermore, "[f]ull and fair disclosure cannot be achieved through piecemeal release of subsidiary facts which if stated together might provide a sufficient statement of the ultimate fact." *Kennedy v. Tallant*, 710 F.2d 711, 720 (11th Cir. 1983).

There is no legal support for Defendants' assertion that investors should cobble together information from filings by separate issuers, involving different securities, which are not incorporated by reference. As the Supreme Court has stated, "not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow." *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097, 111 S. Ct. 2749, 2761 (1991) (citing *Gerstle v. Gamble-Skogmo, Inc*., 478 F.2d 1281, 1297).

VIII. ERIN CALLAN IS A PROPER DEFENDANT UNDER SECTION 11

Defendant Callan contends that because she did not sign the Shelf Registration Statement, she cannot be liable as a signatory for any of the Offerings. Def. Br. 71. On the contrary, SEC regulations specifically provide for liability for signatories to documents incorporated by reference into prospectuses and registration statements for delayed or continuous shelf offerings.

As alleged in the Complaint, in 2006 Lehman filed the Shelf Registration Statement and conducted a series of Offerings based upon those documents. ¶¶166-68. The registration statement was continually updated by incorporating Lehman's SEC filings by reference; in this manner, every new Offering contained Lehman's latest public filings. ¶169. Erin Callan became CFO on December 1, 2007, and subsequently signed Lehman's SEC filings, which were incorporated by reference into Offerings after that date.

The statute and regulations governing the update of a shelf registration statement are contained in Section 10(a)(3) of the Securities Act, 15 U.S.C § 77j(a)(3), and 17 C.F.R. § 229.512. Together, these rules obligate an issuer to update a prospectus with current information, and the SEC has stated that the statute may be satisfied by incorporating annual and quarterly filings by reference. *See* 17 C.F.R. § 229.512(a)(i-iii)(B);[85] *see also* SEC Release No. 33-8591, 70 Fed. Reg. 44722-01, 44729 n.61 (Aug. 3, 2005) (Section 10(a)(3) is satisfied by the filing of a Form 10-K). Thus, the SEC filings signed by Callan were incorporated by reference to satisfy the requirements of Section 10(a)(3). Admittedly, the regulations themselves and the interpretive releases are somewhat confusing as to their exceptions:

> ***Except for an effective date resulting from the filing of a form of prospectus filed for purposes of including information required by section 10(a)(3) of the Act*** or pursuant to Item 512(a)(1)(ii) of Regulation S-K (§ 229.512(a)(1)(ii) of this chapter), the date a form of prospectus is deemed part of and included in the registration statement pursuant to this paragraph shall not be an effective date established pursuant to paragraph (f)(2) of this section as to:
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> * * *
>
> (ii) Any person signing any report or document incorporated by reference into the registration statement, ***except for such a report or document incorporated by reference for purposes of including information required by section 10(a)(3) of the Act*** or pursuant to Item 512(a)(1)(ii) of Regulation S-K (such person except for such reports being deemed not to be a person who signed the registration statement within the meaning of section 11(a) of the Act).

17 C.F.R. § 230.430B(f)(4). The SEC interpretive release explaining the regulation restates the rule:

> Therefore, under Rule 430B, ***except for an effective date resulting from the filing of a form of prospectus for purposes of updating the registration statement pursuant to Section 10(a)(3)*** . . . the prospectus filing will not create a new effective date for directors or signing officers of the issuer. Any person signing any report or document incorporated

[85] The issuer may incorporate by reference filings made pursuant to Section 13 of the Securities Exchange Act. *See* 17 C.F.R. § 229.512(a)(i-iii)(B). That statute requires issuers to file annual and quarterly statements in accord with Commission rules. 15 U.S.C.A. § 78m(a)(2).

> by reference in the prospectus that is part of the registration statement or the registration statement, ***other than a document filed for the purposes of updating the prospectus pursuant to Section 10(a)(3)*** or reflecting a fundamental change, is deemed not to be a person who signed the registration statement as a result.

70 Fed. Reg. 44774. The import is that signatories of documents such as annual or quarterly filings that *are* filed to satisfy Section 10(a)(3) are deemed to be signers of the registration statement.

This interpretation is borne out by 17 C.F.R. § 229.512(b). That regulation, to which issuers are required to adhere under 17 C.F.R. § 230.430B(i), states, in relevant part:

> The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant's annual report pursuant to section 13(a) or section 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan's annual report pursuant to section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement ***shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof***.

17 C.F.R. § 229.512(b) (emphasis added).

For these reasons, Defendant Callan was a signatory of the registration statement once documents with her signature, including the 2007 Form 10-K, were incorporated by reference into the Shelf Registration Statement. She is liable under Section 11.

IX. PLAINTIFFS SUFFICIENTLY ALLEGE VIOLATIONS OF THE SECURITIES ACT IN CONNECTION WITH THE PRINCIPAL PROTECTION NOTES

Defendants argue that Plaintiffs fail to allege actionable false and misleading statements and omissions of material fact in the Offering Documents for the Principal Protection Notes. Because they were issued pursuant to the same Offering Documents discussed above, the same false and misleading statements and omissions plague the Principal Protection Notes and subject Defendants to liability under Sections 11 and 12(a)(2). *See, e.g., Countrywide*, 588 F. Supp. 2d at 1164-65. The Pricing Supplements update the Offering Documents, however, and also give

rise to other violations of the Securities Act.

