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-CV-5523-LAK

Civil Action 09-MD-2017 (LAK)

ECF CASE

LEAD PLAINTIFFS' OPPOSITION TO
MOTION TO DISMISS THE EXCHANGE ACT CLAIMS

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I. PRELIMINARY STATEMENT

This is a securities class action on behalf of purchasers of Lehman Brothers Holdings Inc. ("Lehman or the "Company") securities between February 13, 2007, (when Lehman filed its annual report on Form 10-K for the fiscal year ending November 23, 2006) and September 15, 2008, (when Lehman petitioned for bankruptcy protection). The Complaint asserts claims arising under the Securities Act of 1933 (the "Securities Act") and, separately, the Securities Exchange Act of 1934 (the "Exchange Act").[1] ¶¶12-13. This memorandum focuses on the Insider Defendants' motion to dismiss claims against them for violations of §§ 10(b), 20(a) and 20A of the Exchange Act.[2]

The Insider Defendants oversaw Lehman's mortgage- and real estate-related operations and spoke publicly about such operations in SEC filings and press releases and during shareholder meetings and analyst conference calls. Lehman was a major participant in all aspects of the mortgage and real estate markets, including originating residential mortgages and commercial loans, securitizing loans, marketing various asset-backed instruments and investing directly in real estate deals. ¶¶3, 93, 123. Throughout 2006 and 2007, Lehman became increasingly invested in the commercial real estate market. By March 2008, Lehman had more commercial holdings than any other firm. ¶123.

While Lehman amassed its real estate- and mortgage-related portfolio, the markets were in the midst of an unprecedented meltdown. Dozens of companies with mortgage and real estate

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[1] "¶_" refers to paragraphs in the Second Amended Consolidated Class Action Complaint For Violations Of The Federal Securities Laws ("Complaint"). Dkt. No. 30. "Insider Defendants" refers to Richard S. Fuld, Jr. ("Fuld"), Christopher M. O'Meara ("O'Meara"), Joseph M. Gregory ("Gregory"), Erin Callan ("Callan") and Ian Lowitt ("Lowitt").

[2] *See* Dkt. No. 95 ("Exec. Br."). As for the Securities Act claims, Lead Plaintiffs respectfully refer the Court to their concurrently-filed Opposition to Defendants' Motions to Dismiss Securities Act Claims.

exposure booked massive write-downs, ceased operations or petitioned for bankruptcy. Firms like Citigroup, Merrill Lynch, Morgan Stanley, Bear Stearns and UBS booked enormous gross losses related to their mortgage-related assets in 2007.

The Insider Defendants, however, portrayed Lehman as different from its competitors because Lehman supposedly had superior risk management and hedging strategies and was able to weather economic storms due to its purportedly strong capital and liquidity positions. As one analyst wrote following Defendant Lowitt's presentation on November 14, 2007, "The company argued that its business is benefiting from the problems surfacing elsewhere." ¶285.

Internally, however, the Insider Defendants knew the meltdown was badly damaging Lehman. For example, by early 2007, Insider Defendants knew that Lehman's mortgage assets had decreased in value because Lehman made margin calls on loan originators to whom it had extended credit lines due to the decreased value of similar mortgage assets used as collateral underlying the credit lines. ¶145. A January 2008 internal presentation also acknowledged that the mortgage crisis was having a severe impact on the Company's operations and liquidity position, stating "[v]ery few of the top financial issuers have been able to escape damage from the subprime fallout." ¶347. The presentation also warned that, because "a small number of investors account for a large portion of demand [for Lehman issues], liquidity can disappear quite fast." ¶347. Likewise, an internal Lehman memorandum from June 2008 asked of Lehman executives: "Why did we allow ourselves to be so exposed?" The memorandum admitted that "[c]onditions clearly [were] not sustainable. Saw warning signs. Did not move early, fast enough. Not enough discipline in our capital allocation." ¶348.

The Insider Defendants concealed the nature of Lehman's exposure and the precarious nature of Lehman's liquidity and capital positions, even refusing to answer direct questions. *See,*

e.g., ¶¶272-75, 279-280, 354. As explained below, the Insider Defendants made untrue statements and omitted material facts regarding Lehman's (1) high-risk residential mortgage lending practices; (2) concentration of mortgage related risks; (3) the value of Lehman's mortgage-related and real estate investments; (4) risk mitigation and hedging strategies – including what investors would later learn was its inability to hedge Alt-A exposure;[3] and (5) capitalization and liquidity.

Ultimately, the truth about Lehman's financial condition and overvalued assets was disclosed in a series of announcements and events. Before the markets opened on June 9, 2008, Lehman announced its first ever quarterly loss as a public company – and disclosed that it incurred ***additional*** losses due to the very "hedges" that they publicly proclaimed would mitigate losses. ¶363. Even then, however, the Insider Defendants continued to reassure investors that the Company was financially strong. Lehman's Chief Financial Officer ("CFO"), Eric Callan even characterized Lehman's deleveraging as "aggressive" and "complete." ¶6.

Internally, however, the Insider Defendants continued to struggle with Lehman's toxic assets. By September 9, 2008, Lehman executives calculated that the Company required at least $3 billion in additional capital. Lehman also received demands from JPMorgan for $10 billion to cover lending positions. Nonetheless, on September 10, 2008, Defendants Fuld and Lowitt held a conference call to assure investors that "our liquidity position . . . remains very strong," "we have maintained our strong liquidity and capital profiles even in this difficult environment," and "we think that clearly with our capital position at the moment is, it's strong." ¶9.

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[3] "Alt-A," or Alternative A-paper, are loans that are supposed to be less risky than subprime and closer in risk to prime. Lehman's Alt-A loans, however, were actually more akin to subprime loans. ¶96.

While Lehman executives publicly promoted Lehman's supposedly sound financial condition, Fuld was privately trying to sell Lehman's commercial real estate assets to various banks. When experts from such banks analyzed Lehman's $32.6 billion portfolio, however, they found that it was ***overvalued by as much as 35%***. ¶¶9, 320. Treasury Secretary Paulson also later explained that 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.

In sum, the Complaint states a claim against each Insider Defendant, complying with Supreme Court and Second Circuit precedent and the pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The Complaint sets forth each false and misleading statement and explains why each was false and misleading, and the allegations raise a strong inference of the Insider Defendants' scienter through direct and circumstantial evidence.

The Insider Defendants' claims of ignorance are simply incredible. They were responsible for Lehman's strategic direction and its day-to-day affairs. Lehman's real estate and mortgage business was a critical focus of investor attention, and Insider Defendants repeatedly spoke on this topic. Moreover, given Lehman's involvement in all aspects of the real estate and mortgage markets, Insider Defendants had a host of both Lehman-specific and other market data indicating the actual state of Lehman's related businesses and assets. Attempting to diffuse the inference of scienter, the Insider Defendants rely on materials outside the four corners of the Complaint, casting themselves as innocent victims, ignorant of the actual condition of the company they headed. They ignore that Lehman, at their direction, was one of the primary culprits in creating the unsustainable mortgage, securitization, and real estate markets, all of which led to record (if only temporary) profits for Lehman and for the Insider Defendants to profit. Instead of coming clean with appropriate disclosures and valuation write-downs, the Insider

Defendants made the aforementioned misrepresentations and omissions while simultaneously raising over $40 billion through hundreds of public offerings.

Due to Insider Defendants' deception, investors who purchased Lehman common stock, call options, and/or who sold put options between June 12, 2007 (when Lehman issued its second quarter 2007 financial results) and September 15, 2008 (the "Exchange Act Period") suffered substantial losses when the truth was revealed.

II. <u>SUMMARY OF ALLEGATIONS</u>

In their motion, the Insider Defendants' "Factual Background" relies heavily on "facts" from outside of the Complaint, and on Insider Defendants' characterizations of such "facts," for a transparent reason: recounting the allegations pled in the Complaint would force them to admit that the Complaint amply states a claim. If at trial Insider Defendants wish to blame the regulators or portray Lehman as a "victim [of] unforeseen and uncontrollable forces," they may do so. At this stage, however, "[i]t is not the Court's role to speculate on the causes of the current economic situation." *In re Countrywide Fin. Corp. Sec. Litig.,* 588 F. Supp. 2d 1132, 1173-74 (C.D. Cal. 2008) (rejecting defendants' argument that mortgage lender suffered losses due to "an 'unprecedented' external 'liquidity crisis'" and "other macroeconomic arguments").

Lehman's origination of residential loans was conducted through its subsidiaries, BNC Mortgage LLC ("BNC") and Aurora Loan Services LLC ("Aurora"), which originated and acquired subprime and Alt-A loans, respectively. ¶¶97, 106. Lehman directly controlled BNC and Aurora, received regular performance reports from them, and appointed Lehman employees to oversee Aurora's repurchase area. ¶¶332, 336-41.

Lehman's mortgage origination and securitization business contributed substantially to Lehman's Principal Transactions revenue, which accounted for roughly 50% of Lehman's reported net revenues for fiscal years 2005-2007. ¶328. Lehman originated approximately $60

billion in residential mortgages during 2006 and $47 billion in 2007, and it originated approximately $34 billion in commercial mortgages in 2006 and $60 billion in 2007. ¶323. In 2007, Lehman also securitized more than $100 billion in residential mortgages and approximately $20 billion in commercial mortgages. ¶323.

By no later than June 12, 2007, the Insider Defendants were aware or recklessly disregarded that the residential housing market had continued its decline from 2006 and that the commercial mortgage and CMBS markets were declining, as confirmed by internal documents. ¶¶95, 337, 341. The Insider Defendants were also aware or recklessly disregarded that the residential loans originated or acquired by BNC and Aurora were largely impaired due to the inclusion of risky stated income or no documentation loans (or "liar loans"), negative amortization products (pursuant to which borrowers could make monthly payments less than the interest due each month), and loans to borrowers with credit scores in the low 500s, poor credit histories, recent bankruptcies, or who provided no money down. ¶¶97-103. Because of Lehman's risky loan products and the fact that its subsidiaries made "hundreds and hundreds of exceptions" to underwriting guidelines, quality control investigators, who spot-checked a small portion of the loans, regularly found that up to 70% of the loans contained false information. ¶¶103-05, 333.

Starting in early 2007, the ABX, an index that Lehman helped to create, signaled that the value of securities backed by residential subprime mortgages had fallen substantially. ¶142. By this time, loans in Lehman's securitization pools were experiencing increased deficiencies. ¶143. Also, starting in the first quarter of 2007, Lehman's inability to qualify its securitizations as sales for accounting treatment, rather than as financings, demonstrated that Lehman's mortgage-related assets had become increasingly illiquid and suffered deterioration in value.

¶144. By early 2007, Lehman began making margin calls on loan originators to which it had extended credit lines because of the decreased value of mortgage assets used as collateral underlying the credit lines. ¶145. By the spring of 2007, Lehman informed employees that the market's appetite for subprime loans had changed, and "we're not going to make the loans we used to, because there's a problem on the horizon." ¶345.

In May 2007, Michael Gelband, the head of Lehman's Fixed Income division involved with activities concerning mortgage-related products, left the position after he "balked at taking more risk" relating to Lehman's exposure to mortgage-related investments. ¶343.

A. Second Quarter 2007

On June 12, 2007, in a conference call to discuss Lehman's "record" financial results for 2Q07, Lehman's CFO, Defendant O'Meara, told investors and analysts that "[w]e continue to believe the subprime market challenges are and will continue to be reasonably contained to this asset class." ¶¶271-75. O'Meara concealed, however, the size of Lehman's exposure to subprime mortgages – $6.3 billion – and that in addition to its subprime exposure, Lehman was also exposed to vast amounts of Alt-A mortgages issued under conditions which made them more akin to subprime loans, and that the "challenges" in the subprime market had expanded to Lehman's Alt-A holdings. ¶¶180, 271-72, 274. Nor did O'Meara disclose that Lehman had a practice of changing the appraised value of commercial real estate assets to avoid taking write-offs, (¶334) or that Lehman faced increasing repurchase requests by investors who acquired impaired loans from Lehman, subjecting it to large losses. ¶¶109-116. Although O'Meara conceded that Lehman had taken "some amount of marks" on mortgage-related positions, he provided no further information – not even whether the "marks" had been "taken" on residential or commercial properties, whole loans, mortgage-backed securities ("MBS"), or other mortgage-related assets. ¶272. Even when pointedly asked by an analyst whether the marks related to

Lehman's subprime or Alt-A securitizations, O'Meara misleadingly answered that "we do have hedging strategies that are in place and have proven to be quite effective" – even though, as Lehman would later admit, Lehman could not directly hedge its multibillion dollar Alt-A portfolio. ¶¶272-74, 276.

On July 18, 2007, when two Bear Stearns funds collapsed, the Insider Defendants continued to portray Lehman as not being affected and specifically dispelled rumors regarding its exposure, stating through spokesperson Kerrie Cohen on July 18, 2007, that "rumors regarding [Lehman's] subprime exposure are totally unfounded." ¶275. In truth, however, the Insider Defendants were aware or recklessly disregarded that: (1) Lehman's loan pools suffered from increasing delinquency rates and defaults based on internal reports and tracing software; (2) Lehman made margin calls on mortgage originators due to the declining value of the loans Lehman acquired from them; (3) there was a rise in loan repurchase requests to and from Lehman's loan originators for nonperforming and fraudulent loans; and (4) Lehman had filed lawsuits against mortgage originators in connection with nonperforming and fraudulent loans. ¶¶145, 282. Moreover, Lehman's commercial holdings were overvalued by billions of dollars, and it had more than $2 billion in bridge equity that it was unable to sell. ¶¶129, 131-34.

B. Third Quarter 2007

On September 18, 2007, in a conference call with analysts and investors following the announcement of Lehman's 3Q07 financial results, Lehman finally disclosed that it had $6.3 billion in subprime mortgage inventory. The Insider Defendants continued to conceal, however, that Lehman had billions more in Alt-A exposures which, due to Lehman's shoddy lending practices, were much like its subprime loans.

Lehman also announced only $700 million in write-downs on its mortgage-related assets, net of the effects of its "hedging" strategies. This write-down was miniscule compared to the

multibillion dollar write-downs of Lehman peers like Merrill Lynch, Citigroup and UBS. Recognizing this fact, Defendant O'Meara assured investors that "we carry all of our financial instruments, inventory, and lending commitments at fair value," "we have marked our book to the actual prices being transacted in the market," "[w]e feel very good about the marks that are on these [mortgage-related] positions," and "we feel that the worst of this credit correction is behind us." ¶277. However, O'Meara deliberately withheld material information concerning the gross write-downs on its mortgage-related assets – necessary for investors to assess Lehman's potential exposure – stating instead that "knowing the gross numbers particularly in that business, I don't think is really a meaningful thing." ¶¶147, 278, 279.

The foregoing statements were false and misleading because Lehman's Alt-A and subprime mortgage inventory, which stayed on Lehman's books due to the reduced opportunities for securitizing mortgages, were not marked to reflect their true value. Additionally, these statements were false because Insider Defendants implied that the effectiveness of Lehman's hedging strategies made it unnecessary for investors to know the gross write-down figures – but, as Lowitt would later admit (¶¶159, 352), Lehman was incapable of directly hedging its multibillion dollar Alt-A exposure. ¶179.

On November 14, 2007, at an investors' conference, Defendant Lowitt further sought to calm investors by promoting the effectiveness of Lehman's hedges. He told investors that Lehman had a "very active and effective hedging program," such that "we don't believe that there will be any requirement for substantial markdowns and certainly no requirement for us to announce anything," and Lehman was "conservative around where we've marked these [mortgage and mortgage-backed] positions and very comfortable with where we are." ¶284.

Following the conference, analysts reported that "Lehman suggested that there will not be

a meaningful mark down" and that "Lehman went beyond these assertions suggesting that it had no major losses in the impacted areas for the industry. The company argued that its business is benefiting from the problems surfacing elsewhere." ¶285.

C. Fiscal Year End And Fourth Quarter 2007

On December 13, 2007, Lehman held a conference call to discuss the Company's 4Q07 financial results, in which it reported record net income of $4.2 billion and record earnings of $7.26 per diluted common share for the 2007 fiscal year. ¶195. Although Lehman took a $1.3 billion write-down of its $32.1 billion portfolio of residential mortgage-related positions for the year, this write-down of 4% was very small compared to those of competing banks such as Citigroup, which wrote down over 30% of its subprime-related assets. ¶¶147-48. Defendant O'Meara continued to conceal Lehman's exposure to losses on its subprime and high-risk Alt-A loans, instead promoting Lehman's "effective hedging strategies," "the strength of [its] risk management culture," and its "disciplined liquidity and capital management framework." ¶286.

By January 2008, however, an internal presentation made by Eric Felder, a Lehman executive, had recognized that "[v]ery few of the top issuers have been able to escape damage from the subprime fallout" and warned that because "a small number of investors account for a large portion of demand [for Lehman issues], liquidity can disappear quite fast." ¶347.

Nevertheless, at an investor forum on February 6, 2008, Lehman's new CFO, Defendant Callan, assured investors that Lehman had exercised "discipline around liquidity, risk management, capital and expenses," that a component of Lehman's risk management framework was "the active hedging of the residential mortgage book," and that Lehman was "feeling pretty good about [its $90 billion] mortgage portfolio." ¶¶272-74, 276, 293-94. The Insider Defendants continued to conceal information about Lehman's massive exposure to high-risk Alt-A mortgage related assets and its inability to directly hedge these assets. ¶¶273-76, 294, 352.

