UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

| In re LEHMAN BROTHERS SECURITIES AND ERISA LITIGATION<br><br>This Document Applies To:<br><br>*In re Lehman Brothers Equity/Debt Securities Litigation*, 08-CV-5523-LAK | Case No. 09-MD-2017 (LAK)<br><br>ECF CASE |
|---|---|

**LEAD PLAINTIFFS' OPPOSITION TO DEFENDANTS' MOTIONS TO DISMISS**

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# I. INTRODUCTION

The Complaint asserts claims under the Securities Act of 1933 (the "Securities Act") for untrue statements and material omissions contained in offering documents through which Lehman Brothers Holdings Inc. ("Lehman" or the "Company") raised over $31 billion from investors before its historic bankruptcy. Separately, the Complaint asserts claims arising under the Securities Exchange Act of 1934 (the "Exchange Act") on behalf of purchasers of Lehman common stock and call options and sellers of put options between June 12, 2007, and September 15, 2008 (the "Class Period").

Each quarter during the Class Period, Lehman engaged in tens of billions of dollars worth of undisclosed Repo 105 transactions for the sole purpose of artificially lowering the Company's publicly reported net leverage ratio, a critical financial metric for investors because it reflected Lehman's ability to absorb losses. To create the appearance of reduced net leverage, Lehman used Repo 105 transactions to temporarily remove assets from its balance sheet at the end of each quarter, and then treated these transactions as "sales" for accounting purposes – even though Lehman was obligated to repurchase these assets just days later (conveniently, immediately after the quarter ended). Defendants disclosed neither Lehman's accounting treatment for the Repo 105 transactions nor the repurchase obligation – making the statements in the offering documents materially false and misleading.

Lehman's financial statements also violated Generally Accepted Accounting Principles ("GAAP"), and the clean audit report and quarterly reviews from Ernst & Young LLP ("E&Y"), Lehman's auditor, were likewise false. While Defendants now contend that Lehman's financial statements technically complied with GAAP, the notion that GAAP freely allows such balance sheet manipulation is absurd. The Repo 105 transactions had no legitimate business purpose and were done exclusively to present a materially misleading picture of Lehman's true financial condition.

Throughout the Class Period, Defendants also misrepresented Lehman's supposed adherence to sound risk management practices. Given the environment during this period – when Bear Stearns collapsed and Lehman's peers booked enormous losses – strong risk management was particularly important to investors. Defendants publicly differentiated Lehman from its competitors based on its supposedly superior risk management practices, to which it "enforce[d] adherence." In truth, however, Lehman's risk limits were routinely breached and disregarded throughout the Class Period as Lehman accumulated an enormous and concentrated volume of highly-risky real estate assets. As a direct result of such undisclosed risk taking, Lehman amassed billions of dollars of illiquid assets that could not be monetized without taking significant losses. This "sticky" inventory of leveraged loans and commercial real estate ultimately required massive writedowns, and contributed to Lehman's liquidity crisis, investors' losses, and ultimate bankruptcy.

Defendants' statements about Lehman's net leverage and risk management practices, as well as their statements about liquidity risk and the value and concentration of its commercial assets, were materially untrue and misled investors. As Anton R. Valukas, the Bankruptcy Court-appointed examiner (the "Examiner"), testified before Congress, "the public did not know there were holes in the reported liquidity pool, nor did it know that Lehman's risk controls were being ignored, or that reported leverage numbers were artificially deflated. Billions of Lehman shares traded on misinformation." ¶2. [1]

With respect to claims brought under the Exchange Act, Plaintiffs have alleged that beginning on June 9, 2008 and ending with Lehman's bankruptcy on September 15, 2008, the truth about Lehman's financial condition was revealed in a series of Company-specific corrective disclosures and the materialization of risks concealed by Defendants' false statements. In their motions, the Insider Defendants and E&Y respond as if this were a trial, attempting to blame

[1] "¶_" refers to paragraphs in the Third Amended Class Action Complaint For Violations Of The Federal Securities Laws ("Complaint"). Dkt. No. 278. This Opposition responds to the motions to dismiss by all defendants. Dkt. Nos. 293, 296, 299.

external market forces as the sole cause of investor losses.[2] If, at trial, Defendants wish to attempt to blame other causes, they may do so. At this stage, however, the Complaint readily alleges the causal connection between Defendants' conduct and the investors' losses.

In short, the Complaint states claims against each 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 untrue statement and omission in the Offering Materials and explains why each statement was materially false and misleading at the time it was made, violating the Securities Act. Separately, the Exchange Act claims raise a strong inference of the Insider Defendants' and E&Y's scienter, and amply allege loss causation to allow this case to proceed to the discovery phase.

## II. STATEMENT OF FACTS

Beginning in 2006 and continuing through the outset of 2007, Lehman's management pursued an undisclosed aggressive growth strategy. ¶72. Lehman's strategy focused on acquiring and holding commercial real estate, leveraged loans and private equity assets – areas that entailed far greater risk and less liquidity than Lehman's traditional lines of business. ¶72. In doing so, Lehman repeatedly ignored its internal risk controls, accumulating an enormous volume of illiquid assets.

By mid-2007, ratings agencies and investors called upon investment banks to reduce their "leverage" (the amount borrowed to acquire assets for investment). ¶152. However, deleveraging by selling real estate assets would have required Lehman to incur substantial losses, negatively impacted Lehman's earnings and led to a loss of market confidence in the valuations

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[2] "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").

Lehman ascribed to its remaining assets. ¶153. Thus, unbeknownst to investors, Defendants utilized Repo 105 transactions to artificially reduce reported net leverage. *Id.*

### A. Lehman's Repo 105 Transactions Misrepresented Net Leverage

During the Class Period, Defendants used sham "Repo 105" transactions, amounting to tens of billions of dollars at the end of each quarter, to artificially reduce the Company's reported net leverage ratio – a key financial metric for evaluating the strength of Lehman's balance sheet and its ability to absorb losses from the deteriorating real estate markets. ¶26. In these transactions, Lehman purported to "sell" as much as $50 billion of assets to third parties at the end of financial reporting periods, thereby removing them from the Company's balance sheet and lowering its net leverage ratio. ¶¶31, 37, 117. The sales were wholly illusory, however, as Lehman had agreed to repurchase these assets only days after the quarter ended, when the assets would be restored to the Company's balance sheet. Through these transactions, Lehman created a false and misleading picture of the Company's financial strength and ability to withstand losses.

As the Examiner specifically found – and numerous senior Lehman executives have acknowledged – the Repo 105 transactions had no legitimate business purpose and lacked economic substance. According to Lehman senior executives, "the only purpose or motive for the [Repo 105] transactions was reduction in balance sheet," "there was no substance to the transactions," and "no business purpose of Lehman's Repo 105 transactions existed other than obtaining balance sheet relief." ¶148. Bart McDade, Lehman's "balance sheet czar," described Repo 105 transactions as another "drug" that Lehman was on to manage its balance sheet. ¶148. Defendant Lowitt, Lehman's Chief Financial Officer ("CFO"), admitted that Repo 105 was a way for Lehman to meet balance sheet targets. ¶¶149, 212. Further demonstrating the lack of any legitimate business purpose for these transactions, Repo 105 transactions were a more expensive way for Lehman to borrow money than ordinary repurchase agreements, because they

required Lehman to pay a higher interest rate. In sum, Repo 105 transactions were done for one reason, and one reason only – to allow the Company to report an artificially-reduced net leverage ratio and to deceive investors into believing that the Company's balance sheet was less risky than it was.

The Repo 105 transactions were indisputably material. Lehman publicly urged investors to consider net leverage because it was purportedly "a more meaningful, comparative ratio." ¶26. Indeed, even incremental adjustments in the ratio were material. Lehman internally acknowledged that movements of as little as 0.1 in the net leverage ratio were material. ¶28. As the market became increasingly concerned about Lehman's ability to withstand losses during the Class Period, Lehman dramatically increased its use of Repo 105 transactions – from approximately $32 billion in 2Q07, to $36 billion in 3Q07, to $39 billion in 4Q07, to $49 billion in 1Q08, and then to over $50 billion in 2Q08. ¶38. Simultaneously, during this period, Lehman publicly reported a materially reduced net leverage ratio, from 15.4x at the end of 2Q07, to 12.1x at the end of 2Q08. ¶38. Using Repo 105 transactions, Lehman reduced its net leverage ratio by 10% to 15% per quarter during the Class Period, and by 1.50x to 1.90x each quarter. ¶38. Given that Lehman defined materiality as a change in net leverage by 0.1, the reduction in net leverage by 1.50 to 1.90 exceeded Lehman's own materiality threshold by fifteen to nineteen times. ¶¶28, 38.

Significantly, despite the magnitude of these transactions, they were never disclosed to investors during the Class Period. Investors never knew that, days after a quarter ended, tens of billions of dollars in assets would reappear on Lehman's balance sheet, increasing net leverage by as much as 15%. In fact, Lehman's Forms 10-Q and 2007 10-K, incorporated into the Offering Materials, falsely stated that securities sold under agreements to repurchase were "treated as collateralized agreements and financings" (i.e., borrowings) – even though Lehman had recorded tens of billions of dollars worth of Repo 105 transactions as "sales." ¶40. As Lehman's Global Financial Controller acknowledged, "if an analyst or a member of the investing public were to read Lehman's Forms 10-Q and 10-K from cover to cover, taking as much time as

she or he needed, 'they would have no transparency into [Lehman's] Repo 105 program.'" ¶148(a).

Lehman's accounting for Repo 105 transactions in its financial statements violated GAAP, which requires that the overall impression created by financial statements be consistent with the business reality of the Company's financial position and operations; that nothing material be left out of the information that may be necessary to ensure the financial report validly represents the underlying events and conditions; and that substance be elevated over form. ¶¶66-67. Lehman's "sale" and repurchase of assets just days thereafter violated GAAP because it served no purpose other than to enable Lehman "to 'reverse engineer' its net leverage ratio for its publicly filed financial statements." ¶148(d). As the Examiner concluded: "[T]he balance sheet manipulation was intentional, for deceptive appearances, had a material impact on Lehman's net leverage ratio, and, because Lehman did not disclose the accounting treatment of these transactions, rendered Lehman's Forms 10-K and 10-Q (financial statements and MD&A [3] deceptive and misleading." ¶147.