Perhaps recognizing the literal falsity of their promises of "principal protection" in the Pricing Supplements for the Principal Protection Notes, Defendants emphasize that the Court should consider, in addition to the Pricing Supplements, a list of other documents that were incorporated by reference into the Pricing Supplement. According to Defendants, the disclosures contained in these other documents should have made clear to investors that their assurances of "principal protection" were not meant to be taken at face value.

The incorporation by reference of these documents does not help Defendants. According to express provisions in the Offering Documents, the Pricing Supplement's statements about principal protection supersede any inconsistent statements in the documents incorporated by reference. Moreover, even if one disregards the admonition in the Offering Documents that the Pricing Supplement supersedes conflicting disclosures in the documents incorporated by reference, the Offering Documents so obscured the truth about the principal protection characteristics of their Principal Protection Notes as to render the Offering Documents materially misleading in violation of Sections 11 and 12(a)(2), notwithstanding any qualifying statements buried in their disclosures. Thus, because Plaintiffs have identified materially false statements and omitted facts in the Offering Documents, Defendants' motion to dismiss the claims for violations of Sections 11 and 12(a)(2) as to the Principal Protection Notes should be denied.

A. The False And Misleading Statements And Omissions In The Principal Protection Note Offerings

After devoting eight pages of their brief to arguing that the false statements and omissions Plaintiffs allege are not actionable (Def. Br. 61-69), Defendants claim that "Plaintiffs

fail to identify the misleading language with any specificity whatsoever." Def. Br. 69.[86] To the contrary, Plaintiffs have alleged "plausible grounds" that the Offering Documents contained material misstatements and omissions, which is all that is required. *Zirkin v. Quanta Capital Holdings Ltd.*, No. 07 Civ. 851(RPP), 2009 WL 185940, at *9 (S.D.N.Y. Jan. 23, 2009).

Plaintiffs allege that the Principal Protection Notes are a form of structured note linked to the performance of an underlying derivative (such as a single security, a basket of securities, an index, a commodity, a debt issuance, a foreign currency or a derivative based on the difference between currency swap rates). ¶234. The Principal Protection Notes were offered by UBS and Lehman to retail investors, but the only disclosure document delivered to investors was a short (typically six to seven page) Pricing Supplement. ¶¶232, 235, 238-39, 242(g).

Plaintiffs allege that the Pricing Supplement and other Offering Documents for the Principal Protection Notes contained false statements and omissions, and incorporated misleading documents by reference. ¶236.[87] The Complaint summarizes the false and misleading statements about "principal protection" that appear throughout the Pricing Supplements and specifically identifies such false statements as "the guaranteed preservation of all or some specified percentage of the investor's capital," "[a]t maturity, you will receive a cash payment equal to at least 100% of your principal," "100% principal protection if held to maturity," and "[a]t maturity of the Notes, investors will receive a cash payment equal to at least the applicable Protection Percentage multiplied by the principal amount." ¶237.

For example, named Plaintiff Stephen Gott purchased Lehman's "100% Principal

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[86] Defendants also claim they are unclear as to which offerings Plaintiffs contend are "Principal Protection Note" offerings. Def. Br. 61 n.58. As Defendants acknowledge, the "Principal Protection Note" offerings are listed in bold in Appendix A to Plaintiffs' Complaint, which provides the "clear statement" Defendants say they are entitled to receive. ¶234, App. A at 2 n.3.

[87] Appendix A identifies the specific SEC filings that Plaintiffs contend were false and misleading.

Protection Absolute Return Barrier Notes Linked to the S&P 500 Index." ¶¶237, 240. The Pricing Supplement for these securities (and many others) contains repeated references to "100% principal protection." The assurance of a return of the principal at maturity appears on the first page of the Pricing Supplement:

- If the S&P 500 Index closes within 25.41% of the starting level, "at maturity you will receive your principal plus a return equal to the absolute value of the Index return. Otherwise, at maturity you will receive only your principal."
- "**Features: Preservation of Capital** – At maturity, you will receive a cash payment equal to at least 100% of your principal."
- "We are offering 100% Principal Protection Absolute Return Barrier Notes Linked to the S&P 500 Index."[88]

The second page describes the factors that make the investment suitable for an investor, which include a desire to ensure that the principal will be protected:

> "**Investor Suitability: The Notes may be suitable for you if, among other considerations:** You seek an investment that offers 100% principal protection when the Notes are held to maturity."[89]

Page three lists the terms and provides a flowchart for determining payment at maturity, which always includes at least the principal:

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[88] PS No. 1 (52522L525) at 1 (Hou Ex. 28). *See also* PS No. 219 (52520W440) at 1 (Hou Ex. 23) ("Features: 100% principal protection at maturity" and "The Notes . . . are 100% principal protected if held to maturity"); PS No. 264 (52517P2P5) at 1 (Hou Ex. 24) ("Features: 100% principal protection if held to maturity"); PS No. 307 (52517P3H2) at 1 (Hou Ex. 25) (same); PS No. 409 (52517P5K3) at 1 (Hou Ex. 26) (same); PS No. 625 (52520W325) at 1 (Hou Ex. 27) ("Features: 100% principal protection at maturity"); PS No. 1 (52522L566) at 1 (Hou Ex. 29) ("Features: Preservation of Capital − At maturity, you will receive a cash payment equal to at least 100% of your principal"); PS No. 1 (52522L806) at 1 (Hou Ex. 30) ("Features: Partial Protection of Principal − At maturity of the Notes, investors will receive a cash payment equal to at least the applicable Protection Percentage multiplied by the principal amount"); PS No. 1 (52523J206) at 1 (Hou Ex. 31) ("Features: Partial Protection of Principal − At maturity of the Notes, investors will receive a cash payment equal to at least 20% of their invested principal").

[89] PS No. 1 (52522L525) at 2 (Hou Ex. 28). *See also* PS No. 219 (52520W440) at 2 (Hou Ex. 23) (same); PS No. 264 (52517P2P5) at 2 (Hou Ex. 24) (same); PS No. 307 (52517P3H2) at 2 (Hou Ex. 25) (same); PS No. 409 (52517P5K3) at 2 (Hou Ex. 26) (same); PS No. 625 (52520W325) at 2 (Hou Ex. 27) (same); PS No. 1 (52522L566) at 2 (Hou Ex. 29) (same); PS No. 1 (52522L806) at 2 (Hou Ex. 30) ("The Notes may be suitable for you if, among other considerations: . . . You seek an investment that offers partial principal protection when the Notes are held to maturity"); PS No. 1 (52523J206) at 2 (Hou Ex. 31) (same).

- "Principal Protection: 100% if held to maturity."

- Payment at Maturity (per $10 principal amount Note): ". . . you will receive a cash payment, for each $10 principal amount Note, equal to: $10 + [$10 x Absolute Index Return] . . . [or] . . . you will receive a cash payment of $10 for each $10 principal amount Note."

- "**Determining Payment At Maturity (flowchart):** At maturity, you will receive a cash payment of your principal of $10 per $10 principal amount Note. [or] At maturity, you will receive a cash payment, for each $10 principal amount Note, of your principal of $10 plus the Absolute Index Return multiplied by $10."[90]

Page four gives examples of how the payment will be calculated at maturity, always resulting in a return of the principal:

- "Example 1: . . . you will receive a Payment at Maturity of $10.00 per $10 principal amount Note. Example 2: . . . You will receive a Payment at Maturity of $12.00 per $10 principal amount Note. Example 3: . . . you will receive a Payment at Maturity of $10.00 per $10 principal amount Note. Example 4: . . . You will receive a Payment at Maturity of $12.00 per $10 principal amount Note."[91]

- Reaffirms "Principal Protection: 100% at maturity" and includes a chart depicting the hypothetical performance of the Notes that shows no payments less than $10, *even if* the S&P Index closes at 0.00.[92]

Page six lists the "Key Risks" and reiterates that the investor will be paid at least his principal at maturity:

- "**No Principal Protection Unless You Hold the Notes To Maturity.** . . . You will receive at least the minimum payment of 100% of the principal amount of your Notes if you hold your Notes to maturity."

- "YOU WILL RECEIVE NO MORE THAN THE FULL PRINCIPAL AMOUNT OF YOUR NOTES AT MATURITY . . ."

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[90] PS No. 1 (52522L525) at 3 (Hou Ex. 28). *See also* PS No. 219 (52520W440) at 3 (Hou Ex. 23); PS No. 625 (52520W325) at 3 (Hou Ex. 27); PS No. 1 (52522L566) at 3 (Hou Ex. 29); PS No. 1 (52522L806) at 3 (Hou Ex. 30); PS No. 1 (52523J206) at 3 (Hou Ex. 31).

[91] PS No. 1 (52522L525) at 4 (Hou Ex. 28). *See also* PS No. 219 (52520W440) at 4 (Hou Ex. 23) ("Example A . . . the payment at maturity is equal to $12.40 per $10 Note . . . . Example B- . . . the payment at maturity is equal to $10 per $10 Note."); PS No. 625 (52520W325) at 3 (Hou Ex. 27) ("Example A . . . the payment at maturity is equal to $11.95 per $10 Note . . . . Example B- . . . the payment at maturity is equal to $10 per $10 Note."); PS No. 1 (52522L566) at 3 (Hou Ex. 29) (same as Hou Ex. 28).

[92] PS No. 1 (52522L525) at 4 (Hou Ex. 28); PS No. 1 (52522L566) at 3 (Hou Ex. 29) (same).

- "**The Notes Might Not Pay More Than the Principal Amount.** . . . If the Index Ending Level is above the Index Starting Level but the Index closes above the Upper Index Barrier or below the Lower Index Barrier during the Observation Period, you will receive only the principal amount of your Notes."[93]

Each of these statements reflects the Complaint's allegation that the Offering Documents falsely promised "the guaranteed preservation of all or some specified percentage of the investor's capital." ¶237. In each case, the statement that the investor's principal would be protected and returned upon maturity of the note was literally false. Defendants' motion to dismiss Plaintiff's Section 11 and Section 12 claims based on the Principal Protection Notes should be denied on this basis alone.