D. First Quarter 2008

By the first quarter of 2008, Lehman had $786 billion of assets and approximately $25 billion of capital – a dangerous ratio of approximately 32 to 1. ¶161. With such high leverage, a 3.3% drop in the value of assets would wipe out the entire value of equity and render Lehman insolvent. ¶162. As such, Defendant Callan continued publicly to emphasize Lehman's "continued diligence around risk management," that "risk management discipline allowed [Lehman] to avoid any single outsize loss," that Lehman "had disciplined liquidity and capital management," that Lehman "continue[d] to do a very, very good job managing the risk on residential mortgages," and that the Company was "very well hedged." ¶¶297-99, 304. Callan also falsely represented that "our valuations [of Lehman's mortgage-related portfolio] reflect how the market is pricing these positions," ¶302, even though Lehman had shifted mortgage-related assets from Levels I and II to Level III, such that they were valued based on management discretion rather than hard data from observable market transactions. ¶149.

In truth, the Company was desperately in need of capital to absorb Lehman's losses on its toxic mortgage- and real estate-related assets. ¶¶306, 309. Despite this fact, Callan reassured investors that when Lehman raised $1.9 billion through an offering of preferred stock one month earlier, it "took care of [its] full year needs" for capital. ¶¶303, 305. When Lehman sought additional capital through the issuance of Series P Preferred Stock just two weeks later, Callan falsely claimed that the offering was in response to "investor interest" and to "bolster the Firm's capital and increase financial flexibility." ¶306. Callan further stated: "The significant oversubscription for this deal demonstrates the confidence that investors have in Lehman Brothers. The success of the transaction is also reflective of the strength of the business model, the capital base and liquidity profile of the Firm as we continue to successfully weather challenging environments." *Id.* at ¶307.

On April 15, 2008, during Lehman's annual shareholder meeting, Lehman CEO, Defendant Fuld, further assured investors that "the worst [of the troubles in the subprime mortgage market] is behind us." ¶308. Fuld concealed Lehman's multibillion exposure to Alt-A assets, which were akin to subprime.

E. Second Quarter 2008

On June 9, 2008, before the markets opened, Lehman issued a press release announcing a net loss of approximately $2.8 billion, or $5.14 per share, for 2Q08, and disclosed that Lehman incurred losses on hedges in the quarter. ¶¶6, 211, 363. The press release further disclosed that Lehman took $4 billion in mark-to-market write-downs. *Id.* at ¶¶6, 363. On this news, Lehman's shares declined 8.7% and continued to fall an additional 19.44% over the next two days. ¶363.

The June 9 announcement only partially revealed the truth, however, as Insider Defendants continued to misrepresent Lehman's financial condition. ¶363. As a result, Lehman was able to raise an additional $6 billion through the offering of common and preferred shares immediately after the announcement. ¶¶6, 163.

In Lehman's conference call on June 9, 2008 to discuss its 2Q08 financial results, Callan assured investors that with the 2Q08 write-down, Lehman's assets were properly valued because "the aggregate number is very large" and the size of the write-down "gives me confidence in the actual accumulated loss across those portfolios, resi[dential] and commercial." ¶313. Further, Callan stated that the $6 billion in capital raised by the Company that very day would not be used "to further decrease leverage, but to take advantage of future market opportunities." ¶310. Callan characterized Lehman's deleveraging as over, and represented that there were no issues "about our viability or the fact that we will be here or the fact that we have sufficient liquidity." ¶¶310, 314, 359. Just three days, later Lehman announced that Callan was demoted and that

Defendant Gregory, Lehman's president, was replaced. ¶6.

On June 16, 2008, Defendants Fuld and Lowitt reiterated that Lehman's capital and liquidity positions had "never been stronger" and that "we don't believe there will be any issues around capital." ¶317. Around this time, however, Insider Defendants were privately shopping the Company due to capital concerns. ¶320. In addition, Fuld had received increasing pressure from then-Treasury Secretary Paulson to find a buyer or strategic partner due to concerns about Lehman's capital. ¶315. A June 2008 internal Lehman memorandum recognized that Lehman had "allow[ed] [itself] to be so exposed" and that it "[s]aw warning signs," but "[d]id not move early, fast enough" and did not have "enough discipline in our capital allocation." ¶348.

F. Third Quarter 2008

By September 9, 2008, Lehman internally calculated that it needed at least $3 billion of additional capital and had received $10 billion in collateral calls from JPMorgan. ¶320. Moreover, mortgage securities experts from Citigroup, Credit Suisse, Deutsche Bank and Goldman Sachs who analyzed Lehman's commercial real estate portfolio found Lehman's $32.6 billion portfolio to be overvalued by as much as 35%, or $12 billion. ¶10. Further, Treasury Secretary Paulson had warned Lehman CEO, Defendant Fuld, "that if he didn't have a solution by the time he announced his third-quarter earnings, there would be a serious problem." ¶315.

On September 10, 2008, Lehman preannounced its 3Q08 financial results. Despite the Insider Defendants' prior assurances that Lehman would not require any substantial write-downs, Lehman reported $7.8 billion in gross write-downs on its mortgage-related assets and real estate investments, "the majority [of which] were in Alt-A driven by increase in Alt-A delinquencies and loss expectations," and reported a $3.9 billion loss for 3Q08. ¶¶154, 159, 318. Lehman also announced a plan to spin off almost all of its $32.6 billion commercial real estate portfolio into a separate publicly-traded company to get these toxic assets off Lehman's books and alleviate the

strain on its balance sheet. ¶136. In connection with this announcement, Lowitt finally admitted that unfortunately "***there is no direct hedge for Alt-A assets***." ¶¶159, 365. On this news, Lehman shares further declined 7% from the prior day's close to $7.25 per share. ¶365.

Defendants Fuld and Lowitt continued to misrepresent the true value of Lehman's mortgage-related assets and the dire state of Lehman's capital and liquidity position. On the September 10, 2008 analyst call, Fuld and Lowitt repeated that Lehman maintained a "very strong liquidity position" and that the Company "maintained [its] strong liquidity and capital profiles even in this difficult environment." ¶¶9, 320, 352.

On September 15, 2008, after the federal government refused to provide Lehman with a bailout because its toxic assets created a "huge hole" in its balance sheet, Lehman filed for bankruptcy protection – the largest corporate bankruptcy in U.S. history. ¶¶10, 321. Upon this news, Lehman's shares declined over 94% to close at $0.21 per share. ¶366. As Lowitt's own affidavit later admitted, contrary to representations made just days earlier, Lehman filed for bankruptcy because it had "significant liquidity problems." ¶¶11, 164. These true facts, however, were not disclosed to Lehman's investors.

During the Exchange Act Period, Lehman's stock traded at a high of $81.30 on June 19, 2007. By September 15, 2008, Lehman's stock price had declined to $0.21, a 99.7% decline from its high. All told, Lehman's market capitalization declined from over $43 billion to a low of $145.8 million on September 15, 2008.

III. ARGUMENT

In assessing the Insider Defendants' Rule 12(b)(6) motion, the Court must accept the Complaint's factual allegations as true and draw all inferences in Plaintiffs' favor. *See Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC,* 376 F. Supp. 2d 385, 393 (S.D.N.Y. 2005); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 508 U.S. 308, 322, 127 S. Ct. 2499, 2509

(2007). The issue on a motion to dismiss is "not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims."[4] "[T]he court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically." *Id.* at 326.

The modern securities laws were designed to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 186, 84 S. Ct. 275, 280 (1963). "[M]eritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions." *Tellabs*, 551 U.S. at 326, 127 S. Ct. at 2511. Section 10(b) furthers these goals by making it unlawful for a person to employ "any manipulative or deceptive device" in contravention of the rules and regulations of the SEC "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b). To state a claim for violation of Section 10(b) and Rule 10b-5 promulgated thereunder, a plaintiff must allege, as Plaintiffs have here: (1) a misrepresentation or omission of material fact in connection with the purchase or sale of a security; (2) defendants' scienter; (3) reliance; and (4) resulting damage. *ATSI Commc'n, Inc. v. Shaar Fund, Ltd.,* 493 F.3d 87, 105 (2d Cir. 2007).

Although Fed. R. Civ. P. 9(b) provides that the circumstances constituting fraud should be pleaded with particularity, this merely means that the complaint must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *Novak v. Kasaks,* 216 F.3d 300, 306 (2d Cir. 2000); *In re Parmalat Sec. Litig.*, 477 F. Supp. 2d

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[4] *Swierkiewicz v. Sorema N.A.,* 534 U.S. 506, 511, 122 S. Ct. 992, 997 (2002); *see also Ashcroft v. Iqbal,* __ U.S. __ 129 S. Ct. 1937, 1949, 173 L. Ed. 2d 868, 884 (2009) ("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.")

602, 611-12 (S.D.N.Y. 2007) ("Specific pieces of information, such as the identity of the speaker, are required under Rule 9(b) only as necessary to serve its underlying purposes.").

Absent a valid request for judicial notice – and none has been made here – matters extraneous to the Complaint cannot be considered.[5] When a court considers extrinsic documents that are not proper for judicial notice, it must convert the motion to a motion for summary judgment and provide plaintiffs with an opportunity to conduct discovery and submit additional supporting materials. *Chambers v. Time Warner, Inc.,* 282 F.3d 147, 154-55 (2d Cir. 2002).

A. The Insider Defendants Made Materially False And Misleading Statements

"Falsity" exists when a defendant makes an "untrue statement of a material fact" or "omit[s] to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading." 15 U.S.C. § 78u-4(b)(1). An analysis of falsity does not entail whether "particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misled a reasonable investors about the nature of the securities." *In re WorldCom, Inc. Sec. Litig.,* 352 F. Supp. 2d 472, 491 (S.D.N.Y. 2005) (quoting *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003)). "Once a corporation has elected to speak, . . , Rule 10b-5 mandates that its speech must be truthful, accurate, and complete."[6]

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[5] *See, e.g., Staehr v. Hartford Fin. Servs. Group, Inc.*, 547 F.3d 406, 424-25 (2d Cir. 2008) (court must not judicially notice extraneous materials for "the truth of their contents"); *Oneida Indian Nation v. New York,* 691 F.2d 1070, 1086 (2d Cir. 1982) (extrinsic evidence not proper basis upon which to grant motion to dismiss without affording plaintiffs an evidentiary hearing).

[6] *In re Bristol Myers Squibb Co. Sec. Litig.,* 586 F. Supp. 2d 148, 159-160 (S.D.N.Y. 2008); *See also*, *Caiola v. Citibank, N.A., New York,* 295 F.3d 312, 331 (2d Cir. 2002) ("[U]pon choosing to speak, one must speak truthfully about material issues."); *Lapin v. Goldman Sachs Group, Inc.,* 506 F. Supp. 2d 221, 237 (S.D.N.Y. 2006); *Hall v. The Children's Place Retail Stores, Inc.,* 580 F. Supp. 2d 212, 225-26 (S.D.N.Y. 2008).

"Only one of Plaintiffs' allegations must satisfy the pleading standard in order to survive dismissal of the Complaint." *Bovee v. Coopers & Lybrand C.P.A.,* 272 F.3d 356, 362 (6th Cir. 2001)); *see Cooper v. Pickett,* 137 F.3d 616, 623 (9th Cir. 1997). Here, for example, Fuld's bullish statements about Lehman's capital and liquidity on September 10, 2008, shortly after receiving collateral call demands from JPMorgan for $10 billion, ¶¶7, 9, 320, suffice to enable the Complaint to proceed.

1. The Insider Defendants Misled Investors About <u>Lehman's High-Risk Residential Mortgage Lending Practices</u>

The Insider Defendants made numerous statements that led investors to believe Lehman was not exposed to high-risk mortgage loans. ¶¶156-57, 171, 175, 177-78, 184-85, 214-17, 226. For example, on June 12, 2007, in Lehman's 2Q07 conference call with analysts, when Defendant O'Meara stated that "[w]e continue to believe the subprime market challenges are and will continue to be reasonably contained in this asset class," he omitted to disclose that the market challenges were not contained to the subprime asset class but had expanded to other asset classes, including Alt-A, of which Lehman had vast amounts. ¶¶271-72.

Further, O'Meara failed to disclose that the majority of Lehman's Alt-A assets were actually akin to subprime and, as such, suffered from high delinquency and defaults, resulting in repurchase requests and losses. ¶¶97-105. Even when directly asked about Alt-A exposure, O'Meara stated only that Lehman "didn't give out what Alt A is or the other businesses inside the securitization business system." ¶274. On July 18, 2007, following the collapse of two Bear Stearn hedge funds, Lehman spokeswoman Kerrie Cohen even assured investors that "rumors regarding [Lehman's] subprime exposure are totally unfounded." ¶275.

When, as here, the method of presenting information obscures or distorts the significance of material facts, it is misleading.[7] On September 18, 2007, when Lehman revealed that it actually had $6.3 billion of subprime residential mortgage inventory, O'Meara reassured investors that these positions, as well as other mortgage-related assets, were being carried at fair value, that Lehman had "marked [its] book to the actual prices being transacted in the market" and that "[w]e feel very good about the marks that are on these positions." ¶277. At a Merrill Lynch conference on November 14, 2007, Defendant Lowitt suggested that the Company, unlike its competitors, was actually ***benefiting*** from the mortgage crisis. Lowitt further represented that the Company's mortgage and mortgage-backed assets were "aggressively" marked down, and that there would be no substantial write-downs with respect to its mortgage and mortgage-backed assets. ¶¶277, 284-85. These statements were materially false and misleading because the Insider Defendants failed to disclose that, due to the high-risk loans Lehman acquired through BNC and Aurora, a substantial portion of these assets were already impaired, necessitating additional write-downs. Indeed, by this time, Lehman senior managers Michael Gelband (head of Lehman's Fixed Income division) and Madelyn Antoncic (Lehman's Chief Risk Officer) were raising risk concerns, and loan repurchase requests to and from Lehman's mortgage originators for nonperforming and fraudulent loans were increasing dramatically. ¶282.

2. The Insider Defendants Concealed Lehman's Significant And Increasing Concentration Of Mortgage-Related Risks

The Insider Defendants signed Lehman's SEC filings, reported Lehman's financial results, and spoke positively about such results. ¶¶157, 271, 277, 286, 299, 304, 310.

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[7] *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 205 (2d Cir. 1980); *see also, Fogarazzo v. Lehman Bros., Inc.*, 341 F. Supp. 2d 274, 294 (S.D.N.Y. 2004) (a statement can be "misleading, though not technically false, if it amounts to a half-truth by omitting some material fact").

Accounting rules are intended to protect investors by giving them a "clear and accurate picture of the position and performance of the business." *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1306 (C.D. Cal. 1996). Generally Accepted Accounting Principles ("GAAP") are the conventions that constitute the professional standards of the accounting profession. *Id.* at 1304. Financial statements filed with the SEC that are not prepared in compliance with GAAP are "presumed to be misleading and inaccurate." 17 C.F.R. § 210.4-01(a)(1) ("SEC Reg. S-X.").

Under GAAP, Lehman was required to disclose material information regarding "significant concentrations of credit risk arising from all financial instruments." ¶120. In addition, Item 303 of Regulation S-K requires disclosure of any "known trends" that either had affected its business or could reasonably be expected to affect its business. ¶¶176, 223. Violation of Item 303 of Regulation S-K may give rise to violation of Section 10(b). *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 70 (2d Cir. 2001) (finding actionable defendants' failure to disclose trend in declining sales and increasing returns pursuant to Item 303).

During the Exchange Act Period, Lehman violated GAAP and Regulation S-K by omitting facts necessary for investors to assess the concentration of credit risk in Lehman's mortgage portfolio, including its exposure to residential and commercial mortgage assets and, within these portfolios, Lehman's exposure to whole loans or securities. ¶281. Despite questions concerning Lehman's mortgage-related assets, the Insider Defendants, while disclosing tiny net write-downs, deliberately refused or recklessly failed to provide the amount of Lehman's gross write-downs on its mortgage-related assets or describe which specific mortgage assets Lehman marked, and concealed Lehman's full exposure to mortgage-related losses, including omitting material information regarding Lehman's massive undisclosed high-risk Alt-A loans or

its commercial mortgage-related exposure. ¶¶281, 287-88, 294. Indeed, Lehman's reported results did not even include the term "Alt-A" until April 9, 2008. ¶119.

Even the belated information in Lehman's 2Q08 results was misleading. While Lehman's Alt-A loans were more like subprime loans (¶¶96-7, 119), Lehman misleadingly described its Alt-A loans as "associated with borrowers who may have creditworthiness of 'prime' quality but may have traits that prevent the loans from qualifying as 'prime.'" ¶97. And rather than admit that it held over $13.5 billion Alt-A assets, Lehman instead disclosed only that it held $14.6 billion of "Alt-A/***Prime***" exposure, ¶119, a description facially designed to conceal its *de minimis* amount of prime assets and overwhelming amount of Alt-A assets.

Further, the Insider Defendants violated Item 303 by concealing a rising trend in repurchase requests. ¶176. Rather than disclose existing facts, Lehman represented only that repurchases were possible. ¶175.