### B. Defendants Misrepresented <u>Lehman's Risk Management Practices</u>

From early 2007 through 2008, as the lending environment tightened, Defendants were aware that market analysts who followed investment banks placed increasing importance on sound risk management. Defendants publicly stated that Lehman adhered to strong risk policies, utilized stress tests, and had risk mitigants in place to avoid large losses. Internally, however, Lehman systematically increased or exceeded its risk limits, continuing to invest heavily in and acquire risky real estate and other assets.

Contrary to Lehman's repeated assurances in its U.S. Securities and Exchange Commission ("SEC") filings that "appropriate risk mitigants [are] in place," that Lehman

[3] "MD&A" stands for "Management's Discussion and Analysis of Financial Conditions and Results of Operations," a section in the Forms 10-K and 10-Q.

"considered the impact of transactions on its risk appetite, and that Lehman "monitor[ed] and enforce[d] adherence to [its] risk policies," Lehman's risk limits were routinely violated throughout the Class Period. ¶¶74, 117. For example, unbeknownst to investors, Lehman repeatedly raised and breached its firm-wide risk appetite limit – a supposed "hard" limit meant to keep Lehman from taking on too much market risk, credit risk and event risk. Between December 2006 and December 2007, Lehman raised its risk appetite limit four times, almost doubling this supposedly "hard" limit – from $2.2 billion to $4.0 billion. ¶76. This, in turn, facilitated a dramatic (and undisclosed) expansion of the Company's risk profile between 2006 and 2007. ¶¶75-76.

Lehman also disregarded its risk concentration limits – designed to ensure that the Company did not assume too much risk in a single, undiversified business or area – leaving the Company over-concentrated in leveraged loans and commercial real estate assets, for which Lehman eventually reported massive write-downs. ¶¶243, 246. Lehman also failed to enforce its publicly stated "single transaction limits" – meant to ensure that its investments were properly limited and diversified by business line and by counterparty – which enabled it to commit to a series of high-risk, multi-billion dollar deals. ¶77. Further, by exceeding its balance sheet risk limits, which were purportedly designed to contain overall risk and maintain net leverage within the range required by the ratings agencies, the risky real estate assets on Lehman's balance sheet ballooned. As of the end of 1Q08, Lehman's Fixed Income Division ("FID") exceeded its balance sheet limits by $18 billion, and its Global Real Estate Group ("GREG") exceeded its balance sheet limits by $5.2 billion (even after the limit had doubled to $60.5 billion). ¶78. Additionally, Lehman excluded key leveraged transactions from the calculations of its risk limits, including its $2.3 billion bridge equity position in Archstone which, had it been included, would have caused Lehman to further exceed its existing limits. ¶¶76, 91. Investors knew none of these highly material facts.

Further, even though Lehman represented that it "use[d] stress testing to evaluate risks associated with [its] real estate portfolios," Lehman actually excluded its riskiest principal real

estate investments from its stress testing, including commercial real estate investments, private equity investments, and leveraged loan commitments. ¶¶79-80. By disregarding its risk limits and excluding its riskiest investments from stress tests, Lehman entered into multi-billion dollar commercial real estate deals that would have otherwise violated its risk limits, and became over-concentrated in illiquid real estate investments. These transactions directly affected Lehman's balance sheet and liquidity positions. *See*, *e.g.*, ¶¶76, 77, 80.

Despite its decision to disregard its risk limits, Lehman's Forms 10-Q and 2007 10-K repeatedly emphasized the Company's purported adherence to its risk management policies and the Company's ability to manage risks. ¶¶74-84, 117. Moreover, the Insider Defendants repeatedly stressed in conference calls that Lehman had a "strong risk management culture with regards to the setting of limits," had an "extremely deep risk culture which is embedded through the firm," was "very conservative around risk," "[ran] a business where we could distribute all the risk," had a strong "risk management culture in terms of managing our overall risk appetite," and had "risk management discipline." ¶¶175, 178, 181, 187. Due to these misrepresentations, analysts recommended Lehman securities on the belief that Lehman was superior to its competitors because of its "strong risk management abilities (which is enabling them to grab market share)." ¶¶177, 183.

By continuously increasing its risk limits, excluding significant assets from stress tests, and failing to adhere to even its increased risk limits, Lehman misrepresented the highly material fact that the Company had accumulated risky, illiquid assets for which it ultimately reported significant write-downs during the Class Period.

### C. Defendants Misrepresented Lehman's Liquidity Risk

Lehman also falsely represented the material facts that the Company had a "very strong liquidity position" and that "we maintain a liquidity pool . . . that covers expected cash outflows for twelve months in a stressed liquidity environment." ¶¶87-88. By July 2007, the very start of

the Class Period, Lehman had already internally determined that its liquidity pool was short $400 million to meet commitments looking out one year forward, and defendant Lowitt was "anxious" about Lehman's liquidity position and shared his concerns with O'Meara. ¶¶88, 218(c), (d). In fact, Lehman delayed the closing of the Archstone transaction, a $5.4 billion acquisition of real estate assets, for two months because of liquidity concerns. ¶¶91, 218(e). On July 30, 2007, Lehman's Asset Liability Committee ("ALCO"), which was established by Lowitt, O'Meara and other top officers expressly due to liquidity concerns, exchanged an analysis showing that, contrary to the Company's policy to always have a cash capital surplus of at least $2 billion, Lehman was projecting large deficits of cash capital. ¶218(g). Then, in early August 2007, Lowitt suspended the leveraged loan and commercial real estate business until the end of the third quarter of 2007 as a result of Lehman's liquidity problems. ¶218(h). Despite their knowledge of the liquidity problems, the Insider Defendants continued to promote publicly the Company's robust liquidity position. ¶¶176, 182, 185, 194, 198.

Indeed, just five days before Lehman's bankruptcy, Fuld and Lowitt represented in a conference call that Lehman maintained a very strong liquidity position, despite the fact that Lehman had received $5 billion in collateral calls from JPMorgan, which nearly left Lehman with insufficient capital to fund its trading and other operations. Moreover, at the time Fuld and Lowitt made these remarks, Lehman had improperly included over $10 billion in pledged or encumbered assets in its liquidity pool, including (i) approximately $4 billion of collateralized loan obligations ("CLOs") pledged to JPMorgan; (ii) $2.7 billion in cash and money market funds pledged to JPMorgan; (iii) a $2 billion Citibank cash deposit; (iv) a $500 million Bank of America cash deposit; and (v) a nearly $1 billion collateral deposit with HSBC. ¶¶202-05.

Lehman petitioned for bankruptcy protection just days later, citing "significant liquidity problems." ¶205.

In addition, during the Class Period, Defendants' statements about Lehman's liquidity risks were false and misleading for failing to disclose that Lehman was obligated to repurchase the assets covered by the Repo 105 transactions within days after the end of the quarter. Indeed, Lehman's SEC filings failed to include any discussion of the timing and amounts of the cash flow issues accompanying the repayment of the Repo 105 borrowings. ¶86. Disclosures of these known commitments were necessary to prevent Defendants' statements about Lehman's liquidity risks from being false and misleading.

### D. Defendants Failed To Disclose Lehman's Significant Risk Concentrations

Lehman's Offering Materials were also materially false and misleading for failing to disclose Lehman's significant risk concentrations, as required by GAAP. ¶104. This information was especially important during the Class Period because of market concerns over real estate lending. Among other things, even though Lehman was a leading originator of Alt-A loans – typically loans to borrowers with high credit scores who would otherwise qualify as "prime" but for traits that prevent the loans from qualifying as "prime" (such as the lack of documentation verifying income) – Lehman's Offering Materials did not even include the term "Alt-A" until Lehman filed its 1Q08 Form 10-Q on April 9, 2008. ¶106. When Lehman finally began to identify Alt-A holdings on its balance sheet in its 2Q08 Form 10-Q, Lehman misleadingly "consolidated" its Alt-A holdings with prime holdings into a single category labeled "Alt-A/Prime" – even though less than 7% of that category actually included "prime" loans, and more than 93% consisted of Alt-A loans. ¶106. Lehman ultimately reported $2.4 billion in residential asset write-downs in 2Q08, and $7 billion in commercial and residential asset write-downs in 3Q08, much of which related to Alt-A loans. ¶¶243, 246.

Likewise, Lehman failed to disclose its heavy concentration in leveraged loans. These loans were almost double Lehman's reported limit for such exposures. ¶108. When the market significantly slowed by the second quarter of 2007, Lehman had approximately $36 billion of undisclosed, contingent leveraged loan commitments on its books. ¶108. Similarly, Defendants failed to disclose Lehman's heavy concentration in commercial real estate in California and other troubled markets. ¶107. Due to Lehman's over-concentration in commercial real estate assets, the Company ultimately reported write-downs on these positions of approximately $4 billion from 1Q08 to 3Q08. ¶107.

### E. Defendants Misrepresented That Lehman's Commercial Real Estate Assets Were Marked To Fair Value

Lehman's Offering Materials were also materially false and misleading for misrepresenting that Lehman marked its commercial real estate assets to "fair value" – *i.e.*, the market price at which a buyer would pay to acquire the asset – because in reality Lehman failed to consider market-based information for certain important assets. ¶¶89-90. For example, in valuing Archstone, a publicly-traded Real Estate Investment Trust ("REIT"), Lehman employed the same optimistic assumptions it used when it first committed to participate in the Archstone acquisition in May 2007 and disregarded current market information, including available data from comparable publicly traded REITS, which had materially declined in value. ¶93. By failing to consider then-current market information, Lehman overstated the value of Archstone by $200 million to $450 million as of the end of 1Q08, and by $200 to $500 million as of the end of 2Q08. ¶94. Had Lehman properly valued Archstone at fair value, its net income for IQ08 would have been reduced by 40%. *Id.*

Likewise, Lehman did not mark its Principal Transaction Group ("PTG") assets – highly-leveraged debt or equity investments in real estate developments – to fair value. ¶¶97-99.