Defendants do not – and cannot – dispute the literal falsity of these statements or that a reasonable investor would consider the fact that their principal was not actually protected to be material to his investment. Even if Defendants attempt to argue on reply that their promises of principal protection were not material, the question of whether the false statements were material to a reasonable investor is factual in nature and should not be resolved in the context of a motion to dismiss. *See Ganino*, 228 F.3d at 162 ("a complaint may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance") (citations omitted).

B. The Principal Protection Note Offerings Are Misleading

Defendants argue that the false promises of principal protection are not actionable because the Pricing Supplements direct investors to read several incorporated documents that

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[93] PS No. 1 (52522L525) at 6 (Hou Ex. 28) ("**No Principal Protection Unless You Hold the Notes To Maturity**"); PS No. 1 (52522L566) at 5 (Hou Ex. 29) (same); PS No. 219 (52520W440) at 6 (Hou Ex. 23) ("**Principal protection only if you hold the Notes to maturity**"); PS No. 264 (52517P2P5) at 6 (Hou Ex. 24) (same); PS No. 307 (52517P3H2) at 6 (Hou Ex. 25) (same); PS No. 409 (52517P5K3) at 6 (Hou Ex. 26) (same); PS No. 625 (52520W325) at 6 (Hou Ex. 27) (same); PS No. 1 (52522L806) at 5 (Hou Ex. 30) ("**Partial Principal Protection Only Applies if You Hold the Notes to Maturity**"); PS No. 1 (52523J206) at 4 (Hou Ex. 31) (same).

were not actually delivered to investors but were available from the SEC website or by calling UBS or Lehman. ¶239. There is nothing Defendants can possibly point to in the Offering Documents, however, that can counteract the objectively untrue statements in the Pricing Supplements and exculpate Defendants from liability. *See Va. Bankshares,* 501 U.S. at 1097, 111 S. Ct. at 2760.

1. The Offering Documents Confirm That The Assurances In <u>The Pricing Supplements Supersede Any Conflicting Information</u>

An investor following the instructions to read each of the documents incorporated by reference into the Pricing Supplement would have reasonably concluded ***from Lehman's and UBS's own statements*** that the Pricing Supplement's promised return of principal at maturity superseded any contradictory statement in the incorporated documents. Returning to the example of the Pricing Supplement for one of the Notes Mr. Gott purchased (the "100% Principal Protection Absolute Return Barrier Notes Linked to the S&P 500 Index" discussed above), the Pricing Supplement incorporates at least five different documents: (1) Base Prospectus dated May 30, 2006 (Hou Ex. 2); (2) Medium-Term Notes, Series I, Prospectus Supplement dated May 30, 2006 (the "MTN prospectus supplement") (Hou Ex. 19); (3) Product Supplement no. 550-I dated November 27, 2007 (Hou Ex. 20); (4) Underlying Supplement no. 100 dated January 28, 2008 (not included by Defendants as an exhibit, but relating only to the extrinsic index, S&P 500); and (5) "any other relevant terms supplement and any other relevant free writing prospectus."[94]

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[94] PS No. 1 (52522L525) at 2 (Hou Ex. 28). The Base Prospectus, in turn, incorporates Lehman's Forms 10-K, 10-Q and 8-K that were filed with the SEC prior to the offering date of the Notes. For Mr. Gott's Pricing Supplement, this includes: (1) Form 10-K dated Feb. 13, 2007; (2) Form 8-K dated Mar. 14, 2007; (3) Form 10-Q dated Apr. 9, 2007; (4) Form 8-K dated June 12, 2007; (5) Form 10-Q dated July 10, 2007; (6) Form 8-K dated Sept. 18, 2007; (7) Form 10-Q dated Oct. 10, 2007; (8) Form 8-K dated Dec. 13, 2007; and (9) Form 10-K dated Jan. 29, 2008. *See also* PS No. 219 (52520W440) at 2 (Hou Ex. 23); PS No. 264 (52517P2P5) at 2 (Hou Ex. 24); PS No. 307 (52517P3H2) at 2 (Hou Ex. 25); PS No. 409 (52517P5K3) at 2 (Hou Ex. 26); PS No. 625 (52520W325) at 2 (Hou

First, it should be noted that the Pricing Supplement stated that it superseded anything in the earlier documents that is inconsistent:

> To the extent that there are any inconsistencies among the documents listed below [the product supplement, underlying supplement, MTN prospectus supplement and base prospectus], **this pricing supplement shall supersede** product supplement no. 550-I, which shall, likewise, supersede the base prospectuses and the MTN prospectus supplement.[95]

(Defendants replaced this sentence with ellipses in the lengthy quote on page 63 of their opposition.) Thus, even if the remaining documents contradicted the guarantees in the Pricing Supplement – which they do not – investors would still be under the impression that the Pricing Supplement controlled.