3. The Insider Defendants Misrepresented The Value Of <u>Lehman's Mortgage-Related Assets And Real Estate Investments</u>

By failing to properly write down its residential and commercial mortgage and real estate related assets to fair value, Lehman's financial statements were overstated. Nonetheless, throughout the Exchange Act Period, the Insider Defendants assured the market that: (i) "we don't believe there will be any requirement for substantial markdowns and certainly no requirement for us to announce anything" (¶284); (ii) Lehman was "feeling pretty good" about its mortgage portfolio (¶294); (iii) "[Lehman's] valuations reflect how the market is pricing these positions, not the fundamentals of the asset class, regardless of our view on their intrinsic value" (¶302); and (iv) because it had sold its risky assets, "I think the confidence level about the remaining inventory can only be higher than it was given all that sales activity." ¶313. That Lehman took approximately $11 billion in write-downs on both its residential and commercial

mortgage and real estate related assets in the two quarters before its bankruptcy (¶¶363, 365) – and that these write-downs still were not enough to value its portfolio properly (¶139) – support the allegation that these assets were overvalued during the Exchange Act Period. *See Novak v. Kasaks,* 216 F.3d 300, 312-313 (2d Cir. 2000) (significant write-offs support plaintiffs' contention that inventory was overvalued before that time); *Rothman v. Gregor,* 220 F.3d 81, 92 (2d Cir. 2000) ($73.8 million write-off supports allegation that royalty advances should have been expensed earlier).

Lehman's residential loans and MBSs, which in great part consisted of stated income loans, no documentation loans, loans with no money down, and loans to borrowers with FICO scores in the low 500s, carried significant undisclosed risk. ¶¶97-108. In March or April of 2006, a review of loans found that 40-50% of the sample contained material misrepresentations in the loan papers. ¶333. Further, quality control employees for Aurora regularly found that up to 70% of the checked loans involved fraud in the loan documents. ¶104. As such, a substantial portion of loans originated by Lehman's subsidiaries were impaired. ¶¶328-35.

Lehman, however, continued to overstate the value of these assets and failed to write them down to fair value. Among other things, the ABX index, a barometer for assessing the performance of subprime MBSs, dropped precipitously starting in early 2007. ¶142. Additionally, the loans originated by BNC and Aurora experienced increased deficiencies and defaults such that, by July 2007, residential loans became delinquent nearly twice as fast as comparable loans originated in 2006. ¶143.

Further, starting in early 2007, as both the mortgage and MBS markets deteriorated, the percentage of Lehman's inventory that did not qualify for sales treatment increased, demonstrating that Lehman's mortgage-related assets had become increasingly illiquid and less

valuable. ¶144. Also, by early 2007, Lehman began making its own margin calls on loan originators like American Home Mortgage to whom it had extended credit lines because Lehman had determined that the mortgage assets used as collateral for such credit lines had decreased in value. ¶145. By the summer of 2007, Lehman's securitizations had slowed and it had difficulty selling the lower-rated tranches even on prime deals. ¶146.

Instead of accurately writing down the value of its own assets as required by GAAP, Lehman altered the accounting for certain assets, reclassifying them as "Level III," and thus accounting for them using management's own "discretion" rather than observable data. ¶149. While Lehman competitors like Bear Sterns, Merrill Lynch and UBS took multibillion dollar write-downs in connection with their residential subprime mortgages in 2007 (¶¶147-148), Lehman was able to report "record" net revenues of $5.5 billion for 2Q07, net revenues of $4.3 billion for 3Q07, and "record" net income and record earnings per share for its fiscal year ended November 30, 2007. ¶¶170, 184, 186, 189, 195. Lehman ultimately would write down billions of dollars of residential mortgage assets and file for bankruptcy, leaving investors holding the bag as it filed for the largest corporate bankruptcy in history. ¶¶363-66.

Lehman's reported commercial mortgage and real estate-related assets were also overstated. Lehman had invested aggressively in commercial mortgage and real estate assets throughout 2006 and 2007. ¶129. However, when the commercial real estate market plummeted, and the CMBX spreads widened beginning in mid 2007, indicating that the risk of default had increased dramatically, Lehman failed to report such losses on its balance sheet. ¶¶123-29. Even when the index of "AAA" commercial mortgage-backed securities ("CMBS") declined about 10% and lower-rated securities fell even further, Lehman took only a $1.4 billion gross write-down, or less than 3% of its $49 billion commercial real estate portfolio, during the

first quarter of 2008. ¶133. On March 18, 2008, Defendant Callan even stated that there should be no concerns over Lehman's commercial holdings because "[d]elinquencies in commercial mortgage continue to be very low at approximately 40 basis points." ¶302.

According to CW7, who worked in Lehman's Real Estate Group involved with commercial real estate finance from 1996 until early 2008 and helped manage assets that Lehman could not sell in the Bridge Equity Program, Lehman held tens of billions of dollars worth of assets that it could not sell. ¶¶130-31. CW7 also stated that Lehman employees commonly changed the appraised value of the commercial real estate assets by having companies like TriMont Real Estate Advisors provide a specific, higher value. ¶334. CW25, a Lehman employee who handled credit underwriting of individual commercial loans from the CMBS conduit business in the Real Estate Group during his/her last three years with Lehman, also confirmed that appraisals were adjusted in order to push deals through. ¶335. Both CW7 and CW25 stated that communications about changing the appraised value of commercial real estate assets were conducted verbally because Lehman did not want to leave a paper trail. ¶¶334-35. Likewise, CW23, a Product Controller in Lehman's Global Real Estate Group from late 2007 through the fall of 2008, corroborated that Lehman's commercial assets were overvalued and that there were often discussions, including in monthly meetings, regarding the fact that Lehman should be taking write-downs. ¶132.

When Fuld attempted to sell Lehman, valuation experts from potential suitors found that Lehman's $32.6 billion commercial portfolio was overvalued by as much as 35%, or approximately $12 billion. ¶¶10, 136-37, 320. Barclays, which acquired certain of Lehman's assets post bankruptcy, also declined to acquire its commercial real estate holdings because it "did not feel the valuations [of the commercial real estate] were supportable . . . ." ¶139.

Lehman's residential and commercial mortgage and real estate assets were so toxic and overvalued that they dissuaded the Federal government from providing a bailout to Lehman to stave off bankruptcy. ¶138.

Contrary to the Insider Defendants' argument that fair value is subject to judgment and therefore not actionable, courts routinely hold that valuation judgments are actionable where, as here, the complaint shows that those "judgments" were contradicted by then-existing facts.[8] Furthermore, whether the Insider Defendants' properly exercised their judgment in connection with GAAP is a factual issue inappropriate for resolution on a motion to dismiss.[9]

Additionally, that Lehman "has not elected to restate or reverse its earnings or revenue figures . . . does not indicate, much less prove, the accuracy of those figures." *Feiner v. SS & C Techs.,* 11 F. Supp. 2d 204, 209 (D. Conn. 1998). "To hold otherwise would shift to accountants the responsibility that belongs to the courts. It would also allow officers and directors of corporations to exercise an unwarranted degree of control over whether they are sued, because they must agree to a restatement of the financial statements."[10] Additionally, because Lehman

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[8] *See In re RAIT Fin. Trust Sec. Litig.,* 2008 WL 5378164, at *7 (E.D. Pa. 2008) (sustaining claims that company failed to properly value 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).

[9] *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); *RAIT,* 2008 WL 5378164, at *7; *In re Refco, Inc. Sec. Litig.,* 503 F. Supp. 2d 611, 656-57 (S.D.N.Y. 2007) ("At the motion to dismiss stage, the plaintiffs' assertion that certain practices were not generally accepted 'must be taken as true.'" (citing *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 339 (S.D.N.Y. 2004)); *In re WorldCom Inc. Sec. Litig.,* 352 F. Supp. 2d 472, 494 n.30; *Nappier v. PricewaterhouseCoopers LLP,* 227 F. Supp. 2d 263, 276 (D.N.J. 2002).

[10] *Aldridge v. A.T. Cross Corp.,* 284 F.3d 72, 83 (1st Cir. 2002). *See also, Rothman,* 220 F.3d at 93 (denying motion to dismiss § 10(b) claim where plaintiff alleged defendant improperly capitalized royalty advances even though there was no restatement and defendant's auditor issued clean audit opinion); *In re Wells Fargo Sec. Litig.,* 12 F.3d 922, 926-27 (9th Cir. 1993) (without restatement, rejecting defendants' argument that increase in loan loss reserve from one quarter to the next did not imply that earlier reserves were understated); *In re LDK Solar Sec. Litig.,* 584 F. Supp. 2d 1230, 1245-46 (N.D. Cal. May 29, 2008) (upholding § 10(b) claims of accounting fraud even though defendants argued there was no restatement and auditor issued an unqualified audit opinion; "the lack of a

filed for bankruptcy in the third quarter of 2008, no fiscal year-end audit or an evaluation of potential restatements was required.

Defendants' suggestion that Lehman's financial statements were accurate because Ernst & Young LLP ("EY") is not named as a defendant also lacks merit. It is Plaintiffs' prerogative as to whether or when to bring a claim against potential defendants, and no negative inference can be drawn from that fact. *See, e.g., Wyser-Pratte Mgmt. Co. v. Telxon Corp.,* 413 F.3d 553, 559 (6th Cir. 2005) (filing suit against auditor only after complaint withstood company's motion to dismiss). Contradicting Lehman, EY told the bankruptcy court, "EY's role was not to value LBHI's assets or mark them to market – that was LBHI's function." *See* Case No. 08-13555 (JMP) (S.D.N.Y. Bankr.), Dkt. No. 3790-2, at 6. Additionally, financial statements may be false despite the issuance of "clean" opinions by the auditor. *See, e.g.*, *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005). Indeed, the fact that public companies have sometimes restated years of financial results despite clean audit opinions by auditors demonstrate that such opinions do not serve as guarantees.

Moreover, where, as here, a discovery stay pursuant to the PSLRA is in place, and Plaintiffs have pleaded sufficient facts to support their allegations that Lehman's financial statements were overstated, the amount of overstatement need not be quantified.[11]

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restatement did not mean that [defendant] only engaged in legitimate conduct"); *In re Majesco Sec. Litig.,* No. Civ A 05CV-3557, 2006 WL 2846281, at *4-5 (D.N.J. Sept. 29, 2006) (denying motion to dismiss § 10(b) claim where plaintiffs alleged accounting fraud even though there was no restatement and company's auditor issued qualified audit opinion.)

[11] *See In re BISYS Sec. Litig.,* 397 F. Supp. 2d 430, 437 (S.D.N.Y. 2005); *In re Adelphia Commc'ns Corp. Sec. and Deriv. Litig.,* 398 F. Supp. 2d 244, 252 (S.D.N.Y. 2005) (where "plaintiffs' allegations . . . are very specific in other respects," they are "sufficiently particular despite plaintiff's failure to allege by how much [the pertinent items] were inflated."); *Liberty Ridge LLC v. RealTech Sys. Corp.,* 173 F. Supp. 2d 129, 137 (S.D.N.Y. 2001) ("courts should not demand a level of specificity in fraud pleadings that can only be achieved through discovery."); *Ottmann v. Hanger Orthopedic Group, Inc.,* 353 F.3d 338, 350 n.8 (4th Cir. 2003) ("It is inappropriate at the pleading stage, before any discovery, to require Appellants to cite specific transactions . . . .").

The Complaint's allegations are also not, as the Insider Defendants claim, fraud by hindsight. All fraud, by its very nature, is discovered after the fact. Accordingly, the Second Circuit recognizes that plaintiffs may "rel[y] on post-class period data to confirm what a defendant should have known during the class period."[12] Here, Plaintiffs have not only shown that Lehman was forced to take mammoth write-downs, but also that several independent entities all concluded even at the time of its bankruptcy that Lehman's assets had been seriously overvalued (¶¶10, 137, 139) − even though Lehman had been assuring investors of the adequacy of prior write-downs and its own overall stability just days earlier. ¶¶318-20.

Further, the Complaint here does not rely solely on later facts; it alleges contemporaneous facts that support the falsity of defendants' statements at the time they were made. *See RAIT,* 2008 WL 5378164, at *7 (rejecting "fraud by hindsight" defense to allegations that company failed to disclose its subprime exposure, properly value assets collateralizing its CDOs, and account for loss reserves); *In re KeySpan Corp. Sec. Litig.,* No. 01 CV 5852 (ARR), 2003 WL 21981806, at *13-15 (E.D.N.Y. July 30, 2003).

4. The Insider Defendants Misrepresented Lehman's Risk Mitigation And Hedging Strategies

The Insider Defendants repeatedly stated that Lehman had a "comprehensive risk management measurement framework" (*id.*), "devote[d] significant . . . resources to the measurement, analysis and management of risk" (*id.*), had "hedging strategies that are in place and have proven to be quite effective" (¶273), was "very conservative around risk" (¶284),

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[12] *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72, 77 (size of $24 million in special charges "undermines, at the pleading stage," defendants' argument that they were unaware of events negatively affecting financial results). *See also In re JDS Uniphase Corp. Sec. Litig.*, No. C 02-1486, 2005 WL 43463, at *6-7 (N.D. Cal. Jan. 6, 2005) (sudden write-off of $270 million of inventory where plaintiff alleged inventory buildup over previous year created strong inference that statements were "false when made"); *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 175 (S.D.N.Y. 2003) ("The fact that plaintiff relies on evidence that post-date the Form F-4 does not vitiate the false or misleading nature of the registration statement.").

"operat[ed] an extremely conservative liquidity framework" (¶284), "operated with a very active and effective hedging program" (¶284), had a strong "risk management culture in terms of managing [its] overall risk appetite, seeking to appropriate risk reward dynamics and exercising diligence around risk mitigation" (¶286), and had "effective" "risk management. ¶291. Even as late as March 18, 2008, the Insider Defendants continued to represent that "we continue to do a very, very good job managing the risk on residential mortgages" (¶299) and that Lehman was "very well hedged." ¶304.

In fact, the Company did not have an effective framework to manage its risk, engaged in high-risk lending and real estate investment practices that were anything but "conservative," and the so-called "hedges" actually caused additional losses. ¶¶157-58, 179. As Lowitt later admitted, Lehman could not directly hedge against its multibillion dollar Alt-A exposures. ¶¶159, 227, 352.

5. The Insider Defendants Misled Investors About Lehman's Capitalization, Liquidity And Risks Of Insolvency

Throughout the Exchange Act Period, the Insider Defendants represented that Lehman was well capitalized, had more than enough liquidity to withstand economic turmoil, and had no going-concern issues. For example, the Insider Defendants stated that Lehman's "disciplined liquidity and capital management framework [] sets us up to operate our business through periods of market stress" (¶286), Lehman had "discipline around liquidity, risk management, capital and expenses" (¶293), and "[w]e've had disciplined liquidity and capital management, which we consider to be a core competency, and maintained robust liquidity." ¶298. The Company's Forms 10-K and 10-Q also repeatedly asserted that the Company "maintain[ed] a liquidity pool that covered expected cash outflows for twelve months in a stressed liquidity environment." ¶163. In fact, Lehman's liquidity and capital were not enough to absorb the

losses from the massive amounts of delinquent and defaulting mortgage and real estate assets it had accumulated.

Callan claimed on March 18, 2008 that Lehman "took care of [its] full year needs" for capital through its offering of preferred stock in February 2008. ¶303. When, on March 31, 2008, just two weeks later, Lehman issued additional preferred stock, Callan assured investors that this additional capital raise was not out of necessity or to decrease leverage "but to take advantage of future market opportunities . . . we stand extremely well capitalized to take advantage of these new opportunities." ¶¶306, 310. These statements were also materially false and misleading because Lehman's capital needs for 2008 were not satisfied in light of Lehman's highly leveraged mortgage portfolio, the decreased liquidity in the larger asset-backed securities markets, and Lehman's substantial liquidity issues. ¶305.

Only three months before the Company filed for bankruptcy, Lehman raised an additional $6 billion from investors while the Insider Defendants specifically disavowed its demise, stating "the discussions at this point are not about our viability or the fact that we will be here or the fact that we have sufficient liquidity." ¶¶305, 314. The Insider Defendants represented that Lehman's capital and liquidity positions had "never been stronger" (¶317), despite pressure from the U.S. government to either find a strategic partner or sell the business. ¶315.

On September 10, 2008, Fuld and Lowitt continued to represent that Lehman had more than enough capital and that Lehman maintained a "very strong liquidity position." ¶320. Just five days later, however, Lehman filed for bankruptcy, admitting that it had "significant liquidity problems." ¶11. Such temporal proximity between positive statements and adverse disclosure supports both falsity and scienter. *See, e.g.*, *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 271 (3d Cir. 2009).

B. Lehman's Risks Were Not Adequately Disclosed

Contrary to the Insider Defendants' contention, Lehman's so-called "risk disclosures" do not immunize them from liability for their false and misleading statements. Neither the "bespeaks caution doctrine" nor the PSLRA's safe harbor provision applies here. Both only apply to forward-looking statements. Here, all of the challenged statements are statements of current or historical fact.[13]

Moreover, neither "bespeaks caution" nor the safe harbor apply where, as here, the purported warnings were not meaningful. *See, e.g., In re Copper Mountain Sec. Litig.,* 311 F. Supp. 2d 857, 870 (N.D. Cal. 2004). When a false statement is accompanied by cautionary language, courts analyze the alleged fraudulent materials in their entirety to determine whether a reasonable investor would have been misled. The touchstone is not whether isolated statements within a document were true, but whether defendants' representations and 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. *Rombach v. Chang,* 355 F.3d 164, 174 (2d Cir. 2004).