Although real estate prices had declined materially by mid-2007, Lehman assumed that the collateral had actually appreciated. ¶97. Lehman also began implementing a new valuation method using a discount rate that did not reflect the yield an investor would require to purchase the property. ¶98. Thus, as various employees responsible for determining PTG valuations have confirmed to the Examiner, the PTG portfolio was not marked to prices at which the assets could be sold. ¶98.

### F. Lehman's Massive Write-Downs, Liquidity Crisis And Bankruptcy

With respect to the claims brought under the Exchange Act, Plaintiffs have alleged that on June 9, 2008, a series of disclosures and events began to reveal the risks that had been concealed by Defendants' misrepresentations. ¶¶242-46. These disclosures of Lehman's massive write-downs and liquidity problems revealed the truth about Lehman's financial condition and represented the materialization of the concealed risks from Lehman's Repo 105 transactions, its disregard for its risk limits, and its undisclosed risk concentrations, which masked the Company's true net leverage and liquidity condition. Ultimately, on September 15, 2008, Lehman filed for bankruptcy protection – the largest in United States history. ¶247.

## III. THE COMPLAINT STATES CLAIMS UNDER THE SECURITIES ACT

### A. Legal Standard

The Securities Act "was designed to provide investors with full disclosure of material information concerning public offerings." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S. Ct. 1375, 1382 (1976). Section 11 of the Securities Act imposes a "stringent standard of liability" and "places a relatively minimal burden on a plaintiff." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82, 103 S. Ct. 683, 687 (1983). The plaintiff need only "allege that he purchased the security and that the registration statement contains false or misleading

statements concerning a material fact." *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 201 (E.D.N.Y. 2000).[4]

Securities Act claims are governed by the notice pleading standard set forth in Fed. R. Civ. P. 8(a). *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 358 (2d Cir. 2010); *In re NovaGold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 289, 90. Rule 8(a)(2) merely requires "a short and plain statement of the claim showing that the pleader is entitled to relief," and "do[es] not require heightened fact pleading of specifics, but only enough facts to state a claim to relief that is plausible on its face." *Arista Records, LLC v. Doe 3*, 604 F.3d 110, 119-20 (2d Cir. 2010) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555, 570, 127 S. Ct. 1955, 1965, 1974 (2007)). "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." *Arista*, 604 F.3d at 120. 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." *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 511, 122 S. Ct. 992, 997 (2002).

## B. The Offering Materials Contained Untrue Statements Of Material Facts

Lehman raised over $31 billion through the Offerings identified in Appendices A and B to the Complaint, using Offering Materials that incorporated untrue statements and omissions of material fact in Lehman's Forms 10-K, 10-Q and 8-K.

### 1. The Offering Materials Materially Understated Lehman's Reported Net Leverage Ratio

Lehman engaged in billions of dollars of Repo 105 transactions at the end of each quarter in order to artificially reduce its reported net leverage. These transactions lacked economic substance. While Lehman treated the transactions as "sales," it had a simultaneous obligation to

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[4] Throughout, all internal quotations and citations have been omitted unless otherwise indicated.

repurchase the assets just days after the quarter closed. Lehman did not have any economic reason for engaging in these transactions, which were in fact a more expensive form of funding than ordinary repos (¶36), and numerous Lehman employees and insiders admitted to the Examiner that "the only purpose or motive for the [Repo 105] transactions was reduction in balance sheet." ¶148. Indeed, defendant/CFO Lowitt has acknowledged that "Lehman used the transactions to meet balance sheet targets." ¶212. These billions of dollars in undisclosed Repo 105 transactions created a materially misleading picture of Lehman's financial condition in the Offering Materials.

**a) <u>The Repo 105 Transactions Violated GAAP</u>**

Defendants' contention that Lehman's financial statements did not violate GAAP is nonsense. Under GAAP, the overall impression created by financial statements must be consistent with the business realities of the company's financial position and operations, and "nothing material" should be "left out of the information that may be necessary to [ensure] that [the report] validly represents the underlying events and conditions." ¶66 (citing FASCON 1, ¶¶9, 16, 13-34; FASCON 5, ¶5; FASCON 2, ¶¶79-80). As the Second Circuit and numerous courts both in and outside this District have explicitly held, the failure to do so violates GAAP. *See, e.g., United States v. Ebbers*, 458 F.3d 110, 126 (2d Cir. 2006) ("GAAP itself recognizes that technical compliance with particular GAAP rules may lead to misleading financial statements, and imposes an overall requirement that the statements as a whole accurately reflect the financial status of the company."); *In re Global Crossing*, *Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 339 (S.D.N.Y. 2004) (even if accounting practices were in technical compliance with individual GAAP provisions, defendants are not insulated from liability because they are required to provide whatever additional information would be necessary to make their financial reports fair and accurate); *United States v. Sarno*, 73 F.3d 1470, 1484 (9th Cir. 1995) (upholding criminal conviction where elaborate measures were used to satisfy GAAP's technical requirements but nonetheless violated GAAP because form was elevated over substance).

Accordingly, regardless of Defendants' arguments of Lehman's purported technical compliance with FAS 140, the understatement of Lehman's net leverage ratio through the use of sham Repo 105 transactions violated the entire, overarching purpose of GAAP to fairly present a company's financial position in all material respects.

Lehman's "sale" of Repo 105 assets only to repurchase them several days later had no purpose other than to reduce its net leverage ratio for public consumption. This practice distorted Lehman's true financial condition. GAAP – and the federal securities laws – do not sanction the use of such sham transactions without economic substance. *See*, *e.g.*, *In re AOL Time Warner*, *Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 215 (S.D.N.Y. 2004) (upholding securities allegations that agreements for payments between AOL and Gateway had no substance other than swapping checks); *In re Qwest Commc'ns Int'l*, *Inc. Sec. Litig.*, 396 F. Supp. 2d 1178, 1207 (D. Colo. 2004) (use of swap transactions that had no economic substance to inflate revenue violated securities laws); *SEC v. Yuen*, 2006 WL 1390828, at *23 (C.D. Cal. Mar. 16, 2006) (creation of an obligation solely for the purpose of providing funds to "purchase" a corresponding amount of advertising were without economic substance in violation of securities laws). In sum, "under both GAAP and the securities laws, [defendants] are required to provide whatever additional information would be necessary to make the statements in their financial reports fair and accurate, and not misleading." *Global Crossing*, 322 F. Supp. 2d at 340. Disclosures of the Repo 105 transactions was unquestionably required to fairly present Lehman's financial condition.[5]

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[5] E&Y argues that there was no GAAP violation because FASB did not require the specific disclosure of repo transactions as sales until June 2009, after the end of the Class Period. E&Y's Memorandum of Law ("E&Y Br.") at 8. This is irrelevant. Regardless of the exact date on which FASB may have addressed a loophole in its own rules, the Repo 105 transactions fundamentally misled investors because their sole purpose was to artificially reduce net leverage during the Class Period and rendered the overall financial presentation inherently misleading. *See Global Crossing*, 322 F. Supp. 2d at 338 (rejecting argument that accountant cannot be held liable for accounting practices only later declared unacceptable, as the accounting practice was misleading to investors).

Defendants' contention that the Repo 105 transactions complied with FAS 140 is also a red herring as technical compliance does not satisfy GAAP where, as here, the Repo 105 transactions were complete shams.[6] Even if technical compliance were relevant, the Repo 105 transactions still failed the test because to qualify as a sale under FAS 140, the company transferring an asset must divest itself of the asset by relinquishing all control over the asset. ¶62. In contrast to this requirement, Lehman had an obligation to repurchase the assets just days after the close of the reporting period. ¶¶62, 64. In fact, Lehman could not even obtain a true sale opinion for the Repo 105 transactions from any law firm in the United States. ¶65.

Moreover, Lehman's recording of a "right" to repurchase securities as a derivative forward contract – an asset, instead of a liability – on its balance sheet was counter to the true nature of the obligation Lehman assumed in the repurchase transaction. Jt. Br. at 6-7.[7] Lehman did not merely have a "right" to repurchase the sold securities in the future at a discount. Instead, Lehman was required to buy back the securities at the end of the term and pay excess interest (*i.e.*, more than the interest charged for ordinary repurchase agreements) in order to engage in Repo 105 transactions. *See* E.R. at 878, n.3376.[8]

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[6] E&Y's contention that form can be elevated over substance because FAS 140 is a "rules-based" standard is groundless. E&Y Br. at 17. Nothing in FAS 140, or any accounting literature, says that technical compliance with that provision can override the core GAAP concept that form should not be elevated over substance. Moreover, the "authority" on which E&Y relies – a cursory reference about FAS 140 in an SEC "study" – does not support this position.

[7] "Jt. Br." refers to Defendants' Joint Memorandum of Law. Dkt. No. 294.

[8] At best, Defendants raise fact-specific issues concerning a specialized area of financial accounting that will be the subject of expert testimony and is inappropriate for consideration at this stage of the litigation. *See SEC v. Caserta*, 75 F. Supp. 2d 79, 90 (E.D.N.Y. 1999) (whether Plaintiffs have stated a claim for GAAP violation is a fact-specific question that cannot be resolved on a motion to dismiss.); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir. 2001) (accounting issues involve a battle of experts and cannot be resolved on a motion to dismiss); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 656-57 (S.D.N.Y. 2007) (plaintiffs' assertions that certain accounting practices were not generally accepted must be taken as true at the motion to dismiss stage); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 494 n.30 (S.D.N.Y. 2005) (the extent to which financial statements were GAAP compliant is an issue of fact); *Nappier v. PricewaterhouseCoopers, LLP*, 227 F. Supp. 2d 263, 276 (D.N.J. 2002) ("the determination of 'what accounting practices comprise GAAP is a question of fact best addressed through expert testimony and thus inappropriate for resolution on a motion to dismiss.'"); *In re RAIT Fin. Trust Sec. Litig.*, 2008 WL 5378164, at *7 (E.D. Pa. Dec. 22, 2008) ("[I]t is a factual question whether [a

**b) The Offering Documents Did Not Disclose Lehman's Repo 105 Transactions**

Defendants' contention that Lehman's use of Repo 105 transactions was disclosed can be summarily dismissed. As Martin Kelly, Lehman's Global Financial Controller, acknowledged: "[I]f an analyst or a member of the investing public were to read Lehman's Forms 10-Q and 10-K from cover to cover, taking as much time as she or he needed, 'they would have no transparency into [Lehman's] Repo 105 program.'" ¶148(a).