Moreover, the first filed of these incorporated documents, the May 30, 2006 Base Prospectus, does not mention "principal protection" investments at all. As for the MTN prospectus supplement, though Defendants highlight a paragraph that concludes, "we may be unable to make payments of principal or interest in respect of the notes and you could lose all or part of your investment," Def. Br. 66; Hou Ex. 19 at S-7, Defendants fail to note that the MTN prospectus supplement explicitly told investors that any inconsistency between the MTN prospectus supplement and the Pricing Supplement must be resolved in favor of the Pricing Supplement:

> **If the information in the pricing supplement differs from this prospectus supplement, the pricing supplement will control**. The pricing supplement may also add, update or change information contained in the accompanying prospectus and the prospectus supplement. **Thus the statements made in this prospectus supplement or the accompanying prospectus may not apply to your notes.**

Ex. 27); PS No. 1 (52522L566) at 2 (Hou Ex. 29); PS No. 1 (52522L806) at 2 (Hou Ex. 30); PS No. 1 (52523J206) at 2 (Hou Ex. 31).

[95] PS No. 1 (52522L525) at 2 (Hou Ex. 28). *See also* PS No. 1 (52522L566) at 2 (Hou Ex. 29); PS No. 1 (52522L806) at 2 (Hou Ex. 30); PS No. 1 (52523J206) at 2 (Hou Ex. 31).

Hou Ex. 19 at S-13 (emphasis added). In other words, the single-line warning buried in the MTN prospectus supplement could not have overridden the false promises that dominated Pricing Supplement.

The next filed document is the Product Supplement, which is the first of the incorporated documents that actually mentions "principal protection" investments. But rather than contradict the false statements in the Pricing Supplement, the Product Supplement reinforces them with such statements as:

- "Full principal protection if the notes are held to maturity."
- "Unless otherwise specified in the relevant terms supplements, cash payment at maturity of the principal amount plus an Additional Amount, which may be zero."
- "Principal Protection at Maturity: 100%."

And, like the MTN prospectus supplement, the Product Supplement also reaffirms that the Pricing Supplements will have the most up-to-date and accurate information about the investments:

> Lehman may offer and sell 100% Principal Protection Absolute Return Barrier Notes Linked to an Index from time to time. This product supplement no. 550-I describes terms that will apply generally to these notes, and supplements the terms described in the accompanying base prospectus and MTN prospectus statement. **A separate underlying supplement and term sheet or pricing supplement, as the case may be, will describe the Index and the terms that apply specifically to the notes, including any changes to the terms specified below**.[96]

Finally, Underlying Supplement No. 100 relates only to the linked extrinsic index (in this example, the S&P 500) and does not mention "principal protection" investments. Arriving back at the Pricing Supplement, then, the investor reads the numerous statements promising repayment of the principal at maturity, with nothing to contradict them. (*see* Section VIII.B.1

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[96] Product Supplement No. 550-I (Nov. 27, 2007) (Hou Ex. 20). *See also* Product Supplement No. 550-I (Feb. 21, 2008) (Hou Ex. 21); Prod. Supp. No. 820-I (Mar. 26, 2008) (Hou Ex. 22).

above).

2. Defendants Cannot Evade Liability By Burying Critical Facts

The Pricing Supplements disclose one and only one circumstance in which the investor may not be repaid his principal: if the investor sells the Note prior to its maturity date.[97] Nowhere do the Pricing Supplements divulge any other risk to the investor receiving the return of his principal, so long as he holds the Note to maturity. ¶¶239, 242.[98]

Defendants try to shift the focus from Plaintiffs' central allegation regarding Principal Protection Notes in the Complaint − that the Pricing Supplements falsely and misleadingly assure the return of investors' principal investment − by plucking a few statements out of the Pricing Supplements and the underlying Offering Documents that they contend adequately disclosed to investors that the repayment of their principal depended solely on Lehman's solvency. As Defendants acknowledge, however, the relevant inquiry "is not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered." Def. Br. 61-62 (quoting *Halperin*, 295 F.3d at 357); *see also In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 476 (S.D.N.Y. 2004) (a defendant "cannot secure dismissal by cherry-picking only those allegations susceptible to rebuttal and disregarding the remainder").

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[97] PS No. 1 (52522L525) at 6 (Hou Ex. 28) ("No Principal Protection Unless You Hold the Notes To Maturity"); PS No. 1 (52522L566) at 5 (Hou Ex. 29) (same); PS No. 219 (52520W440) at 6 (Hou Ex. 23) ("Principal protection only if you hold the Notes to maturity"); PS No. 264 (52517P2P5) at 6 (Hou Ex. 24) (same); PS No. 307 (52517P3H2) at 6 (Hou Ex. 25) (same); PS No. 409 (52517P5K3) at 6 (Hou Ex. 26) (same); PS No. 625 (52520W325) at 6 (Hou Ex. 27) (same); PS No. 1 (52522L806) at 5 (Hou Ex. 30) ("Partial Principal Protection Only Applies if You Hold the Notes to Maturity"); PS No. 1 (52523J206) at 4 (Hou Ex. 31) (same).

[98] The brochures referenced in paragraph 242(g) of the Complaint are the April 2008 and June 2008 Free Writing Prospectuses, attached as Kessler Exs. G, H_. Defendants are liable under Sections 11 and 12 for false statements in these prospectuses because they were filed with the SEC pursuant to the same shelf registration statement and were explicitly incorporated into the Principal Protection Note offerings. *See* 17 C.F.R. § 230.415; *In re Worldcom,* 346 F. Supp. 2d at 667.