Here, while Lehman disclosed the possibility of market turmoil, the Insider Defendants omitted that Lehman was then being adversely affected by the market turmoil and omitted the extent of such impact; on the contrary, the Insider Defendants said they were benefitting from it. ¶285. Nowhere did Lehman disclose, for example, that: (1) its Alt-A mortgages were actually akin to subprime loans; (2) it had changed the appraised value for its commercial real estate; (3) its capitalization and liquidity were insufficient in light of its vast amounts of toxic mortgage-

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[13] *See, e.g., In re Globalstar Sec. Litig.*, No. 01 Civ. 1748(SHS), 2003 WL 22953163, at *11 (S.D.N.Y. Dec. 15, 2003) (general risk disclosures cannot cure "the alleged misrepresentation of a currently existing fact"); *Heller v. Goldin Restructuring Fund, L.P.,* 590 F. Supp. 2d 603, 617 (S.D.N.Y. 2008) ("the bespeaks caution doctrine only applies to forward-looking statements and not to misrepresentations or omissions of present or historical fact").

and real estate-related assets; or (4) it was on the brink of bankruptcy. Nor did Lehman's disclosures of VaR (or "Value at Risk") and stress testing enhance its risk disclosures. Instead, these disclosures further misled investors, as they assured investors that Lehman's risk of loss was limited even when its losses far exceeded the value that was supposedly at risk. As Insider Defendants acknowledged, VaR is required by the SEC to provide investors with information on the magnitude of the risk facing them. *See* Exec. Br. 15-16. Yet, Lehman's VaR amounted only to $130 million in the first quarter of 2008, and the VaR even decreased in the second quarter 2008 – the quarter prior to Lehman's bankruptcy filing. *Id*. As the VaR amounts were miniscule compared to the ***billions*** in write-downs taken by Lehman before it plunged in to bankruptcy, these VaR disclosures helped to create a false picture of Lehman and mislead investors. As such, Lehman's so-called risk disclosures failed to discredit the misrepresentations "so obviously that the risk of real deception drops to nil," as required.[14]

Further, cautionary words about future risks cannot insulate defendants from liability when, as here, they fail to disclose that the risk was imminent or had already transpired. *Rombach,* 355 F.3d at 174. "[N]o degree of cautionary language will protect material misrepresentations or omissions where defendants knew their statements were false when made."[15] Lehman's disclosure of potential risks was not adequate when those risks had already occurred, were significant, and resulted in overstatement of the value of Lehman's mortgage- and real estate-related assets.

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[14] *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083, 1097, 111 S. Ct. 2749, 2760 (1991); *see also In re Regeneron Pharms., Inc. Sec. Litig*., No. 03 Civ. 3111, 2005 WL 225288, at *19 (S.D.N.Y. Feb. 1, 2005) ("warnings of specific risks . . . do not shelter defendants from liability if they fail to disclose hard facts critical to appreciating the magnitude of the risks described").

[15] *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 231 (S.D.N.Y. 1999); *In re Prudential Ltd. Sec. Inc. P'ships Litig.,* 930 F. Supp. 68, 72 (S.D.N.Y. 1996) ("The doctrine of bespeaks caution provides 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.").

C. Defendant Gregory Made False And Misleading Statements

Under the "group pleading doctrine," statements in company documents, such as annual reports, registration statements, and press releases, are the collective work of the company's officers and directors or other corporate insiders with direct involvement in its day-to-day operations. *See, e.g., In re Take-Two Interactive Sec. Litig.,* 551 F. Supp. 2d 247, 266 (S.D.N.Y. 2008); *Fraternity Fund,* 376 F. Supp. 2d at 394 n.60; *BISYS,* 397 F. Supp. 2d at 438. The group pleading doctrine "simply recognizes, solely for pleading purposes, that some corporate documents, including SEC filings and the like, generally are not created by a single author, but by a group of corporate insiders involved in the daily management of a company." *BISYS,* 397 F. Supp. 2d at 440.

Gregory, as Lehman's President and COO, was responsible for Lehman's day-to-day management (¶¶27, 325) and is liable for misrepresentations in Lehman's corporate documents during his tenure, including the Forms 10-K, 10-Q and 8-K identified in the Complaint.[16]

D. The Complaint Alleges Direct And Strong Circumstantial Evidence Of Conscious Misbehavior Or Recklessness

A plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," 15 U.S.C. § 78u-4(b)(2), but are "not require[d] [to] plead detailed evidentiary matter in securities litigation." *Scholastic Corp.*, 252 F.3d at 72. A "strong inference" of scienter is plead by alleging misstatements that, when "accepted as true and taken collectively, would [have] a reasonable person deem the inference of scienter at least

[16] *See Bondi v. Grant Thornton Int'l (In re Parmalat Sec. Litig.),* 377 F. Supp. 2d 390, 401 (S.D.N.Y. 2005) ("It is not necessary . . . that [a] plaintiff connect a particular insider or affiliate to an allegedly deceptive corporate statement."); *BISYS,* 397 F. Supp. 2d at 441 (group pleading applied to COO and president); *In re Marsh & McLennan Cos., Inc. Sec. Litig.,* 501 F. Supp. 2d 452, 479 (S.D.N.Y. 2006) (group pleading applied to president and COO of a subsidiary company).

as strong as any opposing inference." *Tellabs*, 551 U.S. at. 326, 127 S. Ct. at 2511. Courts determine "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* 551 U.S. at 323, 27 S. Ct. at 2509 (emphasis in original).

In evaluating whether a complaint alleges facts giving rise to a strong inference of scienter, a court also considers plausible, nonculpable explanations, but only those that may be "rationally drawn from the facts alleged." *Tellabs*, 551 U.S. at 314, 127 S. Ct. at 2504. Importantly, "[t]he inference that the defendant acted with scienter need not be irrefutable, *i.e.*, of the 'smoking-gun' genre, or even the 'most plausible of competing inferences[.]'" *Id.* at 2510 (citation omitted). If the inference of scienter is at least as likely as any opposing inference rationally drawn from the facts alleged, the motion to dismiss must be denied. *Id.* In short, "a tie . . . goes to the plaintiff." *Sloman v. Presstek, Inc.*, No. 06-cv-377-JD, 2007 WL 2740047, at *7 (D.N.H. Sept. 18, 2007).

Relying almost exclusively on "facts" outside the Complaint, the Insider Defendants ask the Court to draw the inference that they were unwitting victims of an unforeseen financial crisis. Such factual disputation is improper at this stage.[17] Among other exhibits, the Insider Defendants submit a compilation of information from other securities cases wholly unrelated to

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[17] *See, e.g.*, *New Century,* 588 F. Supp. 2d at 1230 (rejecting claim that mortgage lender and securitizer was "taken by surprise when the [housing] market took an unprecedented turn for the worse"); *Atlas v. Accredited Home Lenders Holding Co.,* 556 F. Supp. 2d 1142, 1161 n.7 (S.D. Cal. 2008) (refusing to consider defense counsel's summary of "non-prime lending industry events" as a defense to liability); *In re Moody's Corp. Sec. Litig.*, 599 F. Supp. 2d 493 (S.D.N.Y. 2009) (rejecting defendants' argument that the decline in stock price was due to intervening cause of market collapse as result of subprime mortgage crisis); *In re StockerYale Sec. Litig.,* 453 F. Supp. 2d 345, 359 (D.N.H. 2006) ("Defendants' reference to a wide range of economic and other factors that may have caused or contributed to the decline in price of StockerYale shares raises issues that will be addressed at later stages of this litigation, but those possibilities do not warrant dismissal . . . ."); *Schnall v. Annuity and Life Re (Holdings), Ltd.,* No. 3:02 CV 2133(GLG), 2004 WL 367644, at *9 (D. Conn. Feb. 22, 2004) ("While a trier of fact might blame market forces rather than accounting violations for that decline, the allegations in the Complaint are sufficient to withstand [this] motion to dismiss."); *Burstyn v. Worldwide Xceed Group, Inc.,* No. 01 Civ. 1125, 2002 WL 31191741, at *6 (S.D.N.Y. Sept. 30, 2002) (same).

Lehman or the Insider Defendants, apparently as "evidence" that ***this*** case should be dismissed. The Insider Defendants omit, however, that Lehman, as directed by them, was one of the primary forces in creating the unsustainable mortgage, securitization, and real estate markets, all of which allowed Lehman to report record profits and for the Insider Defendants to profit from Lehman's purported success. Regardless of whether the Insider Defendants were "victims" of macroeconomic events, they were obligated to speak truthfully to the market and disclose existing facts and circumstances. As described above, they did not.

While plaintiffs are not required to employ certain "magic words" to plead scienter, two common fact patterns create a strong inference of scienter. *Novak,* 216 F.3d at 311. Plaintiffs may "(1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (2) allege facts to show that defendants had both motive and opportunity to commit fraud." *Rothman v. Gregor*, 220 F.3d at 90. Here, the Complaint alleges both direct and circumstantial evidence raising a strong inference of the Insider Defendants' scienter.

1. The Insider Defendants' Knowledge Of, And Access To, Facts Contradicting Their Public Statements

Allegations indicating that a defendant knew, or had access to, information contradicting public statements raise a strong inference of scienter.[18] The Second Circuit has "found allegations of recklessness to be sufficient where plaintiffs alleged facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud." *Novak*, 216 F.3d at 308.

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[18] *See, e.g.*, *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001); *Novak*, 216 F.3d at 308 (such allegations raise strong inference that "defendants knew or, more importantly, should have known that they were misrepresenting material facts related to the corporation").

Here, Lehman's mortgage and real estate businesses were central to Lehman's financial health and continued viability – especially during the Exchange Act Period, when the real estate, mortgage, and securitization markets were all in decline. The Insider Defendants were Lehman's highest-ranking officers, responsible for Lehman's strategic direction and its day-to-day operations.[19] They were responsible for Lehman's public statements regarding these issues, responding to the investment community's repeated questions concerning the central issues in this case. Given this context, it is absurd to suggest that the Insider Defendants did not know the true condition of Lehman's businesses and its asset holdings. Indeed, if they did not know the true condition, they were deliberately reckless for making statements about Lehman's condition without any knowledge of it.

a. The Insider Defendants' Responsibilities And The Serious Problems With Businesses And Assets Crucial To Lehman's Viability Raise A Strong Inference Of Their Scienter

When false statements involve an important aspect of a company's business, relate to a significant transaction, or conceal a company's deep financial difficulties, courts routinely find a strong inference of scienter as to the company's highest ranking officers. The Second Circuit has long recognized that allegations regarding issues "significant" to a corporation's business give rise to a strong inference of scienter. *Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989) (allegations that an import restriction "apparently eliminated a potentially significant source of income for the company" created strong inference of scienter as to director defendants). Likewise, allegations regarding an executive's responsibilities, familiarity with the corporation's

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[19] Defendant Fuld was Lehman's long-time CEO and Chairman; O'Meara served as CFO, Controller, and Executive Vice President from 2004 until December 2007, after which he was in charge of Lehman's worldwide risk management; Gregory was Lehman's COO and oversaw the day-to-day management of Lehman's operations until his resignation in June 2008; Callan was Lehman's CFO and Executive Vice President from December 2007 until her demotion in June 2008; and Lowitt took over as CFO in June 2008 and also served as Co-Chief Administrative Officer, responsible for oversight of Lehman's risk management. ¶325.

business, and involvement in the affairs of the corporation can give rise to an inference of scienter. *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994) (under Rule 9(b), plaintiffs adequately alleged scienter for fraudulent misrepresentation claim where officer defendants "were hands on managers active in [the company's] day to day operations," and were "fully familiar with all aspects of [its] business and financial conditions and operations."); *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 489 (S.D.N.Y. 2004).

Likewise, the Ninth Circuit recently held that a CEO and CFO must have known about stop-work orders significantly reducing a corporation's revenue, even though the plaintiffs "allege[d] no particular facts indicating that [the executives] actually knew about the stop-work orders." *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 988 (9th Cir. 2008). According to the court, the CEO's and CFO's responsibilities made it "hard to believe that they would not have known about stop-work orders," and it was "absurd to suggest that top management was unaware of them."[20]

The Seventh Circuit recently held that plaintiffs adequately pled scienter where the false statements concerned demand for a corporation's major products. *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 709-11 (7th Cir. 2008) (on remand from Supreme Court). As Judge Posner explained, it was "hard to credit" the defendants' argument that "no member of the Company's senior management who was involved in authorizing or making public statements" knew the falsity of statements regarding demand for the company's major products. *Id.* The court held the complaint raised a strong inference of the CEO's scienter, as it was "exceedingly

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[20] *Id.* at 988-89 (quotation omitted); *see also South Ferry LP v. Killinger*, 542 F.3d 776, 785 (9th Cir. 2008) ("Allegations regarding management's role in a corporate structure and the importance of the corporate information about which management made false or misleading statements may also create a strong inference of scienter when made in conjunction with detailed and specific allegations about management's exposure to factual information within the company.").

unlikely" that the CEO was unaware of problems with the company's two major products, particularly when he was responsible for many of the allegedly false statements. *Id.* at 711.

The Third Circuit also recently relied on a defendant's position as CFO and the importance of certain financial metrics in concluding that plaintiffs had pleaded a strong inference of the CFO's scienter. *Institutional Investors*, *Inc.*, 564 F.3d 242, 271. According to the court, the "perceived importance of margins support[ed] an inference" that the CFO "was paying close attention to these numbers." *Id.* Noting that the Supreme Court's opinion in *Tellabs* requires courts to consider the allegations collectively, the court set forth the various types of allegations that all contributed to a strong inference of scienter: the importance to the company of maintaining margins, the significant amount by which the results missed expectations, the CFO's position in the company, the temporal proximity of the CFO's statements to contrary information, and the content and context of the CFO's statements (frequently in response to direct questions from analysts). *Id.* at 272. The court explained that, particularly in light of analysts' consistent focus on the disputed issues, the alleged state of the company at the time and the defendant's position as CFO raised a strong inference of, at a minimum, recklessness as to the truth of his statements. *Id.* at 270.

Likewise, the *Countrywide* court found it "'absurd to suggest' some key insiders lacked knowledge about Countrywide's core mortgage-related operations." *Countrywide Sec. Litig.*, 588 F. Supp. 2d at 1189 (quoting *Countrywide Deriv. Litig.,* 554 F. Supp. 2d 1044, 1057-71 (C.D. Cal. 2008)).

Moreover, where a company's core business is experiencing substantial problems or facing financial difficulties, the inference that the company's executives either knew, or were reckless in not knowing, information regarding those problems is even stronger. As one court

explained: "[I]t is highly significant that what [plaintiff] relies on is the failure of all defendants to have disclosed a deep and pervasive corporate illness . . . . To the outsider looking in, it is surely strongly inferential that every officer or director of [the company] either had the knowledge of such deep financial difficulties or, if not, that his failure to have such knowledge equated to reckless disregard." *Dardick v. Zimmerman*, 149 F. Supp. 2d 986, 988-89 (N.D. Ill. 2001).

Here, Lehman had directed its focus and resources to all aspects of the residential and commercial mortgage markets. Lehman described itself as a "market leader" in these businesses, which made up Lehman's single largest revenue component. ¶93. Lehman had a "fully vertically integrated mortgage business" that was "involved in every step of the financial process." ¶93. Prior to the Exchange Act Period, Lehman purchased subprime and Alt-A mortgage originators BNC and Aurora, which originated tens of billions of dollars of residential and commercial mortgages every year. ¶¶97, 323 (Lehman originated $47 billion in residential mortgages and $60 billion in commercial mortgages in 2007). To meet its securitization demands, Lehman also purchased billions of dollars in mortgages each year. All together, Lehman securitized roughly $120 billion in residential and commercial loans in 2007 alone. ¶323. In addition to originating and securitizing mortgages, Lehman and its subsidiaries also serviced a significant number of loans. *See, e.g.*, ¶105. Lehman's "vertically integrated" model allowed for profits at each step in the mortgage and securitization process. When, however, the markets slowed, Lehman was poised to suffer exponential losses.

Lehman also spent billions directly investing in real estate deals, taking on increasing levels of risk. ¶129. Indeed, even as internal and external indicators demonstrated that real

estate was in serious decline, Lehman continued its direct investment in real estate, committing financing and direct equity to several deals in mid-2007. *Id.*

As Lehman's mortgage and real estate businesses slowed, Lehman accumulated massive quantities of mortgage- and real estate-related assets. By the end of 2007, Lehman had amassed roughly $89 billion of these assets, up more than 50% from 2006. ¶94. These amounts dwarfed Lehman's available capital, and even a small decline in value threatened Lehman's solvency.

In short, by the start of the Exchange Act Period, Lehman's overall health and viability was dependent upon the Company's real estate and mortgage businesses. The increasing amounts of real estate-and mortgage-related assets on Lehman's books required the constant attention of Lehman's executives, particularly once the investing public began questioning Lehman about these assets. The Insider Defendants either made, or were responsible for, Lehman's public statements regarding these matters.

Fuld, Callan, and Lowitt were also members of Lehman's Executive Committee, which Fuld chaired. ¶326. As members of the Executive Committee, they were responsible for assessing Lehman's "risk exposures, position concentrations and risk-taking activities," as well as allocation of capital to Lehman's businesses. *Id.* According to Callan, the Executive Committee met twice a week for two hours at a time and "devote[d] a significant amount of that time to risk." *Id.* Callan stated that the Executive Committee was "intimately familiar with the risk that we take in all the different areas of our business," noting that "[Fuld] in particular . . . keeps very straight lines into the businesses on this topic." *Id.* Indeed, Fuld stated publicly that the Company's losses were "his responsibility," as he "ultimately signs off." ¶316.