Lehman's statements in its 2006 10-K and 1Q07 10-Q that the overall size of its balance sheet "will fluctuate from time to time" and "may be higher than the year-end or quarter-end amounts" (Jt. Br. at 6) say nothing about Lehman's use of tens of billions in Repo 105 transactions, and do not correct Defendants' specific misrepresentation in the Offering Materials that Lehman treated all repurchase transactions as financings. ¶40(a).[9]

Similarly, the mere inclusion of the fair market value of the right to repurchase the Repo 105 assets in Lehman's derivative inventory did not inform investors that Lehman had engaged in Repo 105 transactions. As acknowledged by Lehman's own, high-ranking employees, no one reading these financial statements – or Lehman's 10-Qs and 2007 10-K in their entirety – would have been able to discern that Repo 105 transactions had occurred. Moreover, Lehman affirmatively represented in its SEC filings that all of its repurchase agreements were treated as "financings," or borrowings, which required the recording of a liability – not an asset like a derivative forward contract. ¶40(a). *See Morgan Stanley*, 592 F.3d at 366 (2d Cir. 2010) ("[t]he literal truth of an isolated statement is insufficient" for compliance with securities laws; "'defendants' representations, taken together and in context'" must be examined.).

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company's] accounting practices were consistent with GAAP, and thus, we cannot determine this issue on a motion to dismiss"); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1421 (3d Cir. 1997) (whether a defendant's accounting practices were consistent with GAAP is a question of fact that cannot be addressed on a motion to dismiss).

[9] These "asset fluctuation warnings" were not even contained in any of the Offering Materials as the 2Q07 and 3Q07 10-Q did not incorporate the 2006 10-K by reference, and the statements do not appear in later filings in the Class Period.

Finally, E&Y's contention that Lehman's 2007 10-K adequately disclosed the Repo 105 transactions by stating that Lehman "recognize[s] transfers of assets as sales" under FAS 140 fares no better. E&Y Br. at 17-18. The section E&Y refers to in the 10-K, on its face, relates only to "securitization activities" – not Repo 105 transactions. *See* 2007 10-K at 96. Moreover, even if repurchases like Repo 105 could somehow be characterized as "securitization activities" (they cannot), the disclosure was insufficient because nowhere did Lehman advise that it was using Repo 105 transactions to manipulate its balance sheet. Indeed, Lehman specifically represented that it accounted for repo transactions as financings, not sales. *See*, *e.g.*, *In re Flag Telecom Holdings*, *Ltd. Sec. Litig.*, 352 F. Supp. 2d 429, 465 (S.D.N.Y. 2005) (disclosure of relevant accounting policy inadequate where booking swaps at "fair value" rather than "book value" allowed the company to exchange useless capacity to generate revenues).[10]

### c) <u>The Repo 105 Transactions Were Material</u>

The very fact that Lehman engaged in sham Repo 105 transactions – which were more expensive than ordinary repos – for the sole purpose of reducing its reported net leverage alone establishes their materiality. Lehman emphasized net leverage as "a more meaningful, comparative ratio" than total leverage. ¶26. Moreover, as the Examiner found, reported net leverage was of "critical importance" to Lehman. E.R. at 5. Defendant/CEO Fuld acknowledged that he personally focused on this metric because of its importance to ratings agencies. *Id.* Net leverage was so important that Lehman tied the very definition of "materiality" to changes in the ratio and considered amounts that affected net leverage by "one-tenth" of a point to be material. ¶28. Lehman's Repo 105 transactions during the Class Period did not simply reduce net leverage by fractions of a point, but rather, they moved the ratio by entire points – changes which Lehman

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[10] For this very reason, Defendants' purported disclosures regarding the success of Lehman's deleveraging activities were also materially false and misleading, because they failed to disclose that Repo 105 transactions were being utilized to manage the balance sheet, thereby masking the true financial health of the Company and its ability, or in this instance, inability, to address a continued downturn in the real estate and credit markets.

expressly pointed out to investors to show how the Company's financial health and competitive advantage was improving throughout the Class Period. ¶38.

Unbeknownst to the investing public, the 10% to 15% reduction in Lehman's reported net leverage ratio attributable to Lehman's Repo 105 transactions exceeded the Company's own materially threshold by ***15 to 19 times*** when compared to what Lehman's actual net leverage ratios would have been without use of the Repo 105 transactions. *Id.* These differences are plainly material. *See*, *e.g.*, *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) ("[A] complaint may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."); *SEC v. Biovail Corp.*, 2009 WL 361997, at *1 (S.D.N.Y. Feb. 10, 2009) (Kaplan, J.) ("[defendant's] claim that his alleged misstatements were immaterial as a matter of law is similarly unavailing. Materiality is a mixed question of fact and law, and here the Court cannot say that [Defendant's] alleged misstatements were 'so obviously unimportant . . . that reasonable minds could not differ on the question of their importance.'"). [11]

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[11] Defendants' assertion that the Repo 105 transactions were not material because they were at or less than 6% of total liabilities is unavailing. To the extent that the magnitude even needs to be measured, the financial metric in question "should be compared to like items on the corporate financial statement." *See Ganino*, 228 F. 3d at 165. Defendants' reliance on *In re Turkcell Iletisim Hizmetler*, *A.S. Sec. Litig.*, 202 F. Supp. 2d 8, 12 (S.D.N.Y. 2001), for the proposition that a 9% drop in operating income was not material is misplaced because *Turkcell* did not consider whether such a drop was material, but rather whether the drop was such an "extreme departure from the range of results" anticipated that was required to be disclosed prior to the end of the quarter. Here, Lehman is purportedly disclosing end of quarter results. Moreover, The SEC emphasizes that materiality cannot be reduced to a numerical formula, and that both quantitative and qualitative factors must be considered. *See* SEC's Staff Accounting Bulletin 99 ("SAB 99"), available at http://www.sec.gov/interps/account/sab99.htm; *see also Ganino*, 228 F.3d at 163 (applying SAB 99 and holding that there is no bright line test for materiality); *Akerman v. Arotech*, *Corp.*, 2009 WL 840380, at *8-9 (E.D.N.Y. Mar. 30, 2009) (denying motion to dismiss, noting that "[i]n [SAB 99], the SEC urges that both quantitative and qualitative factors be considered in assessing a statement's or omission's materiality, and in the Circuit's view, courts [should] consider the factors it sets forth in determining whether [a] misstatement significantly altered the 'total mix' of information available to investors").

**d) Disclosure Of The Repo**
**105 Transactions Was Required**

Irrespective of whether Lehman's financial statements violated GAAP, Defendants were required to disclose the Repo 105 transactions. It is black-letter law that "[u]pon choosing to speak, one must speak truthfully about material issues." *Caiola v. Citibank*, *N.A.*, 295 F.3d 312, 331 (2d Cir. 2002); *In re WorldCom Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 428 (S.D.N.Y. 2003) (same); *see also Hall v. The Children's Place Retail Stores*, *Inc.*, 580 F. Supp. 2d 212, 226 (S.D.N.Y. 2008) (Once defendants choose to speak, they undertake a duty "to speak truthfully and to make such additional disclosures as . . . necessary to avoid rendering the statements misleading."). Accordingly, in discussing Lehman's net leverage ratio and purported improvements in the ratio, Defendants were required to disclose the impact of the Repo 105 transactions on net leverage in order to make their statements not false or misleading. That the Repo 105 transactions amounted to tens of billions of dollars, were made at quarter-ends, were more expensive than ordinary repos, benefited Lehman's reported net leverage, and required Lehman to repurchase the assets just days after their initial transfer, were all material facts. Indeed, Fitch and S&P analysts told the Examiner that the Repo 105 transactions would have been "material" or "relevant" to their assessment of the Company, and a Moody's analyst said he would have wanted to know if Lehman reduced its net balance sheet by $20 billion, much less $50 billion. *See* E.R. at 905-909. As such, the Complaint states a claim under Section 11. *See WorldCom*, 294 F. Supp. 2d at 407-08 (where "'material facts have been omitted' from a registration statement or 'presented in such a way as to obscure or distort their significance,'" a Section 11 claim is adequately pled).

Item 303 of SEC Regulation S-K, 17 C.F.R. § 229.303, also gives rise to a separate duty to disclose. Item 303 requires a registrant to discuss, in its MD&A section, all relevant information necessary to an understanding of the registrant's financial condition and results of operations, including any commitments, trends, or uncertainties that would cause reported financial information to not be indicative of its future financial condition or future operating

results. By omitting any mention of Repo 105, the Offering Materials violated Item 303's disclosure requirements.