Defendants' preoccupation with "whether isolated statements within a document were true" contradicts the very purpose of the Securities Act, which is "to promote full and fair disclosure of information to the public in the sales of securities." *Pinter v. Dahl*, 486 U.S. 622, 646 (1988); *see also Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 126 (2d Cir. 1998). "[T]he focus is not 'on whether particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misled a reasonable investor.'" *WRT Energy*, 2005 WL 323729, at *8 (quoting *DeMaria,* 318 F.3d 170, 180).

The isolated statements Defendants identify in the Pricing Supplements fall far short of full and fair disclosure of the risk of default by Lehman and the potential risk to investors. Defendants cite (1) a statement buried at the end of the risks listed on the fifth or sixth page that says the "credit of issuer . . . may affect the market value of the Notes";[99] (2) a footnote on the third page that references Lehman's credit rating;[100] and (3) a statement that "The Notes may not be suitable for you if, among other considerations . . . You prefer the lower risk, and therefore accept the potentially lower returns, of non-structured fixed income investments with comparable maturities and credit ratings."[101] Def. Br. 65-66, 70. None of these statements alerts investors to the fact that their investment will be worthless if Lehman becomes insolvent and cannot pay its debts, and Defendants do not offer any plausible explanation of how a reasonable investor could

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[99] PS No. 1 (52522L525) at 6 (Hou Ex. 28). *See also* PS No. 625 (52520W325) at 7 (Hou Ex. 27); PS No. 1 (52522L566) at 6 (Hou Ex. 29); PS No. 1 (52522L806) at 5 (Hou Ex. 30); PS No. 1 (52523J206) at 5 (Hou Ex. 31).

[100] "Lehman Brothers Holdings Inc. is rated A+ by Standard & Poor's, A1 by Moody's and AA-by Fitch. A credit rating reflects the creditworthiness of Lehman Brothers Holdings Inc. and is not a recommendation to buy, sell or hold securities, and it may be subject to revision or withdrawal at any time by the assigning rating organization. Each rating should be evaluated independently of any other rating. The creditworthiness of the issuer does not affect or enhance the likely performance of the investment other than the ability of the issuer to meet its obligations." PS No. 1 (52522L525) at 3 n.1 (Hou Ex. 28).

[101] PS No. 219 (52520W440) at 2 (Hou Ex. 23); PS No. 625 (52520W325) at 2 (Hou Ex. 27). *See also* PS No. 1 (52522L525) at 2 (Hou Ex. 28); PS No. 1 (52522L566) at 2 (Hou Ex. 29); PS No. 1 (52522L806) at 2 (Hou Ex. 30); PS No. 1 (52523J206) at 2 (Hou Ex. 31).

draw that conclusion.

Even if these statements are "literally true," they are too vague to alert a reasonable investor to the actual risk to their principal investment. *See, e.g., Credit Suisse,* 2001 WL 300733, at *8. The most a reasonable investor is likely to infer from the "creditworthiness" statement is that the extrinsic index might fluctuate, thereby affecting whether the investment pays anything more than the principal at maturity, or that the value of Notes sold prior to the maturity date might be impacted. This is particularly evident when the statements are read in context, buried among abundant references to "principal protection," as well as other references to the "market value" of the Notes that focus on the price an investor might receive for the sale of the Notes in a secondary market prior to maturity.[102] The reference to "non-structured fixed income investments with comparable maturities and credit ratings" is no more illuminating because it merely points out the risk associated with fluctuations in the linked index, not the principal. *See, e.g., Hunt*, 159 F.3d at 728-29 (cautionary language did not foreclose liability because it "did not warn of the risk plaintiffs claim was not disclosed"); *In re Flag Telecom*, 2009 WL 1181293, at *8 ("The requirement that the cautionary language match the specific risk

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[102] See PS No. 1 (52522L525) at 6 (Hou Ex. 28) ("Market Risk − Amounts payable on the Notes and their market value will depend on the performance of the Index and will depend on where the Index closes on any single trading day . . . ." and "Certain Built-in Costs are Likely to Adversely Affect the Value of the Notes Prior to Maturity"). See also PS No. 1 (52522L566) at 5 (Hou Ex. 29) (same); PS No. 219 (52520W440) at 6 (Hou Ex. 23) ("The trading value of the Notes will be affected by factors that interrelate in complex ways, including (but not limited to) the prevailing exchange rates of the Basket Currencies relative to the U.S. dollar from time to time . . . selling this or any fixed income security prior to maturity may result in a dollar price less than 100% of the applicable principal amount of Notes sold"); PS No. 625 (52520W325) at 6 (Hou Ex. 27) (same); PS No. 264 (52517P2P5) at 7 (Hou Ex. 24) ("The market value of the Notes may be influenced by unpredictable factors − The existence, magnitude and longevity of the risks associated with the Notes depend on factors over which we have no control and that cannot be readily foreseen, including, but not limited to, economic events, changes in monetary policy, inflation, interest rate volatility, supply and demand for the Notes, [etc.] . . ." and "if you sell this or any fixed income security prior to maturity, you may receive a dollar price less than 100% of the applicable principal amount of Notes sold"); PS No. 307 (52517P3H2) at 7 (Hou Ex. 25) (same); PS No. 409 (52517P5K3) at 7 (Hou Ex. 26) (same); PS No. 1 (52522L806) at 5 (Hou Ex. 30) ("If you sell your Notes in the secondary market, you may have to sell them at a discount . . ." and "Certain Built-in Costs are Likely to Adversely Affect the Value of the Notes Prior to Maturity"); PS No. 1 (52523J206) at 4 (Hou Ex. 31) (same).

is particularly important, considering that most, if not all security offerings contain cautionary language").