In sum, the Insider Defendants knew or should have known the true facts regarding Lehman's core mortgage- and real estate-related businesses, its asset holdings, and its capital and

liquidity positions. *See, e.g.*, *Countrywide Sec. Litig.*, 588 F. Supp. 2d at 1189. Indeed, it is hard to imagine that the Insider Defendants were not keenly aware of Lehman's toxic mortgage assets as: (i) these assets were significantly distressed during the Exchange Act Period, ultimately leading to Lehman's bankruptcy; and (ii) the investment community was keenly focused on Lehman, its troubled businesses, and its increasingly toxic assets, repeatedly asking the Insider Defendants targeted questions about the nature and quality of Lehman's mortgage assets and any mark-to-market losses incurred on the same during Company conference calls. In this context, the Insider Defendants' current claims of ignorance regarding the true state of Lehman's affairs ring especially hollow. *See, e.g.*, *Dardick*, 149 F. Supp. 2d at 988-89.

b. The Insider Defendants Knew, Or Recklessly Ignored, Numerous Red Flags Indicating The False And Misleading Nature Of Their Statements

The Insider Defendants were aware of detailed information concerning Lehman's capitalization and liquidity, and they were involved in non-public discussions with potential investors and acquirers, as well as with government regulators. These facts, or "red flags," support a strong inference of scienter, particularly when viewed collectively.[21]

For example, the Insider Defendants had reasonable access to, among other things, the following red flags: (i) internal documents regarding Lehman's financial condition and mortgage-related exposure; (ii) high risk and improper mortgage and real estate operations, leading to widespread fraud and impaired assets; (iii) internal information demonstrating that Lehman's mortgage and securitization businesses were suffering and that its mortgage-related

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[21] *See, e.g.*, *In re Comverse Tech., Inc. Sec. Litig.*, 543 F. Supp. 2d 134, 142 (E.D.N.Y. 2008) (strong inference of scienter where plaintiffs alleged existence of obvious red flags); *Refco*, 503 F. Supp. 2d at 649 ("[s]cienter may be found where there are 'specific allegations of various reasonably available facts, or "red flags," that should have put the officers on notice' that the public statements were false").

assets were significantly impaired; and (iv) external information regarding Lehman business and asset values.

(1) Internal Documents Confirm Lehman's <u>Deteriorating Condition And Increasing Exposure</u>

While Plaintiffs have not yet had access to discovery, various internal Lehman documents indicate that the Insider Defendants had access to information regarding the true condition of Lehman, including its exposure to loss and liquidity concerns. For example, a January 2008 internal presentation made by Eric Felder, a Lehman executive, acknowledged that the mortgage crisis was having a severe impact on the Company's operations and liquidity position. ¶347. Slides accompanying Felder's presentation explained that "[v]ery few of the top financial issuers have been able to escape damage from the subprime fallout." *Id.* The presentation warned that, because "a small number of investors account for a large portion of demand [for Lehman issues], liquidity can disappear quite fast." *Id.*

Similarly, after the Exchange Act Period, Fuld produced to Congress an internal Lehman memorandum in June 2008 indicating that management was aware of warning signs regarding the sustainability of Lehman's business model and its exposure to losses. ¶348. This memorandum asked: "Why did we allow ourselves to be so exposed?" *Id.* According to the memorandum, as of June 2008, management had long been aware that "[c]onditions clearly [were] not sustainable. Saw warning signs. Did not move early, fast enough. Not enough discipline in our capital allocation." *Id.*

Further, according to a long-time senior vice president in Lehman's Global Real Estate Group, internal Lehman documents from 2006 discussed how a meltdown in the commercial mortgage market would follow a meltdown in the residential market. ¶337. This senior vice president explained that Lehman's senior management commissioned a report confirming the

danger to the commercial mortgage and CMBS markets beginning in mid-2007. *Id.* The senior vice president believed that the report was most likely commissioned for Fuld's office. *Id.*

These internal Lehman documents indicate that information concerning the condition of Lehman's businesses and asset holdings was not only readily available to the Company's senior management, but a prominent area of concern. The Insider Defendants knew, or at a minimum had access to, these "red flags."

(2) High Risk And Improper Mortgage And Real Estate Operations Lead To Widespread Fraud And Impaired Assets

The Insider Defendants also had access to a wealth of non-public data on the health of Lehman's mortgage-related businesses and quality of its mortgage-related assets through its origination and acquisition of billions of dollars of mortgages and its investment and management of billions of dollars in direct real estate investments.

Lehman originated and purchased high-risk loans to fuel its securitization business in large part through its subsidiaries, BNC and Aurora. ¶¶96-108. Lehman set the underwriting guidelines for and directed its subsidiaries' practices, and it received numerous reports from Aurora and BNC regarding the loans they originated. *See, e.g.,* ¶¶103, 338-41. The Insider Defendants had access to information regarding Lehman's underwriting practices and reports from BNC and Aurora detailing the impaired nature of Lehman's originated mortgage assets, or were reckless in not discovering the information.

For example, numerous former employees explained that BNC and Aurora originated loans with no documentation requirements to borrowers with low credit scores and with severely blemished credit histories (including recent bankruptcies), and for amounts up to the entire purchase price of the home. *See, e.g.*, ¶¶98-101. These subsidiaries also originated billions in adjustable rate mortgages and offered various negative amortization products, allowing

borrowers to make payments less than the interest due each month, with the unpaid interest added to the principal. ¶101. Lehman set underwriting guidelines and directed its subsidiaries' practices, and it received numerous reports from Aurora and BNC. *See, e.g.*, ¶¶338-41.

Lehman also purchased risky loans through its subsidiaries. ¶104. A former Aurora vice president explained that Lehman approved underwriting guidelines for Aurora and directed the loans it bought from third parties. ¶103. Lehman and Aurora were much slower than the rest of the industry to tighten guidelines and as a result purchased low-quality loans. *Id.* Further, according to a former employee, Aurora made numerous exceptions to the already lax guidelines to "get the loans through." *Id.* All purchased loans were signed over to Lehman, which categorized the loans. *Id.*

Lehman engaged in similarly risky commercial lending practices. ¶335. Lehman employees described how the Company pushed the envelope on risk tolerance, allowing nearly all loans to go through. *Id.* Rather than turn down loans, Lehman would simply negotiate with third party appraisal companies where necessary, causing values to be "tweaked." *Id.*

Lehman also made high-risk direct investments in real estate, investing heavily in an already cooling market. ¶¶129-31. According to a former employee who helped manage a large portion of retained assets called the "Bridge Equity Program" from mid-2007 until his/her departure from Lehman in early 2008, Lehman employees regularly changed the appraised value of its commercial real estate assets. ¶334. Lehman's Global Real Estate Group held monthly meetings regarding valuation of these investments, and at least one former employee recalled that there were discussions regarding overvaluation all the time. ¶132. Lehman had the largest exposure to commercial real estate of any investment bank, increasing the prominence of this red flag for the Insider Defendants. ¶133.

(3) Internal Information Demonstrates That Lehman's Mortgage-Related Assets Were Significantly Impaired

The Insider Defendants also had access to internal data and information demonstrating that Lehman's mortgage and securitization businesses, and its increasing holdings of mortgage-related assets, were severely impaired.

Increasing Delinquency Rates: Lehman monitored loan performance for its originations, purchased loans, and securitizations. This data provided the Insider Defendants with access to detailed information on the declining performance of billions of dollars of loans. For example, Aurora's Alt-A servicing portfolio (over $60 billion) indicated a rapid and steady rise in delinquency rates – from 2% in 2005 to 12% in the first quarter of 2008. ¶105. Former employees confirm that default rates were increasing, *see, e.g.*, ¶¶106, 111, and the Complaint details various regular reports regarding this data. *See, e.g.*, ¶¶338-41.

Moreover, the Insider Defendants had access to detailed information on the performance of loans in Lehman's securitizations, and these analyses showed increasing default rates. ¶143. For example, a former employee described analyses performed in 2006 on loans backing certain securitization vehicles. ¶333. The first analysis indicated that 40-50% of the small number of loans reviewed contained material misrepresentations in the loan papers. *Id.* A second team conducted several reviews and consistently found that approximately 70% of the loans in the pool were fraudulent and should be repurchased. *Id.*

Loan Repurchase Data: Lehman and its subsidiaries acquired billions of dollars of loans from brokers and other originators and then made repurchase requests from these entities pursuant to representations and warranties concerning loan quality, such as when mortgage loans went into first payment default or early payment default, *i.e.*, when the borrower failed to make the first or second monthly mortgage payments within thirty days of the due date. ¶109.

As confirmed by numerous former employees, Lehman faced drastically increased repurchase requests beginning even prior to the Exchange Act Period, reflecting the poor and decreasing quality of Lehman's mortgage-related assets.[22] ¶¶109-13. Lehman was forced to hire more personnel to handle the repurchase requests, and a former vice president at Aurora explained that these teams were "buried" with repurchase activity beginning in the fall of 2006. ¶113. Indeed, Lehman filed lawsuits as early as 2006 seeking to require entities to repurchase nonperforming loans. ¶115. Exacerbating the problems for Lehman, the Aurora vice president described how many of the originating entities were going out of business. ¶113. A managing director at Lehman confirmed these difficulties, explaining that Lehman was forced to keep more and more nonperforming loans on its books as these entities went out of business or did not have funds to repurchase loans. ¶114.

Deteriorating Mortgage and Securitization Businesses: The Insider Defendants had access to various internal indicators and reports demonstrating that the mortgage markets were in serious decline and that mortgage-related assets were impaired. For example, in early 2007, Lehman issued margin calls to two large mortgage originators to which it had extended lines of credit – American Home Mortgage and Accredited Home Lenders. ¶145. Similarly, in July 2007, Lehman cut off a $1.5 billion line of credit to subprime lender Option One Mortgage Corporation. *Id.* These actions demonstrate that Lehman recognized the rapidly declining value in the mortgage assets used as collateral and, thus, should have written down such assets in its own portfolio.

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[22] Lehman and its subsidiaries also faced increased repurchase requests from investors who bought nonperforming loans from Lehman. A former employee explained that BNC was "bombarded" with repurchase requests in mid-2006. ¶116.

The Insider Defendants also had information from Lehman's own mortgage activities. Lehman held a major conference for employees in Phoenix in spring 2007, where Lehman reported that the market's appetite for subprime loans had changed and, as a result, Lehman needed to "tighten up guidelines." ¶345. The loan underwriters were told: "We're not going to make the loans we used to, because there's a problem on the horizon." ¶345. Moreover, as a result of the real estate and mortgage market decline, Lehman ceased lending activities at its subsidiaries. In August 2007, Lehman halted BNC's lending operations, stating that "market conditions . . . necessitated a substantial reduction in its resources and capacity in the subprime space." ¶107. Similarly, Lehman suspended lending activities at Aurora in January 2008, citing "the dislocation in the mortgage markets." *Id.* The Insider Defendants had access to performance information on these subsidiaries and the quality of their loans, ultimately determining whether and when to cease their lending activities.

The Insider Defendants also had access to detailed information indicating that Lehman's securitization business and related assets were deteriorating. A former Lehman vice president on the prime and Alt-A mortgage trading desk described how, by summer 2007, Lehman was having difficulty selling the lower-rated tranches of MBSs even on prime deals. ¶146. As further confirmation, starting in the first quarter of 2007, the percentage of Lehman's securitization inventory that did not qualify for sales treatment increased. ¶144. The decrease in Lehman's ability to qualify its securitizations as sales rather than financings demonstrated that Lehman's mortgage-related assets had become increasingly illiquid and had lost value before and during the Exchange Act Period. *Id.*

<u>Efforts to Secure Funding or Sell Company</u>: In mid-June 2008, Treasury Secretary Paulson pressed Defendant Fuld to find a buyer for Lehman. ¶315. Lehman unsuccessfully

shopped parts of its business throughout summer 2008. *See, e.g.*, ¶321. According to a Lehman executive director, as far back as August 2007, Lehman's treasury department (under Fuld's direction) worked to put together "funding vehicles" so that Lehman could obtain cheaper funding from the Federal Reserve Bank and the European Central Bank. ¶346. As they chose to pursue and attempted to execute these efforts, the Insider Defendants would have had access to detailed information concerning Lehman's businesses and assets.

Collateral Calls: Prior to Lehman's bankruptcy, the Insider Defendants were aware of collateral calls by counterparties, which severely compromised Lehman's available capital. For example, at least twice during the week prior to bankruptcy, JPMorgan's co-CEO told Fuld that Lehman needed to provide billions in additional collateral to cover lending positions. ¶351. These collateral calls demonstrated the true condition of Lehman's businesses prior to bankruptcy and contradicted the Insider Defendants' public statements made at the time.

(4) External Information Available To The Insider Defendants Constituted An Additional Red Flag Regarding Lehman's Businesses And Asset Values

Beginning prior to the Exchange Act Period, residential housing prices stopped rising and began to decline. As noted above, various loan originators filed for bankruptcy, with Lehman directly involved with several – either as a lender or as a purchaser of mortgages. The ABX and CMBX fell, indicating that Lehman's residential and commercial MBSs declined in value. ¶¶126, 142. The Insider Defendants' public statements demonstrate that they monitored these indices. ¶¶289, 302.

Moreover, Lehman's peers took massive write-downs beginning in 2007 on assets similar to those Lehman held. *See, e.g.*, ¶¶147-48. Further, two Bear Stearns hedge funds collapsed in June 2007 due to losses on securities tied to subprime loans. ¶147. Lehman, however, despite the market's consistent focus on the value of its similar assets, took much smaller net write-

downs at later times, and the Insider Defendants distinguished Lehman from its competitors. ¶¶147-48. At a minimum, this information should have served as a "red flag" for the Insider Defendants. Making this "red flag" even more prominent, the investment community repeatedly questioned the Insider Defendants regarding the type and value of the Company's assets, frequently in comparison to the overall market and the problems faced by Lehman's competitors.

2. The Opacity Of Lehman's SEC Filings And The Insider Defendants' Public Statements Raises A Strong Inference Of Scienter

The Insider Defendants' public statements during the Exchange Act Period, including statements of Lehman's financial results, demonstrated a deliberate lack of transparency. Such opaque financial statements could only result from intentional or severely reckless conduct, and, thus, the statements themselves contribute to an inference of scienter. *Cf. City of Monroe Emples. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 (6th Cir. 2005) (inference of scienter exists from "disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication").

For example, as described in the Complaint, Lehman originated billions in loans that it classified as Alt-A whose characteristics were similar to those of subprime loans. ¶¶97-101. Despite being a leading originator of such loans, however, Lehman's financial statements did not even include the term "Alt-A" until the first quarter of 2008. *See, e.g.*, ¶119. Even when Lehman finally began to disclose some information on its Alt-A loans, it misleadingly grouped them with a relatively small set of prime holdings into a single category labeled "Alt-A/Prime" – despite the fact that only about $1 billion of its reported $14.6 billion exposure consisted of "prime" loans. *Id.* The "Alt-A/Prime" categorization was especially misleading in light of the subprime-like characteristics of Lehman's Alt-A portfolio.

Likewise, Lehman referred to its "economic hedges," but failed to provide meaningful information on these "hedges," including any detail on the amounts and percentages of assets hedged. *See* ¶¶158, 281, 354. Further, it failed to disclose that its "hedges" could actually increase its losses on the hedged assets. *See, e.g.*, ¶158.

Additionally, the Insider Defendants' evasive responses to direct questions concerning key corporate metrics further demonstrate fraudulent intent to conceal Lehman's true financial condition. Corporate officers who choose to speak have "a duty to be both accurate and complete." *Caiola*, 295 F.3d at 331. Here, for example, on September 18, 2007, Lehman disclosed that it took only a $700 million write-down (net of hedging gains) and did not disclose how much of this was attributed to its mortgage-related assets. ¶147. When asked directly about this on a conference call later that day, O'Meara refused to reveal the amount of gross write-downs, stating that "knowing the gross numbers particularly in that business, I don't think is really a meaningful thing." *Id.*

Similarly, in announcing Lehman's $1.5 billion net ($3.5 billion gross) write-down of its residential and commercial mortgage-related positions in the fourth quarter of 2007, O'Meara omitted material information about the exposure to losses on Lehman's subprime and Alt-A assets and instead focused on Lehman's hedging strategies − which Lehman would only later admit did not exist for Alt-A loans. ¶¶286, 352. When directly asked to provide a breakdown of the size of the write-downs taken on the commercial mortgage portfolio, O'Meara refused to answer, stating "[w]e're not giving that." ¶288.

By providing total asset write-down figures, but not disclosing the exposure levels related to subprime, Alt-A, and commercial mortgages, the Insider Defendants sought to, and did, obscure Lehman's true exposure to deteriorating assets through opaque financial reporting.

3. The Temporal Proximity Of The Insider Defendants' Public Statements To Contrary Information Raises A Strong Inference Of Their Scienter

The close temporal proximity between the Insider Defendants' misstatements regarding Lehman's risk management, hedging abilities, capitalization and liquidity, and the materialization of risks regarding the same, bolsters the inference of scienter against the Insider Defendants. *See Institutional Investors Group*, 564 F.3d at 283. For instance, less than a week before Lehman petitioned for bankruptcy, Lowitt falsely stated that "our liquidity position . . . remains very strong," "we have maintained our strong liquidity and capital profiles even in this difficult environment," and "we think that clearly with our capital position at the moment is, it's strong." ¶9.

Likewise, during a November 17, 2007, investor conference, Lowitt falsely stated that the economic hedges employed by Lehman to offset losses on residential and mortgage-backed assets had been "very effective." ¶284. Additionally, during Lehman's earnings conference call for the first quarter of 2008, Callan falsely represented that "[w]e are very well hedged . . . we would consider ourselves at this point net short in the residential asset class." On September 10, 2008, however, Lowitt contradicted the earlier statements by admitting that there was no "direct hedge for Alt-A assets." ¶365.