Defendants' contention that a plaintiff must allege sufficient facts to show that a trend existed at the time of the offering, that Defendants had actual knowledge of that trend, and that the trend was material in order to state a violation of Item 303, is incorrect. Jt. Br. at 10. Although certain provisions of Item 303 require the identification of "known trends," other provisions simply require the registrant to disclose information "necessary to an understanding of its financial condition, changes in financial condition and results of operations" and "material commitments for capital expenditures." *See* 17 C.F.R. §§ 229.303(a) & 229.303(a)(2)(i). Disclosure of Lehman's massive Repo 105 transactions at quarter-ends was necessary to an understanding of the Company's true financial condition. Not only did the Repo 105 transactions artificially reduce Lehman's net leverage ratio, but the investing public was unaware that the Company was required to spend tens of billions of dollars to buy back the assets it had purportedly "sold" in the Repo 105 transactions. By failing to make these disclosures, Defendants violated Item 303 and are liable under the Securities Act. *See Panther Partners*, *Inc. v. Ikanos Commc'ns*, *Inc.*, 538 F. Supp. 2d 662, 669-70 (S.D.N.Y. 2008) ("Failure to make the requisite disclosures under Regulation S-K will generally produce liability under the Securities Act"); *J&R Mktg.*, *SEP v. General Motors Corp.*, 549 F.3d 384, 391 (6th Cir. 2008) (noting that allegations that undisclosed information had an effect on the company's current, reported financial condition in contravention of Item 303's requirements would suffice for violation of Securities Act).[12]

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[12] The pleading of "known trends" pursuant to Item 303 under the Securities Act does not convert the pleading standard from Rule 8 to Rule 9(b). *In re NovaGold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 295 (S.D.N.Y. 2009), is inapposite because plaintiffs challenged forward-looking statements that invoked the PSLRA's safe harbor provision, pursuant to which the Court found that plaintiffs had failed to plead defendants' actual knowledge of the falsity of those forward-looking statements. In *Panther Partners*, *Inc. v. Ikanos Commc'ns*, *Inc.*, 538 F. Supp. 2d at 668-674, the district court – as well as the Second Circuit later in the same case – ultimately applied Rule 8 notice pleading to the Securities Act allegations. *Id.* at 671 (considering whether plaintiffs met the pleading requirements of *Twombly*, 550 U.S. at 572, 127 S. Ct. at 1975 – the Rule 8(a)(2) standard); *Panther Partners Inc. v. Ikanos*, 347 Fed. Appx. 617, 620 (2d

### e) E&Y's Statements About GAAP And GAAS Compliance Are Actionable

E&Y's argument that Plaintiffs must establish that the false and misleading statements in E&Y's audit opinion were both objectively and subjectively false is incorrect and contrary to Section 11. The Securities Act imposes strict liability for misstatements appearing in the auditor's expertised portion, but provides a due diligence defense if the expert can ***prove*** that in the exercise of reasonable care, the expert could not have determined that the statements were false. 15 U.S.C. § 77k(b)(3) (2004) (due diligence defense available to defendants "who shall sustain the burden of proof" that they conducted a reasonable investigation).[13] Indeed, the role of every auditor is to provide an opinion. If subjective falsity were required to plead a Section 11 claim against an auditor every time an audit opinion is at issue, the negligence standard under Section 11 would be converted to require a heightened state of mind – thereby eviscerating the purpose of Section 11 to hold auditors strictly liable for materially false or misleading audit reports.[14]

By alleging that Lehman's financial statements violated GAAP and that E&Y failed to conduct its audit in accordance with GAAS, the Complaint alleges that E&Y's statements were materially false and misleading. Nothing more is required to plead a *prima facie* case under the Securities Act against an auditor. The burden now shifts to E&Y to "prove" that it exercised due diligence in connection with its expertised portion of the Offering Materials. *In re*

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Cir. 2009) (non-published) (applying the *Twombly* standard in assessing the adequacy of plaintiffs' claims). *See also Oxford Asset Mgmt., Ltd. v. Jaharis*, 297 F.3d 1182, 1191 (11th Cir. 2002) ("We interpret [Item 303] as establishing a negligence standard."). In any event, even if Rule 9(b) pleading applies, Plaintiffs have met the requirement by pleading with particularity the circumstances of the misconduct.

[13] *See also King v. Livent, Inc.*, 161 Fed. Appx. 116, 117-118 (2d Cir. 2005) (same); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir. 1973) (same); *Turkcell*, 202 F. Supp. 2d at 12 ("Section 11 does provide a due diligence defense . . . but the burden of proof for the defense is on the defendants.")

[14] While E&Y points out that Rule 436 exempts quarterly reviews from Section 11 liability, the fact remains that E&Y is liable under Section 11 for false and misleading statements in its audit report for Lehman's 2007 financial statements, and is also liable under Section 10(b) of the Securities Exchange Act for its false statements in that report and each quarterly review.

*WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 492 (S.D.N.Y. 2005) (requiring auditor to prove that they conducted a reasonable investigation to successfully invoke due diligence defense). Here, not only is it apparent that E&Y cannot establish a due diligence defense as a matter of law on the face of the pleading, E&Y will have tremendous difficulty proving its defense at trial.[15]

The Complaint alleges that even before E&Y was specifically told by a whistleblower, Matthew Lee, who had been in charge of Lehman's Global Balance Sheet and Legal Entity Accounting, about Lehman's removal of $50 billion of inventory off its balance sheet at quarter-end through Repo 105 transactions and their return to the balance sheet about a week later (¶230), E&Y was aware of Lehman's large transactions at quarter-ends through its receipt of the "Netting Grid," a document that identified the mechanisms Lehman used to manage its balance sheet, including Repo 105. ¶227. The presence of large transactions at the end of a financial reporting period should have been a red flag to E&Y, requiring additional consideration under GAAS. *Refco*, 503 F. Supp. 2d at 658 ("large transactions near the end of financial reporting periods can be a significant red flag"); *In re Winstar Commc'ns*, 2006 WL 473885, at *4, *11 (S.D.N.Y. Feb. 27, 2006) (significant end-of-quarter transactions constitute red flags that support allegations of defendants' recklessness). At a minimum, E&Y should have conducted additional inquiries or tests, pursuant to GAAS, to ensure that these transactions were not being used to manipulate Lehman's balance sheet.

Moreover, after E&Y was specifically informed by the whistleblower of these transactions, rather than investigate further or inform the Audit Committee – as required by GAAS and instructed – E&Y did neither. ¶231. Instead, E&Y allowed Lehman to issue its 2Q08 Form 10-Q on July 10, 2008, in which E&Y represented that Lehman's 2Q08 financial results complies with GAAP. ¶232. Had E&Y conducted the investigation required by GAAS,

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[15] *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268, at *11 (S.D.N.Y. 2005) ("A defendant's assertion of the due diligence defense requires an exquisitely fact intensive inquiry into all of the circumstances surrounding the facts upon which the Section 11 claim is premised.").

it could have found that numerous Lehman employees understood that the "only purpose or motive for the [Repo 105] transactions was reduction in balance sheet" and that "there was no substance to these transactions." *See* ¶¶148(a)-(h). *See Lincoln Sav. and Loan Ass'n v. Wall*, 743 F. Supp. 901, 913 n.17 (D.D.C. 1990) (accountants must be particularly skeptical where a transaction has little or no economic substance, because the goals of accounting is to measure, record and communicate economic reality). Based upon these facts, it is difficult to fathom how E&Y will prove its due diligence defense at trial, much less on the face of the pleadings pursuant to a Rule 12(b)(6) motion.[16]

### 2. The Offering Materials Misrepresented Lehman's Risk Management Practices

As set forth above, in its SEC filings Lehman repeatedly represented that it adhered to its risk management policies when, in fact, the opposite was true. Significantly, in their motions, Defendants do not challenge the falsity of their statements about risk management. Rather, they argue that Plaintiffs' risk management allegations are inactionable because the risks undertaken were a matter of business judgment; Lehman had warned that the effectiveness of its risk management could not be assured; and the statements constitute inactionable puffery. All of these contentions fail.

First, while Defendants contend that the Complaint challenges Defendants' business judgment, this case is about the indisputably false statements Defendants made about their risk management systems and stress tests. As the Supreme Court held in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476, 97 S. Ct. 1292, 1295, 1302 (1977), where the conduct involves ***misstatements*** related to mismanagement – and not mismanagement alone – the claims are

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[16] *Fait v. Regions Fin. Corp.*, 2010 WL 1883487 (S.D.N.Y. May 10, 2010) is easily distinguished. Whereas accounting judgment as to the adequacy of loan loss reserves was at issue in *Fait*, here, Plaintiffs have alleged that Lehman falsely stated that all of its repurchase agreements are treated as financings, thereby concealing the fact that billions of dollars of repurchase agreements were, in actuality, treated as sales. ¶40(a). No amount of accounting judgment or subjective determination by the auditor is necessary to ascertain the falsity of this statement.

actionable under the federal securities laws. *See id.* at 465-74. "The 'mere fact that the conduct . . . arguably constitute[s] mismanagement will not preclude a claim . . . 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.'" *Freudenberg v. E*Trade Fin. Corp.*, 2010 WL 1904314, at *19 (S.D.N.Y. May 11, 2010) (citing *In re Donna Karan Int'l Sec. Litig.*, 1998 WL 637547, at *10 (E.D.N.Y. Aug. 14, 1998)); *see also In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 926 (9th Cir. 1993) ("omission[s] or misrepresentation[s] of existing fact . . . cannot be dismissed as a mere matter of internal mismanagement"). The Complaint alleges that Defendants' statements concerning the Company's risk management were untrue and omitted material facts. These allegations are actionable under the securities laws. *See Cornwell v. Credit Suisse Group*, 666 F. Supp. 2d 381, 391 (S.D.N.Y. 2009) (finding allegations about risk management actionable where defendants made misrepresentations about those practices.)

Second, Defendants' contention that they are immune from liability because the Offering Materials said that "the effectiveness of our approach to managing risks can never be completely assured" (Jt. Br. at 16), is simply wrong. Plaintiffs have alleged that Defendants did not follow their stated "approach to managing risk" – namely, to "monitor and enforce adherence to risk policies." Consequently, this supposed warning did not adequately warn investors that Lehman was already disregarding its policies, risk limits and excluding key assets from stress tests in loading its (expanded) balance sheet with concentrated holdings of commercial real estate assets, Alt-A loans, and leveraged loans. Moreover, this blanket "no assurance" warning is mere boilerplate and thus inadequate. *See Slayton v. Am. Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010) ("defendants must demonstrate that their cautionary language was not boilerplate and conveyed substantive information"). In addition, Defendants' invocation of the "bespeaks caution doctrine" is misplaced. That defense is narrow and only applies to forward-looking

statements.[17] It does not apply here, where Plaintiffs allege that Defendants' statements of historical and then-existing fact were false and misleading.[18] In fact, "no degree of cautionary language will protect material misrepresentations or omissions where defendants knew their statements were false when made." *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 231 (S.D.N.Y. 1999).[19]

Defendants also wrongly contend that this risk was adequately disclosed by Defendant Callan's passing remark during a conference call that Lehman had more difficulty hedging commercial real estate assets than residential assets. Jt. Br. at 16 n.40. This remark clearly did not warn investors that Lehman had not adhered to its risk limits or controls. *See*, *e.g.*, *P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d at 97 (cautionary language must warn of the specific contingency). In addition, the transcript of the conference call was not contained in any of the Forms 10-Q or 10-K incorporated into the Offering Materials, and thus, cannot immunize

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[17] *See In re Flag Telecom Holdings*, *Ltd. Sec. Litig.*, 618 F. Supp. 2d 311, 322 (S.D.N.Y. 2009) (cautionary language must be specific, prominent and must directly address the specific risk that plaintiffs' claim was not disclosed, especially considering that most, if not all securities offerings contain cautionary language); *Credit Suisse First Boston Corp. v. ARM Fin. Group*, *Inc.*, 2001 WL 300733, at *8 (S.D.N.Y. Mar. 28, 2001) (defendants are not sheltered from liability if they "fail to disclose hard facts critical to appreciating the magnitude of the risks described").