Moreover, these purported disclosures were not "in close proximity" with, or given the same prominence in, the Pricing Supplements as the literally false promise of "principal protection." *Id.*, at *10; *see also Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 210 (2d Cir. 1980) ("disclosure in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither over subtle nor overplayed, its meaning accurate, yet accessible . . . . The disclosure must be capable of being perceived as material and its significance, that is, its relationship to other aspects of the company's condition susceptible to common understanding.").[103]

Because the purported "disclosures" are de-emphasized, imprecise and untethered to the assurances of "principal protection," the Pricing Supplements fail to provide investors with the full and fair disclosure required by the Securities Act. *See McMahan*, 900 F.2d at 579 ("[s]ome statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors . . . when read as a whole, the defendants' representations connoted a richer message than that conveyed by a literal reading of the statements"); *see also In re Flag Telecom*, 2009 WL 1181293, at *11 (court "cannot rule that the scattered disclosures in various amendments, annexes and exhibits to the Prospectus and Registration Statement were sufficient as a matter of law to disclose the material facts to reasonable investors"); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 453 n.11 (S.D.N.Y. 2005) ("An investor should not be called upon to piece together buried information from distinct

[103] In *Greenapple*, unlike here, the disclosure was made in "fair and intelligible" language and was "a fair disclosure of unsurpassed depth." *Id.* at 211.

parts" of defendants' reports to investors).[104]

Defendants also argue that investors should have parsed the incorporated materials and focused on statements made on pages 2 and 8 of the base prospectus, pages 4, 6 and 7 of the MTN prospectus supplement, and page 7 of the Product Supplement. Def. Br. 65, 65 n.64, 66 & 70. Although somewhere on each of these pages is a brief reference to the investments as Lehman's unsecured debt, a reasonable investor would have accepted the admonition in the Pricing Supplement that those inconsistencies simply do not apply to the Principal Protection Notes. Moreover, this handful of statements suffers from the same problem as the obscure references to "creditworthiness" in the Pricing Supplements − they do not qualify the Pricing Supplement's promise of "principal protection," much less inform investors about Lehman's precarious financial status or the consequences of Lehman's default.

Even if one interprets these disclosures as qualifications to the assurance of principal protection, the disclosures are buried in documents that were not actually delivered to investors. Although the SEC regulations permit the incorporation of other filings by reference, compliance with the shelf registration procedures did not give Lehman and UBS license to obscure the facts from investors by scattering purportedly critical information throughout numerous lengthy documents. "The entire legislative scheme can be frustrated by technical compliance with the requirements of the Securities and Exchange Commission's [Forms] for preparation of registration statements in the absence of any real intent to communicate." *Feit*, 332 F. Supp. at 564. "In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information

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[104] The other disclosure that Defendants point to in the UBS Pricing Supplements is that "[e]ach PPN pricing supplement itself states that Lehman is the issuer." Def. Br. 64. But that is not information that Plaintiffs identify as omitted. What Plaintiffs point out (and Defendants do not contest) is that the Pricing Supplements fail to disclose that the Notes do not protect the investor's principal. ¶239(f).

as possible while exuding an air of total candor." *Id.* at 565.

The cases Defendants cite confirm that "[a] prospectus will violate federal securities laws if it does not disclose material objective factual matters, or buries those matters beneath other information, or treats them cavalierly," but ultimately hold that − unlike here − the Offering Documents included "cautionary statements and . . . specific, prominent disclosures."[105]

X. THE COMPLAINT STATES A CLAIM UNDER SECTION 15 OF THE SECURITIES ACT

The Complaint properly pleads a claim for control person liability under Section 15 of the Securities Act by alleging both a primary violation of the Securities Act and that the Securities Act Control Person Defendants controlled the primary violators. *See In re Adelphia Commc'ns Corp. Sec. Litig.*, No. 03 MD 1529 (LMM), 2007 WL 2615928, at *10 (S.D.N.Y. Sept. 10, 2007); 15 U.S.C. § 77o. The Securities Act Control Person Defendants' sole argument is that the Complaint fails to state a claim for a predicate primary violation of the Securities Act. Therefore, if the Court finds that Plaintiffs have stated a claim under Sections 11 or 12 of the Securities Act, it need not make any further inquiry to determine that Plaintiffs have adequately pleaded control person claims against Defendants Fuld, O'Meara, Callan, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez, Kaufman and Macomber (the Securities Act