4. The Magnitude Of Lehman's Exposure To Loss And Write-downs, In Combination With Its Significant Liquidity Problems And Rapid Bankruptcy, Contributes To A Strong Inference Of The Insider Defendants' Scienter

Courts have recognized that, when combined with other factors, the scope and magnitude of a fraudulent scheme may give rise to a strong inference of scienter. *See, e.g.*, *Global Crossing,* 322 F. Supp. 2d at 347; *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 506 (W.D. Pa. 2002). Moreover, the Second Circuit has held that the magnitude of a write-down contributes to

an inference of recklessness as to prior statements regarding factors leading to the write-down, and "render[ed] less credible" a defendant's explanation that it did not appreciate negative ramifications of the poor performance of its products. *Rothman*, 220 F.3d at 92 (in finding strong inference of scienter, "deem[ing] significant the amount of the write-off [the defendant] eventually did take for the final quarter"); *see also Scholastic Corp.*, 252 F.3d at 77 (magnitude of $24 million in special charges "undermines, at the pleading stage," defendants' argument that they were not aware of events negatively affecting financial results). Here, the size of Lehman's exposure to loss, its billion-dollar write-downs, and its liquidity concerns contribute to a strong inference of the Insider Defendants' scienter.

The write-downs were the direct result of Lehman's undisclosed exposures to risky mortgage-related assets. Even more striking, Lehman took the write-downs following its reporting of record profits and payment of record bonuses. Finally, the write-downs and related liquidity concerns led directly to Lehman's bankruptcy, strengthening the inference of recklessness. *See, e.g.*, *BISYS*, 397 F. Supp. 2d at 448 (noting that several courts within Second Circuit had held that size of a fraud could contribute to inference of scienter, at least where the "fraud actually bankrupted the company").

5. Terminations And Demotions During The Exchange Act Period Contribute To A Strong Inference Of The Insider Defendants' Scienter

The timing of certain employment decisions at Lehman also lends support to an inference of the Insider Defendants' scienter. For example, after Madelyn Antoncic, Lehman's Chief Risk Officer, and Michael Gelband, head of Lehman's Fixed Income division, "urged caution" or otherwise questioned the Company's risky lending practices, they were "pushed aside" from any dealings with respect to Lehman's mortgage operations. ¶343.

Additionally, three days after Lehman's announcement of its first ever quarterly loss on June 9, 2008, Defendant Callan was demoted and Defendant Gregory was replaced. *Id*. The termination and demotion of these key executives just months prior to Lehman's collapse further give rise to scienter. *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1338 (S.D. Fla. 1999) (circumstances surrounding termination of key executive contributes to inference of scienter).

E. The Accounts Of Former Employees <u>Contribute To A Strong Inference Of Scienter</u>

The accounts of former employees of Lehman and its subsidiaries corroborate other information in the Complaint and contribute to an inference of the Insider Defendants' scienter. The Insider Defendants' various entreaties to disregard these fruits of Co-Lead Counsel's investigation are unavailing.

The Insider Defendants challenge the CWs' knowledge and also their credibility. Exec. Br. at 45, 49. In the Second Circuit, a complaint need only identify 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*, 216 F.3d at 314. Consistent with Second Circuit requirements, Plaintiffs provide specific job titles, the divisions in which sources worked, and dates of employment.[23] Accordingly, Plaintiffs have alleged information supporting the CWs' knowledge of the facts they provided.

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[23] *See, e.g.*, ¶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"); ¶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

Contrary to the Insider Defendants' characterization, the Complaint contains allegations of many high-ranking officials at both Lehman and its subsidiaries. *See, e.g.*, ¶100 (CW16, vice president at Aurora); ¶103 (CW3, vice president at Aurora); ¶106 (CW6, BNC's COO); ¶114 (CW12, Lehman managing director). Moreover, employees from various Lehman divisions and subsidiaries, from different geographic locations, and at different seniority levels provide consistent accounts across various time periods. Likewise, the CW accounts also presaged the causes for Lehman's bankruptcy – its deteriorating businesses and assets and declining capital. Such consistency demonstrates the CWs' reliability and provides strong support for scienter. *See, e.g.*, *Countrywide Deriv. Litig.*, 554 F. Supp. 2d 1044, 1058-59 (that sources from various offices of a large company, from different geographic regions, and at different levels of corporate hierarchy provide consistent accounts over different time periods supports strong inference of scienter).

Next, relying largely on out-of-circuit authority, the Insider Defendants contend that the CWs' statements should be discounted because they "likely have 'an axe to grind.'" Exec. Br. 49 (quoting *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007)). However, the Seventh Circuit has limited *Higginbotham*'s application, *Makor Issues & Rights*, 513 F.3d at 711-12, and courts within this Circuit have declined to follow it. *See 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 *Higginbotham*); *City of Brockton Ret. Sys. v. Shaw Group Inc.*, 540 F. Supp. 2d 464, 474 (S.D.N.Y. 2008) (declining to adopt *Higginbotham* approach). In any event, the Insider Defendants' assertions are no more than speculation, and where, as here,

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investors while employed at BNC from mid 2005 to October 2007"). The remaining sources are also identified sufficiently under Second Circuit law.

multiple sources corroborate each other and other facts alleged in the Complaint, this contributes to their reliability and to an inference of scienter. *See, e.g.*, *Makor Issues & Rights*, 513 F.3d at 712; *Countrywide Deriv. Litig.*, 554 F. Supp. 2d at 1058.

Finally, the Insider Defendants contend that either individual CW accounts or the CW allegations as a whole "do not establish a strong inference of scienter," *see* Exec. Br. 45, 47, but Lead Plaintiffs do not rely on the CW allegations alone. Rather, consistent with *Tellabs*, the CW allegations add to the other indicia of scienter in the Complaint, which collectively raise a strong inference of the Insider Defendants' scienter.

F. Competing Inferences Presented By The Insider Defendants Are Implausible

Relying largely on material outside of the Complaint, the Insider Defendants attempt to characterize themselves as "victims." This is both absurd and offensive. This case concerns the Insider Defendants' false statements and omissions regarding Lehman's businesses, exposures, asset types and values, and liquidity.

The Insider Defendants refer the Court to the number of securities filings in other cases, apparently to suggest that *this* case should be dismissed. Exec. Br. 3, 54. As *Tellabs* instructs, however, courts may only consider competing inferences "rationally drawn from the facts alleged." *Tellabs*, 551 U.S. at 324, 127 S. Ct. at 2504. There is nothing rational about dismissing meritorious claims because different companies in the same industry are also subject to litigation. *See also In re Scottish Re Group Sec. Litig.*, 524 F. Supp. 2d 370, 389-90, n.149 (S.D.N.Y. 2007) ("Defendants' arguments [outside the four corners of the complaint] are inappropriate at this stage of the litigation. Opposing inferences may only be based on the allegations of the Complaint, which must be taken as true, and other documents properly before the court on a motion to dismiss.").

The Insider Defendants also incorrectly contend that the Complaint alleges nothing more than corporate mismanagement. They repeatedly assert that the Complaint's claims are based on their failure to predict the economic downturn. *See, e.g.*, Exec. Br. 1-4, 30-31, 54. Again, the Insider Defendants mischaracterize the Complaint's allegations.

Without doubt, the Insider Defendants mismanaged Lehman, committing such large amounts and resources (exacerbated by leverage) to mortgage- and real estate-related businesses and assets that a decline in these businesses risked the entire Company and its long term prospects on a gamble to maximize short term profits from these businesses. But the focus here is less on what Insider Defendants ***did*** as it is on what they ***said*** and ***did not say*** to the market about their activities. "[T]he mere fact that the conduct in question arguably constitutes mismanagement will not preclude a claim under the federal securities laws if the defendant made a statement of material fact wholly inconsistent with known existing mismanagement or failed to disclose a specific material fact resulting from that mismanagement." *In re Donna Karan Int'l Inc. Sec. Litig.*, No. 97-CV-2011, 1998 WL 637547, at *10 (S.D.N.Y. Aug. 14, 1998); *see also Rothman*, 220 F.3d at 90-92 (allegations of "poor business judgment [are] not actionable under section 10(b)," but false statements regarding a company's condition or failing to write down values when known are actionable).

Similarly, this case is not about whether the Insider Defendants failed to predict an economic downturn, but alleges that Insider Defendants made false statements and concealed information regarding the condition of Lehman and its assets. Accordingly, the Insider

Defendants' citations regarding failures to predict unexpected events are inapposite, and in any event, the complaints in those cases suffered from deficiencies not present here.[24]

The Insider Defendants also erroneously contend that they had no motive to lead Lehman into bankruptcy while maintaining large stock holdings. While the Supreme Court has made clear that motive and insider trading allegations are not required to allege a claim under Section 10(b), *see Tellabs*, 551 U.S. at 325, 127 S. Ct. at 2511, Fuld and the additional Insider Defendants had powerful motives to conceal Lehman's true financial condition. In particular, they needed to raise capital in light of Lehman's accumulation of toxic assets and the risks these assets posed to the Company's solvency. To do so, they issued bonds, preferred shared and equities in hundreds of offerings – including offerings exceeding $1 billion.[25]

Moreover, the Insider Defendants were uniquely motivated to conceal the truth in order to postpone Lehman's demise, in the hopes of avoiding it. *See, e.g., In re Cabletron Sys.,* 311 F.3d 11, 39 (1st Cir. 2002) (finding sufficient motive where "the executives' careers and the very survival of the company were on the line"); *Nathenson v. Zonagen Inc.,* 267 F.3d 400, 426 (5th Cir. 2001) (scienter for misstatements about patent supported by fact that company's future depended on patent); *In re Sepracor, Inc., Sec. Litig.,* 308 F. Supp. 2d 20, 24 (D. Mass. 2004) (evidence that company was burning cash at high rate and was dependent on Soltara as most

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[24] *See, e.g.*, *Shields v. Citytrust Bancorp,* 25 F.3d 1124, 1129 (2d Cir. 1994) (scienter allegations insufficient because, apart from conclusory statements regarding intent, complaint did not allege that public statements were contrary to internal information); *Denny v. Barber*, 576 F.2d 465, 467-69, 471 (2d Cir. 1978) (complaint failed to identify false statements, and its "general allegations of knowledge or recklessness" were insufficient; additionally, plaintiff failed to indicate any damages and could sell his $400 investment for a profit); *In re Aegon N.V. Sec. Litig.*, No. 03 Civ. 0603, 2004 WL 1415973 (S.D.N.Y. June 23, 2004) (scienter allegations deficient because complaint did not allege that public statements were contrary to internal information).

[25] *See In re Time Warner Sec. Litig.,* 9 F.3d 259 (2d Cir. 1993) (motive to enable company to set higher price for offering sufficient for scienter); *Howard v. Everex Sys.,* 228 F.3d 1057, 1064 (9th Cir. 2000) (desire to raise company financing can be probative of motive to defraud); *In re Resource Am. Sec. Litig.,* No. Civ. 98-5446, 2000 WL 1053861, at *6 (E.D. Pa. July 26, 2000) (alleged desire to raise capital gives rise to strong inference of scienter).

promising drug in pipeline were relevant to scienter).

The Insider Defendants also profited from their false statements. Their compensation depended on hitting certain short-term benchmarks. In 2007, the benchmark required 10% increase in net revenues, 2% in pretax income, 4% in net income, and 7% earnings per share over 2006. ¶358. By misrepresenting Lehman's financial results and the value of its assets, Insider Defendants were able to report in 2007 the highest earnings ever for Lehman in the midst of record declines in the mortgage and securitization markets. ¶357. In 2007, because the Insider Defendants "successfully navigat[ed] the difficult credit and mortgage market environments and maintain[ed] the Firm's strong risk controls," Fuld received total compensation of $40 million (including a cash bonus of $4.25 million), O'Meara received $9.49 million (including a cash bonus of $2.65 million), Gregory received $34 million (including a cash bonus of $4.5 million), and Lowitt received $9.49 million (including a cash bonus of $2.65 million). ¶358. Such "concrete benefits" were "realized by one or more of the false statements and wrongful non-disclosures" and thus support a strong inference of scienter.[26]

The Insider Defendants argue that there is no scienter because Fuld engaged in a single stock sale while other executives did not sell Lehman shares. They are wrong. Insider trading is not a prerequisite to scienter.[27]

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[26] *See Novak,* 216 F.3d at 307; *see also, In re Orbital Scis. Corp. Sec. Litig.,* 58 F. Supp. 2d 682, 687 (E.D. Va. 1999) (allegations that incentive compensation affected fraudulent conduct should not be disregarded); *Schlagal v. Learning Tree Int'l,* No. CV 98-6384 ABC (Ex), 1998 WL 1144581, at *16-17 (C.D. Cal. Dec. 23, 1998) (executive compensation and bonuses when combined with other incentives can establish scienter).

[27] *See Tellabs*, 551 U.S. at 325, 127 S. Ct. at 2511; *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.,* 320 F.3d 920 (9th Cir. 2003); *Elkind v. Liggett & Myers, Inc.,* 635 F.2d 156, 172 (2d Cir. 1980) ("ordinarily gain to the wrongdoer should not be a prerequisite to liability" under § 10(b)); *Greebel v. FTP Software, Inc.,* 194 F.3d 185, 197 (1st Cir. 1999) ("the PSLRA neither prohibits nor endorses the pleading of insider trading as evidence of scienter").

Moreover, Fuld's June 13, 2007 sale of approximately 300,000 shares at $77.56 per share – from which he received proceeds of over $22 million – was unusual and suspicious because the sale was made just after Lehman reported "record" quarterly results for 2Q07, while Lehman's stock price was near its peak, before the Insider Defendants disclosed that Lehman had subprime and Alt-A exposures, and while Lehman was repurchasing approximately 43 million shares at $73.83 per share. ¶356. *See Countrywide Deriv. Litig.,* 554 F. Supp. 2d at 1068 (insider sales coinciding with stock repurchase by company can create inference of scienter).

The fact that some Insider Defendants did not engage in stock sales during the Exchange Act Period does not negate the direct and circumstantial evidence of scienter in this case.[28]

Additionally, the Insider Defendants' argument that they actually increased their holdings during the Exchange Act Period is deceptive. These Defendants ***did not*** accumulate any Lehman shares during this period by spending their own money. Instead, the increase in their ownership of Lehman shares during this period was the result of ***stock options*** that were awarded because they were purportedly able to successfully navigate Lehman through the mortgage crisis. Defendants' argument that Fuld supposedly lost $860 million when Lehman filed for bankruptcy also carries no weight, because they provided no information on how this amount was calculated and whether it is based on option grants. Even if Fuld lost this amount on paper, he paid nothing for his shares and options, and his paper loss cannot compare to the billions in ***actual*** losses suffered by Lehman investors. Indeed, Fuld pocketed $480 million in earnings over eight years

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[28] *See In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1427 (9th Cir. 1994); *In re Nuko Info. Sys., Sec. Litig.,* 199 F.R.D. 338, 344 (N.D. Cal. 2000) ("the absence of Defendants' selling or trading has little bearing on determining whether Plaintiffs' have adequately pleaded scienter"); *In re U.S. Aggregates, Inc. Sec. Litig.,* No. C 01-1688 CW, 2003 WL 252138, at *3 (N.D. Cal. Jan. 24, 2003) (rejecting defendants' contention that lack of insider trading can negate inference of fraud).

at Lehman while taking (and camouflaging) risks with investors' money.

Additionally, the Insider Defendants' fact-intensive argument that they had no motive to commit fraud because their compensation comprised largely of RSUs (restricted stock units) is not grounds for dismissal. It is precisely because these Insider Defendants held such large amounts of RSUs that they were motivated to conceal the truth in order to inflate Lehman's stock price. As long as the Insider Defendants made false and misleading statements and Lehman's stock price remained artificially inflated, the possibility of collateral calls was reduced, thus enabling Lehman to raise capital, while providing these Insider Defendants time to seek a buyer and negotiate a bailout.

In short, a variety of reasons exist for the Insider Defendants' improper actions. Prompt disclosure of Lehman's true condition would have caused the prices of its securities to plummet, as they did, and likely would have led to an earlier bankruptcy filing. As Judge Posner, writing for the Seventh Circuit, explained in rejecting arguments similar to those put forth by the Insider Defendants here, a defendant may decide to gamble and conceal bad news in the hopes that it is overcome by good news. *Makor Issues & Rights, Ltd.*, 513 F.3d at 710. That the gamble ultimately fails does not eliminate the inference of scienter. *Id.* ("The fact that a gamble – concealing bad news in the hope that it will be overtaken by good news – fails is not inconsistent with its having been a considered, though because of the risk a reckless, gamble. It is like embezzling in the hope that winning at the track will enable the embezzled funds to be replaced before they are discovered to be missing." (internal citation omitted)); *see also Green Tree*, 270 F.3d at 661-62.

Finally, even assuming that the Insider Defendants' actions were "irrational," the Second Circuit long ago noted that persons "who find themselves in a bad situation of their own making

do not always act with full rationality." *United States v. Simon*, 425 F.2d 796, 809 (2d Cir. 1969). "[I]rrational schemes have as much potential to defraud investors as do rational schemes." *Robbins v. Moore Med. Corp.*, 788 F. Supp. 179, 191 n.8 (S.D.N.Y. 1992).[29]

G. The Complaint Pleads Loss Causation

The Complaint's loss causation allegations amply satisfy Rule 8, which requires only that a defendant must be given fair notice of the plaintiff's claim through "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2); *Dura Pharms. Inc. v. Broudo,* 544 U.S. 336, 346, 125 S. Ct. 1627, 1634 (2005); *Lormand v. US Unwired, Inc.*, 565 F.3d 228, 256 (5th Cir. 2009) (loss causation must be pled in accordance with Rule 8); *Bristol Myers Squibb*, 586 F. Supp. 2d at 163 (same).