[18] *See also P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 96-7 (2d Cir. 2004) ("By its terms, the 'bespeaks caution' doctrine . . . is directed only to forward-looking statements."); *In re Complete Mgmt.*, *Inc.*, 153 F. Supp. 2d 314, 340 (S.D.N.Y. 2001) (bespeaks caution doctrine applies "to forward-looking statements *only*, and not to material omissions or misstatements of historical fact") (emphasis in original); *In re Globalstar Sec. Litig.*, 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").

[19] Defendants' contention that investors supposedly understood that Lehman could exceed risk limits if they chose to entirely misses the point. First, what investors purportedly understood is a question of fact. Second, Defendants represented that Lehman enforced "adherence to [its] risk policies." ¶¶70, 74. That statement is false, and contradicts any argument that investors knew Lehman was routinely violating its most important risk practices. *See In re Dynex Capital*, *Inc. Sec. Litig.*, 2009 WL 3380621, at *8 (S.D.N.Y. Oct. 19, 2009) ("At some point, statements by a defendant that it "generally" adheres to a particular policy become misleading when in fact there is no such policy or the policy is something else altogether . . . . [T]he SAC sufficiently alleges that the Underwriting Statements are misleading to the extent that they claim that some standards pertaining to borrower documentation or creditworthiness were followed when in fact such requirements were regularly or routinely disregarded or were based upon falsified loan documentation.").

Defendants for misrepresenting Lehman's risk management practices in those documents. *See In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1454 n.3 (N.D. Cal. 1996) (cautionary statements must appear within the four corners of the same document); *In re Flag Telecom*, 618 F. Supp. 2d at 324 (investors need not cobble together information to uncover material information). Further, defendant Callan undermined any effect of this reference by repeatedly stressing in the same conference call Lehman's "continued diligence around risk management" and its "risk management discipline." ¶187.

Third, the risk management statements are hardly immaterial puffery. Indeed, the fact that Lehman understood their importance to investors is evidenced by the fact that it repeatedly discussed these practices in its SEC filings and conference calls. "By addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully." *In re CIT Group Inc. Sec. Litig.*, 2010 WL 2365846, at *3 (S.D.N.Y. June 10, 2010); *Freudenberg*, 2010 WL 1904314, at *11 (finding the statement "[w]e also maintained strict discipline with respect to risk mitigation" was actionable).[20]

Finally, Lehman's statement that it "monitor[ed] daily trading net revenues compared to reported historical simulation VaR" was materially false and misleading because Lehman failed to disclose that its GREG, High Yield and FID businesses repeatedly breached VaR limits on an almost daily basis.[21] Lehman also breached its firm-wide VaR limits 44 separate times during the Class Period. ¶83. This misrepresentation was not cured by Defendants' disclosure of an

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[20] *See also In re Ambac Fin. Group, Inc. Sec. Litig.*, 2010 WL 727227, at *24 (S.D.N.Y. Feb. 22, 2010) (misstatements that the company's underwriting standards were "rigorous" and "conservative" were not immaterial puffery because they conveyed something concrete about its financial situation); *Freudenberg*, 2010 WL 1904314, at *16 (rejecting defendants' argument that misstatements concerning risk management were "mere puffery"); *Wash. Mutual*, 2009 WL 3517630, at *11, *14 (finding statements about WaMu's risk management, such as "[w]e continue to proactively manage our credit risk," to be actionable); *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1072-73 (C.D. Cal. 2008) (same).

[21] VaR is a statistical measure of the potential loss in the fair value of a portfolio due to adverse movements in underlying risk factors. *See* 2007 10-K at 70 (Chepiga Decl. Ex. 8).

increase in its average historical simulation VaR. Jt. Br. at 17. In fact, immediately following its statement that Lehman "monitor[ed] daily trading net revenues compared to reported historical simulation VaR," Lehman falsely claimed that, for year-end 2007, there were only "four days or 1.6% of days in the [twelve month] period . . . when our daily net trading loss exceeded our historical simulation VaR as measured at the close of the previous business day" (2007 10-K at 71) and that "[i]n the quarter ended February 29, 2008, there were no days when daily net trading loss exceeded historical simulation VaR as measured at the close of the previous business day" (1Q08 10-Q at 79). These specific misrepresentations are demonstrably false and actionable as they falsely conveyed that VaR breaches were infrequent, when they were in fact occurring on an almost daily basis. *See In re Sadia, S.A. Sec. Litig.*, 643 F. Supp. 2d 521, 530-31 (S.D.N.Y. 2009) (sustaining alleged false statements concerning VaR because they did not reflect the Company's true exposure to market risks).

### 3. The Offering Materials Contained Untrue Statements Regarding Lehman's Liquidity Risk And Risk Of Bankruptcy

Regulation S-K required Lehman to disclose, in its MD&A, any commitments that were reasonably likely to result in a material decrease in Lehman's liquidity. ¶86; 17 C.F.R. § 229.303. Lehman violated this requirement by failing to disclose its obligation to repurchase tens of billions of dollars worth of Repo 105 assets immediately after the quarter closed. The commitment to repurchase was not only "reasonably likely" to impact Lehman's liquidity, but was certain to affect it. Nevertheless, Lehman's MD&A failed to disclose the timing and amounts of the cash flow issues accompanying the repayment of Repo 105 borrowing, including the amount of cash available after repayment. ¶¶87-88.

In addition, in its 2007 Form 10-K, Defendants misleadingly told investors that Lehman had a "very strong liquidity position." ¶87. Contrary to this statement, Lehman had a large concentration of illiquid assets with deteriorating values, such as residential and commercial real

estate.[22] Moreover, while Lehman publicly stated that "we maintain a liquidity pool . . . that covers expected cash outflows for twelve months in a stressed liquidity environment" (¶87), by the start of the Class Period in July 2007, Lehman had already internally determined that its liquidity pool was short $400 million to meet its commitments one year forward. ¶88. *See also* E.R. at 124.

Defendants contend that the effect of the Repo 105 transactions on Lehman's liquidity was immaterial as a matter of law. However, "'a complaint may not be properly dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.'" *Ganino*, 228 F.3d at 162 (quoting *Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985)). Likewise, now is not the time to address Defendants' factual arguments. *See*, *e.g.*, *Ellenburg v. JA Solar Holdings Co. Ltd.*, 2010 WL 1983375, at *1 (S.D.N.Y. May 17, 2010) ("The Court's function on a motion to dismiss is not to weigh the evidence . . . but merely to determine whether the complaint is legally sufficient."); *DiBlasio v. Novello*, 344 F.3d 292, 304 (2d Cir. 2003) (holding that "a disputed issue of fact . . . is inappropriate to consider in the context of a 12(b)(6) motion").

The Complaint alleges that Defendants failed to disclose Lehman's obligation to repurchase billions of dollars of securities immediately after the quarter ended. There can be no doubt that such an impact on Lehman's liquidity was material to investors. Indeed, as Lehman stated in its 2007 10-K, liquidity was "essential" to its business and "failures in our industry are typically the result of insufficient liquidity." ¶85. Defendants also speculate that Lehman's failure to disclose the effect of its Repo 105 transactions on its liquidity ***might*** have been immaterial because Lehman's "obligation" to repurchase the Repo 105 securities ***might*** have

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[22] Defendants' factual contention that Lehman's heavy concentration of illiquid assets has no relation to the strength of Lehman's liquidity position because it did not affect its liquidity pool, is both premature in the context of a 12(b)(6) motion and factually inaccurate. This statement was not limited to a description of the liquidity pool, but rather to the Company's overall liquidity position.

been "financed," as opposed to "funded by the liquidity pool." Jt. Br. at 18. However, Defendants' assertions of unsupported facts are not grounds for dismissal at this stage. Indeed, the notion that Lehman could borrow billions of dollars in funds, in the midst of a financial crisis and without disclosing the purpose for which these funds were to be used, is implausible.

Likewise, Defendants' contention that their misstatements concerning liquidity were immaterial as a matter of law because "the vast majority" of the securities used in the Repo 105 transactions were "investment grade" and thus, in their view, "as good as cash" (Jt. Br. at 17-18), also raises factual issues. Furthermore, Defendants' "vast majority" argument concedes, as they must, that certain securities used in the Repo 105 transactions were not investment grade. Nonetheless, they ask this Court to assume that (1) the amount of non-investment grade securities involved in the Repo 105 transactions was so *de minimis* that it could not possibly have affected Lehman's liquidity risk; and (2) that each of the "investment grade" securities used in the Repo 105 transactions was highly liquid, and thus capable of being included in Lehman's liquidity pool. Neither assumption is appropriate on a motion to dismiss.

Indeed, given that Lehman's quarterly Repo 105 usage exceeded the value of its reported liquidity pool throughout the Class Period,[23] even if only 5% of the securities used in the Repo 105 transactions were below investment grade, Lehman's failure to disclose the Repo 105 transactions would have had the effect of materially overstating Lehman's liquidity pool by billions of dollars. Similarly, there is no support for Defendants' assertion that the assets were as good as cash. A substantial portion of the assets collateralizing the Repo 105 transactions were not Level 1 assets. *See* E.R. at Appx. 17 at 13. Moreover, at the pleading stage where the Complaint's allegations are accepted as true and inferences are drawn in favor of Plaintiffs, [d]efendants are not entitled to any inference that the assets were as good as cash.

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[23] Compare ¶37 (setting forth tens of billions in Repo 105/108 usage during the Class Period) with Lehman's Forms 10-K and 10-Q during the Class Period (describing amounts in the liquidity pool.).