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[105] *DeMaria*, 318 F.3d at 181 (citations omitted); *see also Halperin*, 295 F.3d at 359 (the cautionary language in the offering documents "explicitly warned" of the risk that the stocks might not be registered); *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5-6 (finding that consecutive disclosures made in a single paragraph adequately disclosed investment risk and that "assurances of hedging" in the prospectus "were balanced by extensive cautionary language"); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 762 (2d Cir. 1991) ("we find the language remarkably direct"); *Lin v. Interactive Brokers Group, Inc.*, 574 F. Supp. 2d 408, 417 (S.D.N.Y. 2008) (although "no amount of general cautionary language can protect a company from failure to disclose a specific, known risk," disclosures of known risks in defendant's materials were "accurate and sufficiently candid"); *In re WorldCom,* 346 F. Supp. 2d at 657 (recognizing that Section 11 reflects "Congress' sense that underwriters, issuers and accountants 'bear a moral responsibility to the public [that] is particularly heavy'") (citations omitted); *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000) (finding plaintiffs' allegations of omissions conclusory and insufficient); *In re Union Carbide*, 648 F. Supp. 1322 (S.D.N.Y. 1986) (plaintiffs asserted fifteen omissions from the offering documents but did not identify any affirmative statements that were rendered misleading by the omissions).

Individual Defendants), and Defendants' motion to dismiss the control person claims should be denied.

Defendants Gregory (COO) and Lowitt (CFO and Co-Chief Administrative Officer) advance two additional arguments, without citation to authority. They argue that because (1) they individually are not alleged to have violated Section 11 (a primary violation of the Securities Act), and (2) they did not sign the Registration Statement, they cannot be charged as control persons under Section 15 of the Securities Act. Def. Br. 72. Both arguments fundamentally misconstrue the nature of control person liability.

Gregory and Lowitt are charged with control person liability because they are alleged to have *controlled* a primary violator, not because they personally *committed* a primary violation or signed the Offering Documents. *See Briarwood Inves. Inc. v. Care Inv. Trust Inc.*, No. 07-8159(LLS), 2009 WL 536517, at *5 (S.D.N.Y. Mar. 4, 2009) (liability attaches to one who *controls* a primarily violator).[106] Plaintiffs have satisfied the pleading standard by alleging a primary violation of Section 11 against the Company's most senior officers responsible for the content and dissemination of the Shelf Registration Statement, Defendants Fuld (CEO and Chairman), O'Meara (CFO, Controller and Executive Vice President), and Callan (CFO and EVP). ¶¶243-54. Each of these Defendants is alleged to be a control person of Lehman, ¶¶266-67, and under basic agency principles, the actions of these Defendants can be imputed to Lehman. *See, e.g., Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001) (In the securities fraud context, as in other spheres, "a corporation can only act

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[106] Gregory and Lowitt along with Fuld, O'Meara and Callan, are included in the group referred to in the Complaint as the Insider Defendants, who "because of their senior positions at Lehman, were controlling persons of the Company and possessed the power and authority to control the contents of Lehman's reports to the SEC, press releases, and presentations to securities analysts, money and portfolio managers, and institutional investors – *i.e.,* the market." ¶30.

through its employees and agents."); *Tellabs II*, 513 F.3d at 708-10 (a corporate officer's conduct generally is imputed to the corporation).

Moreover, it is irrelevant that Lehman is not a named defendant in the Complaint. Where, as here, a primary violator is absent or unavailable because it is in bankruptcy, control person liability claims have routinely been allowed to proceed.[107]

XI. CONCLUSION

For the reasons set forth above, the Court should deny the Defendants' motion to dismiss the Complaint. In the event the Court finds that the Securities Act claims do not state a claim, because the Complaint's Securities Act claims sound in fraud and do not meet the Rule 9(b) pleading requirements, or suffer from any other pleading deficiency, Plaintiffs respectfully request leave to amend. As the Court noted at the January 8 hearing, if the Securities Act claims have "crossed the line" and inadvertently alleged fraud, "it can be cured by amendment." Tr. 1/08/09 at 24.

Dated: June 29, 2009

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[107] *See, e.g., Suprema*, 438 F.3d at 285 (there is no requirement in the language of Section 15 that the controlled person be named as a defendant as a predicate to imposing liability upon the controlling individual defendants. A plaintiff need only establish the controlled person's liability). Cases sustaining control person liability claims under Section 20(a) of the Exchange Act where the corporate entity is unavailable are equally persuasive in the context of Plaintiffs' Section 15 claim. *See. e.g., In re U.S. Interactive, Inc.*, No. 01-CV-522, 2002 WL 1971252, (E.D. Pa. 2002) (company not a named defendant because of bankruptcy); *Schleicher v. Wendt*, 529 F. Supp. 2d 959 (S.D. Ind. 2007) (issuer's potential liability discharged through bankruptcy); *In re Hayes Lemmerz Int'l, Inc.*, 271 F. Supp. 2d 1007, 1022 n.11 (E.D. Mich. 2003) ("[I]f the complaint states a primary violation by the [c]ompany, even if the [c]ompany is not named in the complaint as a defendant, then a [control person] claim can stand if the individuals were controlling persons."); *In re CitiSource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1077 (S.D.N.Y. 1988) ("liability need not be actually visited upon the primary violator before a controlling person may be held liable for the primary violator's wrong").

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