In *Dura*, the Supreme Court explained that a plaintiff must allege that the fraud "proximately caused the plaintiff's economic loss." *Dura*, 544 U.S. at 346, 125 S. Ct. at 1634. The Court did not hold that all securities fraud claims must be characterized by a corrective disclosure followed by an immediate stock price drop; to the contrary, the Court explained that a loss may occur after "the relevant truth *begins to leak out*." *Id.* at 342, 125 S. Ct. at 1631-32 (emphasis added).

This standard is consistent with preexisting law in the Second, Third, Seventh, and Eleventh Circuits, *id.* at 344-45, 125 S. Ct. 1632-33, and stands for two principles. First, by writing that truths may "leak out," the Court made clear that some cases may involve a gradual price decline as the truth is slowly revealed. *See In re TyCom Ltd. Sec. Litig.*, No. 03-CV-1352, 02 MDL-1335-PB, 2005 WL 2127674, at *12 (D.N.H. Sept. 2, 2005) (loss causation exists when

[29] Insider Defendants assert that it would be irrational for them to grow Lehman's mortgage and asset-backed securities over 50% from 2006 to 2007. Exec. Br. 29. This increase, however, was likely the result of Lehman's deteriorating securitization business and the corresponding accumulation of mortgages on its books that it was not able to securitize or sell.

"over time, the true facts came out regarding [the company's] prospects"); *City of Hialeah Employees' Ret. Sys. & Laborers Pension Trust Funds for N. Cal. v. Toll Bros. Inc.*, C.A. No. 07-1513, 2008 WL 4058690, at *5-6 (E.D. Pa. Aug. 29, 2008) (defendants "gradually revealed the truth" about prior misrepresentations).

Second, *Dura*'s "relevant truth" is not necessarily the fact of *fraud* – *i.e.*, that the Insider Defendants lied about their business − but may also refer to the underlying facts that were concealed from the public by the fraud. This is exactly how the Second Circuit has articulated loss causation: loss causation exists when "the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005). Loss causation thus represents a "materialization" of a risk concealed from investors. *See id.*

A concealed risk may materialize in different ways. Most obviously, the risk may materialize if the public becomes aware of the fraudulent conduct. *See In re Initial Pub. Offering Sec. Litig.,* 399 F. Supp. 2d 298, 307 (S.D.N.Y. 2005). In this respect, if the company restates prior financial reports, the market will learn that prior statements were false, and the stock price will correct. *See, e.g.*, *In re Openwave Sys. Sec. Litig*., 528 F. Supp. 2d 236, 252-53 (S.D.N.Y. 2007). However, concealed risks may materialize without the public becoming aware that it was misled earlier. For example, the "risk" associated with accounting fraud may materialize when the fraud ceases and the company reports lower earnings from previous (fraudulently inflated) periods. *See, e.g.*, *Fraternity Fund*, 376 F. Supp. 2d at 403. The market may not know that the sudden drop in earnings was due to false reporting, but one of the concealed risks of such fraud has nonetheless materialized – namely, that disclosure of the company's true financial condition

would cause the market to devalue the stock.[30]

1. The Complaint Pleads The Materialization Of Concealed Risks

As explained above, the Complaint alleges that the Insider Defendants knowingly and/or recklessly concealed material risks about Lehman's financial condition and liquidity during the Exchange Act Period, inflating the Company's stock price. Specifically, the Complaint pleads in detail that, among other things, the Insider Defendants held Lehman's mortgage-related assets on their books at inflated values, did not reveal the extent of their Alt-A holdings, and did not disclose their risky lending practices. They also misled the market about their capital position and liquidity. By concealing these risks, the Insider Defendants buoyed Lehman's stock price throughout most of the Exchange Act Period.

The risk concealed by these omissions and false statements was that Lehman would be forced to acknowledge large losses, ultimately leading to insolvency. On June 9, 2008, the Company reported its financial results for the 2008 second quarter, announcing a net loss of approximately $2.8 billion, or approximately $5.14 per share, and disclosing losses on hedges. ¶363. In a conference call that same day, Lowitt explained that "[t]he majority of our write

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[30] *See Parmalat*, 375 F. Supp. 2d at 305 ("An allegation that a corrective disclosure caused the plaintiff's loss may be sufficient to satisfy the loss causation requirement. It is not, however, necessary."; s*ee also In re Loewen Group Inc. Sec. Litig.*, 395 F. Supp. 2d 211, 217-18 (E.D. Pa. 2005); *Freeland v. Iridium World Commc'ns, Ltd.*, 233 F.R.D. 40, 47 n.9 (D.D.C. 2006) (collecting cases); *Global Crossing*, 471 F. Supp. 2d at 348 (truth revealed through the "release of financial information, which disclosed that the promised revenues . . . were not being received"); *In re Priceline.com Inc. Sec. Litig.*, 236 F.R.D. 89, 93-94 (D. Conn. 2006) (truth revealed through unfavorable financial information); *In re NTL, Inc. Sec. Litig*, 2006 WL 330113, at *8 (Peck, M.J.) (S.D.N.Y. Feb. 14, 2006), *objections overruled*, 2006 WL 568225 (S.D.N.Y. Mar. 9, 2006) (gradual disclosure of the "truth about NTL's underlying problems"); *Teamsters Local 445 Freight Div. Pension Fund v. Bombadier, Inc.*, 05 Civ. 1898, 2005 WL 2148919, at *12 (S.D.N.Y. Sept. 6, 2006) (truth revealed through unfavorable financial results). When applying the statute of limitations, it is universally recognized that fraud may cause great losses, but investors may not become *aware* that their losses are due to fraud until some time after the initial stock price drop. *See, e.g.*, *Law v. Medco Research*, *Inc.* 113 F.3d 781, 783-784 (7th Cir. 1997); *New England Health Care Emples. Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 502 (6th Cir. 2003); *cf. LC Capital Partners, L.P. v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 155 (2d Cir. 2003) (stock price drop alone will not place investors on inquiry notice).

downs were in Alt-A driven by increase in Alt-A delinquencies which were specific to Alt-A prices." ¶151. Callan stated on the same call that Lehman had sold off $130 million in assets that were difficult to sell. ¶311. In addition, the Company announced that it would raise $6 billion through a combined offering of preferred and common shares. ¶¶6, 163, 359. Lehman's shares declined by 8.7% on June 9 and an additional 19.44% by market close on June 11, 2009. ¶363.

Company announcements and news events continued to reveal Lehman's undisclosed risks throughout the summer of 2008. For example, on June 16, 2008, Lowitt disclosed in Lehman's 2008 second quarter conference call that Lehman had marked down its multibillion dollar positions in SunCal and Archstone. ¶135. On September 8, 2008, Lehman announced it would release its third quarter 2008 results, as well as "key strategic initiatives" on September 18, 2008. Market analysts at Bernstein Research and Oppenheimer predicted further write-downs in the third quarter of between $4 billion and $5 billion, and Lehman's shares dropped 12.7% as a result. ¶364.[31]

On September 10, 2008, Lehman pre-announced that it expected its largest quarterly net loss ever of $3.9 billion, driven in large part by gross write-downs of $1.7 billion on its commercial mortgage positions and $5.3 billion in residential mortgage-related positions. Lehman also announced a plan to rid itself of its troubled commercial real estate assets by

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[31] The Insider Defendants claim without authority that "a company's identification of the date on which it will release results can hardly constitute a corrective disclosure" and that "analysts predictions" do not reveal "any wrongdoing on the part of Lehman." Exec. Br. 58 n.68. Regardless of whether this news is properly characterized as a "corrective disclosure," the Complaint alleges facts supporting the inference that the market perceived the materialization of previously undisclosed risks in the September 8 announcement relating to Lehman's improper asset valuations and potential insolvency, and that Lehman's stock price dropped accordingly. *See Schleicher v. Wendt*, 529 F. Supp. 2d 959, 966, 976 (S.D. Ind. 2007) (holding that analyst's downgrade constitutes materialization of risk and stating: "[P]laintiffs' materialization of the risk theory is a method of showing loss causation without having to show the typical drop in stock price following a *mea culpa* announcement by the company."); *In re Winstar Commcn's*, No. 01 CV 3014(GBD), 2006 WL 473885, at *14 (S.D.N.Y. Feb. 27, 2006) (market may learn of fraud through "analysts questioning financial results.").

spinning off almost all of its $32.6 billion commercial real estate portfolio into a separate publicly traded company. ¶¶8, 136, 154, 318, 365. In a conference call that same day, Lowitt acknowledged for the first time that "there is no direct hedge for Alt-A assets." ¶¶159, 352, 365. Further, Fuld and Lowitt continued to misrepresent Lehman's financial condition by stating that it maintained a "very strong" liquidity and capital positions. ¶¶9, 320. As with Lehman's June 9, 2008 announcement, the partial disclosures provided the market with additional, but still incomplete, information about Lehman's concealed risks, and Lehman's stock price dropped an additional 7% following this announcement. Finally, on September 15, 2008, Lehman filed for bankruptcy, effectively destroying the value of its common shares. ¶366.

As these facts show, the market "responded to and 'corrected' the price of [the company's] stock over [time] as bits and pieces of negative information became available."[32]

The Insider Defendants contend that none of these announcements constitute "corrective disclosures." To the extent that the Insider Defendants mean that these announcements did not reveal that prior representations were *false*, the Insider Defendants' argument is beside the point – it is not necessary that the market recognize that prior representations were *false*, so long as the stock price drops represent a risk concealed by the fraud.[33]

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[32] *Danis v. USN Commc'n., Inc.*, 73 F. Supp. 2d 923, 943 (N.D. Ill. 1999); *see In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 288 (S.D.N.Y. 2008) (loss causation may "be pleaded on the theory that the truth slowly emerged through a series of partial disclosures."); *In re Vivendi Universal S.A.*, No. 02 Civ. 5571(RJH), 2004 WL 876050, at *7 (S.D.N.Y. Apr. 22, 2004) (denying motion to dismiss where complaint alleged that fraud may emerge through a "series of corrective disclosures."); *Winstar Commc'ns*, 2006 WL 473885, at *14 ("[I]n addition to formal disclosure by a defendant, 'the market may learn of possible fraud [from] a number of sources: *e.g.*, from whistleblowers, analysts' questioning financial results, resignation of CFOs or auditors, announcements by the company of changes in accounting treatment going forward, newspapers and journals, etc.'"). *See Heller*, 590 F. Supp. 2d at 624 (loss causation exists where defendant concealed its undercapitalization, undercapitalization led to high-risk strategy, and risk foreseeably materialized causing plaintiff's monetary loss); *Winstar Commc'ns*, 2006 WL 473885, at *5 (short-seller reveals that company "was incapable of funding its operations and would likely default on its credit facility, facts which defendants had allegedly repeatedly denied and actively concealed.").

[33] *See Lentell*, 396 F.3d at 72-74; *Parmalat*, 375 F. Supp. 2d at 305; *Initial Public Offering Sec. Litig.*, 544 F. Supp. 2d at 289 (plaintiffs have the *option* of showing loss causation *either* by identifying "particular 'disclosing event[s]'

And, if the Insider Defendants mean to say that the disclosures were somehow not detailed or vigorous enough to reveal Lehman's financial condition, that argument has been soundly rejected by courts. *See, e.g.*, *Initial Public Offering*, 544 F. Supp. 2d 277 at 289 (corrective disclosure need not "take a particular form or be of a particular quality"); *Lapin*, 506 F. Supp. 2d at 243 (same); *In re Vivendi Universal*, 2009 WL 1066254, at *13 (ratings downgrades and rapid asset sales can signal a firm's liquidity problems to the market); *Schleicher v. Wendt*, 529 F. Supp. 2d at 976 (analyst's downgrade constitutes materialization of risk).

The Insider Defendants assert the *non sequitur* that "the fact that a company filed for bankruptcy protection does not establish that prior thereto its offices were engaged in securities fraud." Exec. Br. 58. Rather than alleging that the bankruptcy proved Defendants' malfeasance, the Complaint alleges that the risks theretofore concealed had now fully materialized. As this Court held in *Parmalat*:

> Among the risks concealed by these reports was that Parmalat had massive undisclosed debt and was unable to service it. Defendants reasonably could have foreseen that Parmalat's inability to service its debt would lead to a financial collapse. The concealed risk materialized when Parmalat suffered a liquidity crisis on December 8, 2003 and was unable to pay bonds as they came due . . . . *That the true extent of the fraud was not revealed to the public until February - after Parmalat shares were worthless and after the close of the Class Period - is immaterial where, as here, the risk allegedly concealed by defendants materialized during that time and arguably caused the decline in shareholder and bondholder value*.

375 F. Supp. 2d at 307 (emphasis added).[34]

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that reveal the false information" *or* by showing "the materialization of the undisclosed condition or event" concealed by the false statements (quotations omitted). Moreover, Plaintiffs do allege that market analysts began to suspect that Lehman had overvalued its holdings. ¶¶10, 137, 313, 364.

[34] The Insider Defendants' list of holdings on loss causation by courts and judges in this district is not instructive. *See* Exec. Br. 56. In *In re OmniCom Group, Inc. Sec. Litig.*, 541 F. Supp. 2d 546 (S.D.N.Y. 2008), ruling on defendants' motion for summary judgment *following expert discovery*, Judge Pauley began his discussion of loss

The nearly complete loss of value in Lehman's common stock following its September 15, 2008 bankruptcy filing further supports Lead Plaintiffs' loss causation allegations. As Judge Scheindlin held recently: "[S]ome loss causation may be inferred simply from the disappearance of the original inflation. Indeed, there can be little argument that near-worthless shares are no longer inflated . . . . *Dura's* reasoning does not apply where a stock loses virtually all of its value." *In re Initial Public Offering Sec. Litig*., No. 21 MC 92(SAS), 2009 WL 1649704, at *19 (S.D.N.Y. June 10, 2009) (citations omitted). Whatever inflation remained in Lehman's stock before September 15, 2009, Insider Defendants can give no plausible argument that it remained in the stock after Lehman filed for bankruptcy protection.

2. The Insider Defendants' Fraud, Not "Unforeseen And Uncontrollable Market Forces," Caused Plaintiffs' Losses

The Insider Defendants attempt to rewrite the Complaint's allegations, claiming in essence that the downturn in the housing market caused Lehman's decline. Relying inappropriately on self-excusing testimony by former Fed Chairman Alan Greenspan and on comparisons to Lehman's competitor firms, the Insider Defendants ask this Court to reject the Complaint's loss causation allegations because Lehman's downfall coincided with a "market-wide decline" and/or a "global market downturn." Exec. Br. 59-60. This "intervening cause" argument must fail not only because it relies impermissibly on facts outside of the Complaint, but because it raises far more questions of fact than it answers.

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causation: "This is not a case about materialization of an undisclosed risk," *id.* at 551. Defendants cite Judge Cote in *In re WorldCom Inc. Sec. Litig.,* No. 02 Civ. 3288, 2005 WL 375314 (S.D.N.Y. Feb. 17, 2005) (citing the same footnote in *Lentell* that Defendants cite a quarter page earlier) for the proposition that "a concealed fact cannot cause a decrease in the value of a stock before the concealment is made public." Judge Cote's opinion resolved a motion *in limine* on negative causation issues under Securities Act § 11(e), and has little relevance to the issue here. *Id.* at *6-7.

The specific, factual question of whether an intervening event disrupts the chain of causation is a matter for trial.[35] Moreover, in this case, the market downturn may have exacerbated Lehman's weaknesses, making it more difficult for Lehman to conceal its fraud.[36] If so, plaintiffs are entitled to recover:

> [W]hen the financial condition of a corporation is misrepresented and it is subsequently driven into insolvency by reason of the depressed condition of an entire industry, which has no connection with the facts misrepresented, it may still be found that the misrepresentation was a legal cause of the recipient's loss, since it may appear that if the company had been in sound condition it would have survived the depression.

Restatement (Second) of Torts § 548A.

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[35] *See, e.g., Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) ("Of course, if the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss."); *Nathel v. Siegal*, 592 F. Supp. 2d 452, 467-68 (S.D.N.Y. 2008) ("The existence of intervening events that break the chain of causation, such as a general fall in the price of stocks in a certain sector, is a 'matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss.'"); *In re DRDGold Ltd.*, 472 F. Supp. 2d 562, 576 (S.D.N.Y. 2007) (whether it was defendants' fraud, or other factors, that caused the losses is a matter for trial); *In re Converium Holding AG Sec. Litig.*, No. 04 Civ.7897, 2007 WL 2684069, at *4 (S.D.N.Y. Sept. 14, 2007) ("The extent to which subsequent events and post-IPO statements may be intervening events cannot be determined at this motion to dismiss stage."). *Accord Wortley v. Camplin*, 333 F.3d 284, 285 (1st Cir. 2003) (existence of intervening causes is a jury question); *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (plaintiff need not eliminate other potential causes of injury at the pleading stage); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 187 (3d Cir. 2000) (cited with approval in *Dura*, 544 U.S. at 344) (existence of an intervening cause may not be determined on motion to dismiss); *TyCom*, 2005 WL 2127674, at *13 ("Even if, as defendants maintain, there had been an intervening event that interrupted the chain of causation, such a determination is a matter of proof after discovery…"); *cf. Basic Inc. v. Levinson*, 485 U.S. 224, 249 n.29, 108 S. Ct. 978 (1988) (recognizing that in an efficient market, individual false statements may not infect stock prices for prolonged periods; "[p]roof of that sort is a matter for trial").