Finally, while Defendants contend that the Offering Materials warned investors of potential liquidity risks, the purported "risk" disclosure said nothing about Lehman's obligation to repurchase assets or that the Repo 105 transactions were certain to impact Lehman's liquidity pool.[24]

### 4. The Offering Materials Overstated The Value Of Lehman's Commercial Real Estate Holdings

Throughout the Class Period, Lehman represented that it marked its commercial real estate assets to "fair value." Lehman further represented in its securities filings that the Company measured fair value in accordance with SFAS 157, and that "SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." *See*, *e.g.*, Form 10-Q dated July 10, 2007. In actuality, Lehman did not mark its real estate assets to fair value. Indeed, as the real estate market plunged, Lehman continued to report the value of these assets at prices at which they were no longer marketable. Lehman did not take market information into account in valuing certain of its largest commercial real estate assets.

For example, as late as the second quarter of 2008, Lehman valued more than one-third of its PTG assets, which were commercial assets that were under development, using a capitalization rate that assumed a 5% ***appreciation*** of collateral even though commercial real estate values were in substantial ***decline***. ¶¶97-98. Similarly, Lehman valued other PTG assets utilizing yields that did not reflect market-based interest rates. ¶98. Lehman also failed to consider market information, including rental growth rates, exit capitalization rates, and exit

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[24] Lehman's statement that "the liquidity pool's size was based in part on judgment about future events" did not indicate, much less warn investors that Lehman would fail to take into account billions of dollars of currently known obligations in sizing its liquidity pool. Likewise, Lehman's statements that it relied upon "external borrowings for the vast majority of its funding," that "failures in our industry are typically the result of insufficient liquidity," and that Lehman's "liquidity could be impaired by an inability to access secured and/or unsecured debt markets" did not warn of the risk that Lehman's liquidity position would be materially overstated as a result of its failure to take into account currently known obligations.

platform values, in valuing its sizeable position in Archstone. ¶¶92-94. Lehman's systemic failure to value its commercial real estate assets in a manner consistent with its publicly stated methodology was confirmed during witness interviews with the Examiner. ¶98. For example, Lehman's Senior Vice President responsible for overseeing valuation of assets in Lehman's real estate group admitted that the PTG portfolio was generally not marked to prices at which the asset could be sold. *Id.* These allegations are easily sufficient to establish the falsity of Lehman's statements.

In response, Defendants contend that Lehman's misstatements concerning its method of valuing its commercial real estate assets are inactionable opinions. Jt. Br. at 19. This is incorrect. As this Court recognized in *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt.*, *LLC*, 479 F. Supp. 2d 349 (S.D.N.Y. 2007), while "a statement as to the value of a [security] . . . may be considerably more a statement of opinion than a report of objectively determinable fact," misstatements concerning the methodology used for valuing assets constitute "representation[s] of fact." *Id.* at 362. Judge Sweet similarly held that a misrepresentation as to the methodology for valuing assets constitutes a misrepresentation of fact in a factually analogous circumstance. *See Automatic Catering*, *Inc. v. First Multifund For Daily Income*, *Inc.*, 1981 WL 1664, at *7-9 (S.D.N.Y. Aug. 3, 1981). In *Automatic Catering*, the defendants represented that they valued securities for which market quotations were not readily available at "fair value." *Id.* at *7. The plaintiffs alleged that this representation was false and misleading because defendants did not value such securities based on their current market value, but rather on an amortized cost basis which "fail[ed] to account for fluctuations in the market rate of interest or other factors that may have an effect on the price at which a debt instrument . . . could be sold." *Id.* The defendants moved for summary judgment on this claim, arguing that the amortized cost valuation method represented their good faith effort to determine fair value for these securities. *Id.* at *9. Judge Sweet found that a material issue of fact existed as to whether the defendants had misrepresented their valuation policy and denied the motion. *Id.*

As in *Automatic Catering*, Defendants represented that they were valuing Lehman's commercial real estate assets at fair value, but in reality were "fail[ing] to account for fluctuations in the market rate of interest or other factors that may have an effect on the price at which [the assets] could be sold." Lehman's valuation models, for example, used discount rates that departed significantly from market-based interest rates. ¶98. Thus, the Complaint asserts misrepresentations of methodology, not opinion. *See Abrams v. Van Kampen Funds, Inc.*, 2002 WL 1160171, at *11 (N.D. Ill. May 30, 2002) (misrepresentation of fact where plaintiffs alleged that defendants "ignor[ed] market pricing as a factor in determining fair value" because this was "inconsistent with the representation that this factor was part of the fair value method.").

Even if Lehman's misstatements concerning the value of its commercial real estate portfolio were construed as statements of opinion, the Complaint explains that there was no reasonable basis for holding the opinion that the value of Lehman's reported commercial real estate reflected the expected market price of those assets. As set forth above, numerous members of Lehman's PTG group told the Examiner that Lehman did not value its assets at the price at which they could be sold in the market. *See* ¶98. Thus, Lehman lacked a reasonable basis for the opinion that its commercial real estate assets were valued at fair value – *i.e.*, the price at which they could be sold in the market.

While Defendants contend that their misstatements were immaterial as a matter of law, the very case Defendants rely upon explains that a 5% impact "with respect to a particular item on [a] registrant's financial statement" presumptively establishes materiality, even without regard to qualitative considerations. *ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 204 (2d Cir. 2009). Plaintiffs have alleged that the write-downs identified by the Examiner and set forth in the Complaint would have impacted Lehman's income statements to a far greater extent. For example, the Examiner found that Lehman's valuation of its Archstone position alone was overstated by $200-$450 million as of the end of the first quarter of 2008, when Lehman's pre-tax income during that quarter was $489 million. ¶94. Thus, if Lehman had taken at least a $200 million write-down on its Archstone position

during the first quarter of 2008, its pre-tax income would have fallen 40% (from $489 million to $289 million). This dramatic reduction in the Company's income, which would have been even further exacerbated by millions of dollars in additional write-downs on Lehman's PTG assets, clearly would have been material.

Defendants' contention that quarterly income is, in their view, a "micro-metric," (Jt. Br. at 21) and thus not material, has been expressly rejected by the Second Circuit. In *Ganino*, the Second Circuit held that "[m]isstatements of income could be material because 'earnings reports are among the pieces of data that investors find most relevant to their investment decisions.'" 228 F.3d at 164 (quoting *Burlington Coat Factory*, 114 F.3d at 1420 n.9). There, the Second Circuit reversed a lower court's decision that materiality was not adequately pled because the alleged misrepresentations amounted to only 1.7% of total revenue. *Ganino*, 228 F.3d at 166. Because the alleged misrepresentations substantially affected the company's quarterly net income (by up to $125 million in absolute terms and by 8-17% as a percentage of total net income), it was "inappropriate to determine at this stage of the litigation that these substantial amounts, both in absolute terms and as percentages of total net income for the respective quarters, were immaterial as a matter of law." *Id.* at 166; *see also SEC v. Penthouse Int'l*, *Inc.*, 390, 410 F. Supp. 2d 344, 354 (S.D.N.Y. 2005) (overstatement of income by more than 9%, converting a $167,000 loss into a profit of $828,000, establishes materiality); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, (S.D.N.Y. 1998) (rejecting allegations that misstatements of over $338 million in profits were immaterial as a matter of law even though comparatively minor in relation to earnings because profit statements are "of particular importance to the market").

Moreover, Defendants' misrepresentations as to how Lehman was valuing its commercial real estate assets were even more material than they otherwise may have been because investors were specifically "focused" on the quality of Lehman's valuations given the dislocation of the markets. In addition, the materiality of Defendants' misstatements, and the overvaluation of the assets, is corroborated by the fact that multiple financial institutions refused to acquire such

assets even at fire sale prices. Bank of America CEO Ken Lewis, whose officers reviewed Lehman's commercial real estate portfolio in September 2008 in connection with a possible acquisition of Lehman, told the Examiner that Lehman's commercial real estate assets were extremely overvalued, describing a "$66 billion hole." ¶102. Similarly, Barclay's President Robert E. Diamond, Jr., whose firm's post-bankruptcy acquisition of Lehman excluded Lehman's real estate holdings, explained that this exclusion was because "[w]e did not feel the valuations [of the commercial real estate] were supportable." ¶103. The banks found that Lehman's commercial portfolio was overvalued by as much as 35%. ¶102.[25]

#### 5. The Offering Materials Failed To Disclose Lehman's Risk Concentrations

FAS 107 requires companies to disclose "*all* significant concentrations of credit risk from *all* financial instruments." (emphasis added). Likewise, American Institute of Certified Public Accountants Statement of Position ("SOP") No. 94-6 requires disclosure of risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term (*i.e.*, one year), including current vulnerability resulting from significant concentration of risk. Notwithstanding these provisions of GAAP, Lehman failed to adequately disclose the Company's risk concentrations in (a) highly risky Alt-A loans; (b) illiquid commercial real estate assets; and (c) leveraged loan commitments.