[36] The Insider Defendants cite *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763 (2d Cir. 1994), in which the Second Circuit dismissed plaintiffs' RICO claim in part because "[plaintiff's] injury was insufficiently close in time to the alleged misrepresentations." *Id.* at 772. In *First Nationwide* the court considered the question of materiality – transaction causation – simultaneously with the question of loss causation, and determined that the complaint had not sufficiently alleged the magnitude of the alleged overstatement or a method for calculating it, so it was difficult to determine from the face of the complaint whether there had been an overstatement at all. *See* 27 F.3d at 770-71. It was this factor, as well as the potential intervening cause of a marketwide downturn in real estate prices, that undermined the complaint's allegations of loss causation. *Id.* As the court explained, "We do not mean to suggest that in all cases a fraud plaintiff will be unable to plead proximate cause when the claim follows a market collapse. In this case, it is the cumulative effect of the considerations discussed above, rather than any single factor, that compels our decision." *Id.* at 772. Similarly, in *Powers v. British Vita, P.L.C.*, 57 F.3d 176, 189-90 (2d Cir. 1995), another RICO action cited by the Insider Defendants, the Second Circuit relied only in part on a market downturn in finding that the plaintiff did not establish loss causation. Its loss causation holding was primarily based on its legal interpretation of a voting agreement between the parties.

Seen in this light, the fact that the stock prices of some of Lehman's competitors fell during the same rough period that Lehman's stock fell to zero further highlights the *differences* between Lehman and its competitors, suggesting that Lehman was even more vulnerable to the crisis than they were – that difference was due to Lehman's fraud.

Moreover, given Lehman's central role in creating the mortgage crisis, the Insider Defendants should not be allowed to escape liability simply by pointing to that crisis of their own making. An intervening cause is an "external and unforeseeable factor[]" that directly causes the plaintiff's loss. *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001); *see Restatement (Second) of Torts* § 548A cmt b ("[T]here is no liability when the value of the stock goes down after the sale, *not in any way because of the misrepresented financial condition*, but as a result of some subsequent event that has *no connection* with or relation to its financial condition." (emphasis added)). Here, of course, Plaintiffs allege that Lehman's activities were themselves one cause of the crisis, and thus cannot be said to be unrelated to the fraud (and certainly not as a matter of law at the pleading stage).

DeMarco v. Robertson Stephens Inc., 318 F. Supp. 2d 110, 114 (S.D.N.Y. 2004), involved a so-called "pump and dump" scheme in which defendant banks promoted Corvis, a telecommunications stock, as undervalued despite their belief that the stock was overvalued. When Corvis's stock price collapsed, contemporaneously with the telecom bubble, plaintiffs sued. As here, defendants moved to dismiss arguing that the bursting of the telecom bubble was an intervening cause of plaintiffs' losses. Judge Lynch disagreed, holding:

> [D]efendants' attempt to recast the foreseeable price decline of pumped up stock as an unforeseeable intervening market event is unpersuasive. While defendants may be able to show after discovery that an unforeseeable intervening event caused the stock price to decline, plaintiffs' complaint is sufficient to raise an issue of fact as to whether some part of their losses was proximately caused by defendants' deliberate fraud.

Id. at 126. The Insider Defendants' "intervening cause" argument should therefore be rejected.

3. Lead Plaintiffs Need Not "Apportion" Losses Among Various Causes At This Stage Of The Litigation

Closely related to their argument that this Court must determine as a matter of law that all losses in the Complaint were caused by unforeseen market forces, the Insider Defendants also argue that the Complaint fails adequately to "apportion" losses between concealed and unconcealed risks. This is not required.

As a general matter, the Insider Defendants' argument, taken to its logical conclusion, would mean that corporations could preempt all securities claims by issuing corrective disclosures with other bad news, and then arguing that plaintiffs had not "apportioned" the losses. This is why it is generally accepted that, to satisfy the element of loss causation, plaintiffs need only show that the alleged fraud was a substantial cause of the stock price reaction. *See, e.g., In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 115 n.378 (S.D.N.Y. 2004) ("to prove loss causation, plaintiffs need not show that the alleged scheme was the sole cause of loss") (citation and internal quotation marks omitted), *vacated and remanded on other grounds*, 471 F.3d 24 (2d Cir. 2006); *In re Gilead Scis. Sec. Litig.*, 536 F.3d 1049, 1055 (9th Cir. 2008); *In re Daou Sys., Inc.*, 411 F.3d 1006, 1025 (9th Cir. 2005); *Semerenko*, 223 F.3d at 186-87. Nor are Plaintiffs required to quantify the loss attributable to the fraud even on a motion for summary judgment, let alone a motion to dismiss. *See In re Motorola Sec. Litig.*, 505 F. Supp. 2d 501, 551 (N.D. Ill. 2007); *In re Livent Sec. Litig.*, 148 F. Supp. 2d 331, 366 (S.D.N.Y. 2001). As the Fourth Circuit explained in *Miller v. Asensio & Co.*, 364 F.3d 223 (4th Cir. 2004), although an award of *damages* might require that plaintiffs establish the portion of the losses attributable to the fraud, *loss causation* as an element of a Rule 10b-5 cause of action requires

only a showing that the fraud was a *"substantial contributing cause of"* the loss. *Id.* at 232 (quoting *Semerenko*, 223 F.3d at 186-87).

Lentell is not to the contrary. There, the false statements were the analysts' true opinions of the subject stocks; the inherent riskiness of the stocks themselves was fully disclosed. 396 F.3d at 177. However, the plaintiffs had not even alleged that it was the analysts' true opinions that had ultimately caused the securities to crash; rather, it was the stocks' own fully disclosed volatility that brought about the price declines. *See id.* at 176. It was in this context that it became necessary for plaintiffs to offer some allegations to suggest that their losses were due to *concealed* risks – *i.e.*, the analysts' true opinions – rather than the risks that were actually made public. *See id.* at 177. Thus, *Lentell* did not purport to create a general rule that plaintiffs must plead facts "apportioning" the cause of their losses; the court was merely elaborating on the unremarkable requirement that a complaint provide the court with some allegations to connect their losses with the facts that had been concealed. As the court ultimately concluded, "where (as here) substantial indicia of the risk that materialized are *unambiguously apparent on the face of the disclosures alleged to conceal the very same risk*, a plaintiff must allege . . . facts sufficient to support an inference that it was defendant's fraud – rather than other salient factors – that proximately caused plaintiff's loss." *Id.* at 177 (emphasis added).

Here, by contrast, despite the Insider Defendants' attempt to argue otherwise, the risks that materialized were *concealed* from investors. Because these risks were not "unambiguously apparent on the face of the disclosures alleged to conceal the very same risk," apportionment is not necessary.[37]

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[37] *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147 (2d Cir. 2007), *Initial Pub. Offering*, 399 F. Supp. 2d 298, 309, and *In re The Warnaco Group, Inc. Sec. Litig. II*, 388 F. Supp. 2d 307 (S.D.N.Y. 2005) are not to the contrary.

Moreover, in support of their argument that losses are not properly apportioned, the Insider Defendants contend that many of the price drops were due to external or unrelated events. Exec. Br. 21, 45, 61. To the extent that this is another spin on their claim that the price drops were due to market forces, the Insider Defendants' argument fails for the reasons given above. Nor can the examples Defendants give be considered "external events." For example, they claim that the price of Lehman stock fell because negotiations with the Korean Development Bank were not going well. Exec. Br. 23, 61. But aside from the fact that the disclosure may have alerted investors to Lehman's capitalization problems, those negotiations may have failed, in turn, because of the problems on Lehman's balance sheet that had been concealed from investors. This is exactly the kind of loss for which investors may recover. *See Semerenko*, 223 F.3d at 187 (losses may be recoverable when a chain of events results in a merger being canceled) (cited with approval in *Dura*, 544 U.S. at 344, 125 S. Ct. 1632).

H. The Complaint States A Claim Under Section 20(a) Of The Exchange Act

The Complaint properly states a claim for control person liability under Section 20(a) of the Exchange Act against the Insider Defendants by alleging both a primary violation of the Exchange Act and that each Insider Defendant controlled the primary violator. *See, In re Parmalat Sec. Litig.,* 376 F. Supp. 2d 472 (S.D.N.Y. 2005); 15 U.S.C. §§ 77o, 78t(a); *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 415 (S.D.N.Y. 2003). Culpable participation is not an element of a plaintiff's *prima facie* case under Section 20(a). The Insider Defendants have not challenged Plaintiffs' pleading of control or that the Insider Defendants are in fact "control persons." Instead, lack of culpability is an affirmative defense that must be pleaded and

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All three merely quoted and cited the reasoning of *Lentell* in situations where the risks were, in fact, unambiguously disclosed.

proved by a controlling person in order to escape liability for violations by a controlled person. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 558 (S.D.N.Y. 2008).

The Insider Defendants challenge only the first prong of the Section 20(a) analysis, making a cursory argument that because the Complaint fails to state a claim for a primary violation of the Exchange Act, Plaintiffs' control person liability claim fails as a matter of law. Exec. Br. 63. However, as demonstrated above, the Complaint adequately states a claim for a primary violation of Section 10(b) of the Exchange Act and Rule 10b-5. Accordingly, the Insider Defendants' motion to dismiss the Section 20(a) control person claim should properly be denied.[38]

I. The Complaint States A Claim For Insider Trading Under Section 20A Against Defendant Fuld

Plaintiffs have adequately pled a claim for insider trading under Section 20A of the Exchange Act by alleging 1) a predicate violation of the Exchange Act, 2) that class members traded stock contemporaneously with Fuld, and 3) specifying the dates of Fuld's trades. ¶¶356, 370, 384-388. *See In re Openwave Systems Sec. Litig.*, 528 F. Supp. 2d 236.

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[38] Lehman would have been named as a defendant in the action but for its voluntary petition for bankruptcy protection. ¶¶23, 24. Where, as here, a primary violator is absent or unavailable because it is in bankruptcy, control person claims have routinely been allowed to go forward. *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006) (no requirement in Section 20(a) that controlled person be named as defendant as predicate to imposing liability upon the controlling individual defendants.); *In re U.S. Interactive, Inc.*, No. 01-CV-5222002 WL 1971252, (E.D. Pa. Aug. 23, 2002) (allegations of control person liability sufficient; company found to be a primary violator of Section 10(b) through conduct of named defendants who were controlling persons of company); *Schleicher v. Wendt*, 529 F. Supp. 2d 959 (Discharge of corporate securities issuer's potential liability for securities fraud through bankruptcy did not preclude liability of senior executives under theory of control person liability); *In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig.*, 271 F. Supp. 2d 1007, 1022 n.11 (E.D. Mich. 2003) ("[I]f the complaint states a primary violation by the Company, even if the Company is not named in the complaint as a defendant, then a § 20 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 of the primary violator is simply an element of proof of a section 20(a) claim, and that "liability need not be actually visited upon the primary violator before a controlling person may be held liable for the primary violator's wrong").

Fuld's sole challenge to the insider trading claim is that Plaintiffs have not established a predicate underlying violation of the Exchange Act. As set forth above, the Complaint states a claim against Fuld under Sections 10(b) and 20(a), both of which satisfy the requirement for a "predicate violation" under Section 20A.[39]

In addition, the Complaint identifies Fuld's insider sales of Lehman stock (¶387), and establishes that several Plaintiffs purchased Lehman stock contemporaneously with certain of Fuld's sales. ¶¶386-87. No more is required. *See In re KeySpan Corp.*, 2003 WL 21981806 (denying motion to dismiss Section 10(b) and Rule 10b-5 allegations and denying motion to dismiss Section 20A claims on finding that primary claims adequately pled).

J. The Insider Defendants' Reliance On Materials Outside The Complaint And Not Subject To Judicial Notice Is Improper

The extent to which the Insider Defendants cite to extraneous material and ignore the substantive allegations of the Complaint is remarkable – they have submitted seventy-seven exhibits, some of which themselves contain multiple documents. *See, e.g.*, Declaration of Michael J. Chepiga in support of the Executive Defendants' Motion to Dismiss ("Chepiga Decl.") Ex. 2 (containing 32 documents). The Insider Defendants have not requested that the Court take judicial notice of any of these materials, and, as discussed below, many are in any event inappropriate for consideration at the motion to dismiss stage. Finally, to the extent the Court considers any of the materials, they may not be considered for the truth of the matters asserted in the documents. It remains "the jury's authority to assess the credibility of witnesses, resolve any genuine issues of fact, and make the ultimate determination whether [defendants] acted with scienter." *Tellabs*, 551 U.S. at 328, 127 S. Ct. at 2513.

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[39] *See Refco*, 503 F. Supp. 2d at 664-66 (§ 20(a) control person claim can serve as a predicate violation for an insider trading claim under § 20A).

In evaluating the sufficiency of a complaint, a court may consider: (1) the complaint; (2) documents attached to the complaint or incorporated by reference; (3) and matters of which a court may take judicial notice. *See, e.g.*, *id.* at 322; *Chambers v. Time Warner, Inc.*, 282 F.3d at 152-53. A court may also consider a document "integral" to a complaint, even if not explicitly incorporated by reference. *Id.* at 153. For a document to be "integral" to a complaint, however, the Second Circuit has explained that "a plaintiff's reliance on the terms and effect of a document in drafting the complaint is a necessary prerequisite to the court's consideration of the document on a dismissal motion; mere notice or possession is not enough." *Id.* If a court considers any materials beyond this narrow universe in considering a motion to dismiss, "the motion shall be treated as one for summary judgment." Fed. R. Civ. P. 12(b).

Here, many of the Insider Defendants' exhibits are particularly inappropriate for consideration at the motion to dismiss stage.[40] For example, Defendants include a chart of various securities suits filed in the past several years. They cite to the number of suits and the allegations in these other suits and ask the Court to draw the inference that the allegations in *this* action are not sufficient. *See* Exec. Br. 3, 25, 54. Information concerning these other suits is not relevant to assessing the sufficiency of the Lehman-specific allegations in this action. Moreover, this compilation was not cited or referenced in the complaint, and the information is in no way "integral" to the complaint, and it is not otherwise appropriate for judicial notice. In short, this material should not be considered in evaluating the sufficiency of the Complaint in this action.

Similarly, the Insider Defendants submit various news articles, statements, and quotes from regulators and officials, many of which are related only tangentially to Lehman, if at all.

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[40] Plaintiffs do not object to the Court's taking judicial notice of Lehman's SEC filings. A "court is to consider [SEC filings] . . . only to determine what the documents stated," however, and "not to prove the truth of their contents." *Roth v. Jennings*, 489 F.3d 499, 509 (2d Cir. 2007) (citation and emphasis omitted).

See, e.g., Chepiga Decl., Ex. 2 (collecting statements). Defendants' brief is filled with references to these materials. *See, e.g.*, Exec. Br. 1-3. Contrary to their statement in a footnote that they do not submit these materials for their truth, *see id.* at 2 n.8, the Insider Defendants' cite these materials and assert that, for example, financial leaders "failed to foresee the depth and breadth of the financial crisis." *Id.* at 2, 55. Moreover, Defendants use these materials to pretend that they were innocent victims, highlighting that, "for reasons only history will judge, regulators allowed Lehman to fail." *Id.* at 25. Faced with similar submissions, courts have refused to consider this information at the motion to dismiss stage.[41]

The Insider Defendants also submit an exhibit entitled "Frequently Requested FOIA Document: Failure-to-Deliver Data-Archive Data," Chepiga Decl., Ex. 58, purportedly to support their assertion that short-sellers drove down Lehman's stock price, forcing trading partners to make collateral calls. *See* Exec. Br. 24 & 24 n.50. All that is attached to the declaration, however, is a single-page print out of a web page that contains hyperlinks to certain data. Neither the data, nor the factual assertion, are set forth in the Complaint or integral to the Complaint. Accordingly, any consideration of this exhibit in evaluating the sufficiency of Plaintiffs' claims would be improper.

As one final example, the Insider Defendants submit unauthenticated transcripts of conference calls to dispute certain allegations in the complaint. *See In re Scholastic Sec. Litig.*, No. 97 Civ. 2447, 1998 WL 560052, at *2 (S.D.N.Y. Sept. 1, 1998) (transcripts of conference

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[41] *See, e.g.*, *Atlas*, 556 F. Supp. 2d at 1161 n.7 (on motion to dismiss, declining to consider news articles, remarks by chairman of Federal Reserve, materials related to non defendant companies, and tables summarizing industry events as "inappropriate"); *In re OPUS360 Corp. Sec. Litig.*, No. 01 Civ. 2938(JGK), 2002 WL 31190157, *1-2, n.3 (S.D.N.Y. Oct. 2, 2002) (granting motion to strike "documents, including various articles related to the companies involved in this action and securities trading generally," because they were "not integral to the plaintiffs' claims, relied on by them, or attached to or incorporated by reference in the Consolidated Amended Complaint, and consequently should not be considered by this Court on a 12(b)(6) motion").

calls may not be considered if they were not specifically referenced in the complaint). For example, they contend that Lowitt's statement that "there is no direct hedge for Alt-A assets" actually means something different. Defendants can attempt to persuade a jury of their (strained) characterization of what Lowitt said. Courts are not to weigh evidence at the motion to dismiss stage, however, and must accept all well pled allegations as true.

IV. CONCLUSION

The Complaint meets all of the requirements for pleading violations of the Exchange Act. In the event the Court finds that it does not, Plaintiffs respectfully request leave to amend. *See* Fed. R. Civ. P. 15(a)(2) (advising that a court should freely give leave [to amend] when justice so requires).

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