##### a) Alt-A Loans

By 2007, Lehman had amassed a significant concentration in Alt-A loans. Further, Lehman had relaxed its lending standards for Alt-A loans to such an extent that they were akin to

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[25] Defendants' contention that these statements by senior officials in the financial industry following an in-depth review of Lehman's commercial real estate assets should be disregarded because they constitute "improper fraud by hindsight," is meritless. *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72 (2d Cir. 2001) ("Any information that sheds light on whether class period statements were false or materially misleading is relevant," including post-class period data and pre-class period data); *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 181 (S.D.N.Y. 2003) (permitting the use of post-class period data to confirm circumstances that existed during the class period).

subprime loans. ¶173; *see also* Appx. C to Complaint. As a Lehman Senior Vice President in Risk Management stated in an internal January 30, 2007 email, during the "last 4 months Aurora has originated the riskiest loans ever, with every month riskier than the one before." That same Senior Vice President stated in an internal March 17, 2007 email, that "I have pointed out in the past that Aurora's product is far from Alt-A anymore. The traditional Alt-A program is only 40% of Aurora's production . . . the rest 60% of production has 100% [] financing in lower FICOs with non-full documentation, and/or investment properties." ¶106. Lehman's lending standards had deteriorated so much by the start of the Class Period that loans made pursuant to Aurora's Mortgage Maker program were internally referred to as "Alt-B" rather than Alt-A. ¶173, Appx. C ¶1 to Complaint. A March 2007 internal Lehman report concluded that the "credit deterioration [in Alt-A] has been almost parallel to the one of the subprime market." ¶173.[26]

Nonetheless, in violation of GAAP, Lehman did not disclose its concentration of risky Alt-A loans. Indeed, Lehman's Offering Materials did not even include the term "Alt-A" until Lehman filed its 1Q08 Form 10-Q on April 9, 2008, and that filing was still materially misleading because Lehman consolidated its Alt-A holdings with prime holdings into a single category labeled "Alt-A/Prime," even though less than 7% (*i.e.*, only $1 billion of the reported $14.6 billion "Alt-A/Prime" exposure) actually consisted of "prime" loans. *See Ong ex rel. Ong IRA v. Sears*, *Roebuck & Co.*, 388 F. Supp. 2d 871, 894 (N.D. Ill. 2004) (disclosure of two loan segments as a single, combined portfolio found to mislead investors when the segments had dissimilar characteristics). In fact, Defendants are unable to cite to any statement in any Offering

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[26] Lehman continued to hold this concentration of risky Alt-A loans through 2008. As the Co-Head of Lehman's Global Fixed Income Division stated in a February 20, 2008 email, "I remain concerned as a Lehman Shareholder about our resi[dential] and cmbs [commercial mortgage-backed securities] exposure . . . having 18b of tangible equity and 90b in res[dential] (including alt a) and cmbs (including bridge equity) scares me." ¶186.

Materials that would have fully apprised investors of the true risks associated with Lehman's multibillion dollar exposure to Alt-A mortgage-related assets.

To support their contention that they were not required to disclose their Alt-A exposure, Defendants rely on an SEC "Sample Letter" dated March 27, 2008. However, the SEC Sample Letter is irrelevant because it does not deal with disclosure of risk concentrations under FAS 107.[27] Rather, the SEC Sample Letter was directed at disclosure requirements related to providing further transparency in the proper valuation of assets under FAS 157.[28] The fact remains that the Offering Materials misleadingly reported Lehman's overwhelmingly Alt-A segment as "Alt-A/Prime." *Caiola*, 295 F.3d at 331.

Defendants contend that Plaintiffs have failed to allege that Lehman had a concentrated position in Alt-A loans at the time of each Offering. In truth, however, the Complaint alleges that Lehman had amassed concentrated holdings of Alt-A loans by the start of the Class Period and maintained concentrated holdings of Alt-A loans throughout the Class Period. *See* ¶¶106, 173, 186, 246. In addition, Defendants' contention that Plaintiffs have "ma[d]e no specific allegations that Lehman's alleged omissions violated GAAP" misses the mark. Plaintiffs have alleged that disclosure of Lehman's risk concentration with respect to Alt-A loans was required under FAS 107 and SOP 94-6, and that Defendants failed to make these disclosures. ¶¶104-106. *See SEC v. Spiegel, Inc.*, 2003 WL 22176223, at *69 (N.D. Ill. Sept. 15, 2003) (disclosure required under SOP 94-6 in order to provide transparency to investors concerning the risks to the company). Finally, it is difficult to give any credence to Defendants' contention that their failure to disclose this concentration risk was a "judgment, and therefore inactionable unless it was not

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[27] In doing so, Defendants are asking this Court to resolve a factual dispute, namely, whether Lehman's disclosures were adequate. The Sample Letter was not attached to or incorporated by reference in the Complaint, and it is not integral to Plaintiffs' allegations. Therefore, consistent with *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007), the Court should not consider this document for purposes of Defendants' 12(b)(6) motion.

[28] *See* Chepiga Decl., Ex. 12, ("In this letter, we highlight some disclosure matters relating to SFAS 157 that you may wish to consider as you prepare your Form 10-Q.")

truly held," as there was no reasonable basis upon which to characterize Lehman's Alt-A assets as prime.

#### b) **Commercial Real Estate Concentration**

From the end of Lehman's 2006 fiscal year to the end of its 2007 fiscal year, Lehman increased its global commercial real estate assets by more than 90%, from $28.9 billion to $55.2 billion. However, by July 2007, Lehman personnel had already recognized that the market for placing investments backed by commercial real estate was "virtually closed." ¶107. Moreover, Lehman's commercial real estate portfolio included high-risk development projects, the value of which depended on a successful performance of developments that were concentrated in California and other boom markets.

On November 6, 2007, Lehman's global real estate group made a presentation to Lehman's Executive Committee in which it concluded that its global commercial real estate portfolio was overconcentrated and that "an estimated $15 billion reduction in global balance sheet is warranted," and recommended that this reduction (from $58 billion to $43.7 billion) be completed by March 31, 2008. ¶107. Notwithstanding this instruction, Lehman's commercial real estate portfolio remained over concentrated, and the concentrated risks were not disclosed. ¶107.

Defendants' contention that they meaningfully disclosed the concentration risk posed by Lehman's commercial real estate assets by listing the amount of commercial mortgages Lehman held, and their geographic locations, is simply factually inaccurate. First, Defendants did not disclose the holdings and geographic locations until Lehman's 1Q08 filing in April, 2008 – well into the Class Period and after billions had been raised in Offerings. Second, even after these disclosures had been made, Defendants continued to omit the amount of commercial real estate assets concentrated in, for example, risky bridge equity and PTG investments, thereby rendering subsequent Offering Materials false and misleading. The Complaint alleges that Lehman had concentrated holdings of commercial real estate assets by the start of the Class Period; it

maintained concentrated holdings of commercial real estate assets throughout the Class Period; disclosure of this concentration risk was required under SFAS 107 and SOP 94-6; and the Offering Materials excluded these disclosures. ¶¶104-109; *see Spiegel*, 2003 WL 22176223, at *69.

#### c) **Leveraged Loans**

Defendants also failed to disclose Lehman's risk concentration with respect to leveraged loans. Between December 2006 and June 2007, Lehman participated in at least eleven leveraged buyout deals, each exceeding $5 billion. ¶108. By April 2007, Lehman had approximately seventy high yield contingent commitments – a record. By June 2007, Lehman's lending had doubled from 2006, its record-setting year for high grade and high yield combined. These concentrations were so large that Lehman's high yield book showed a risk appetite usage that was almost double Lehman's risk limit for these exposures. When the market slowed by the second quarter of 2007, Lehman had approximately $36 billion of contingent commitments on its books, and FID was almost $20 billion over its net balance sheet limit. *Id.*

The Offering Materials failed to disclose this material concentration of risk in leveraged loan deals. Specifically, Defendants did not disclose that Lehman had loans that consumed vast amounts of capital, that were made to companies or individuals that already had high levels of debt and were therefore particularly risky, or that Lehman had leveraged loans involving bridge equity commitments in which Lehman took on riskier equity pieces of real estate investments and which could directly affect its balance sheet and liquidity position if not sold. Lehman's mere listing of its lending commitments in its quarterly filings did not adequately disclose its exposure to leveraged loans.

### C. The Principal Protection Note Offering Materials Are Actionable

#### 1. The PPN Offering Materials Were Misleading

Defendants argue that Plaintiffs have not alleged actionable false or misleading statements and omissions of material fact in the Offering Materials for the Principal Protection Notes (PPNs). This contention should be rejected for two reasons. First, the Offering Materials for the PPNs incorporated the same false and misleading documents that the common and preferred stock and note/bond plaintiffs' claims are based upon. *See* ¶¶24-25, Exs. A & B to Complaint. As a result, UBS, Fuld, O'Meara, Callan, the Director Defendants and E&Y are liable to investors in the PPNs under Sections 11 and UBS is liable under 12(a)(2) of the Securities Act for the reasons discussed elsewhere in Section III.[29]

Second, the PPN Offering Materials were false and misleading under the Securities Act because the repeated references to the "principal protection" feature of the PPNs were misleading to a reasonable investor. The PPN pricing supplements described the PPNs as offering "principal protection" or "partial principal protection." ¶¶114, 118(a). The pricing supplements stated over and over that at maturity, investors would receive a payment of at least the "protected" amount of their principal, although the investor might or might not receive an additional payment depending on the performance of the derivative. *Id.* UBS's own financial advisors and their clients who invested in PPNs accepted the representations of principal protection at face value. When Lehman filed for bankruptcy, UBS was forced to release a public statement belatedly explaining that investors had no interest in any instruments used by Lehman to hedge its obligations under the PPNs, that the PPNs were not supported by any security

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[29] The arguments regarding untrue statements of material fact for purposes of Plaintiffs' Section 11 claim apply equally to the Section 12(a)(2) claim against UBS because "[c]laims under Sections 11 and 12(a)(2) are … Securities Act siblings with roughly parallel elements," including "(1) the existence of either a misstatement or an unlawful omission; and (2) materiality." *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d at 359-60 (considering the claims in tandem); *WorldCom, Inc.*, 346 F. Supp. 2d at 659-60 (the claims also have parallel defenses).

interest or collateral and that the PPNs did not offer "principal protection" and were no different from traditional bonds. ¶¶118(a)(i)(iii), 119. These disclosures were necessary because UBS omitted from its "Key Risk" disclosure the key fact that Lehman's "principal protected" notes were nothing more than Lehman's unsecured obligations.

Defendants do not challenge the legal sufficiency of these allegations. Instead, they argue that their disclosures were sufficient to insulate them from liability. But nowhere in the pricing supplements did Defendants alert investors to the fact that their principal investment was unsecured and uncollateralized. In addition to being far from prominent (as Defendants claim), the footnoted, miniscule-print reference to Lehman's creditworthiness conveys nothing more than the notion that repayment of a debt is dependent on the ability of an issuer to pay. The statement Defendants added to the tail end of the "Key Risks" section of the pricing supplements in October 2007—that the investments were subject to Lehman's "credit risk" (or "creditworthiness") and that Lehman's creditworthiness "may affect the market value of the Notes" – was insufficient to place a reasonable investor on notice that "principal protected" meant "same as a traditional bond." ¶¶118(b) & (c).

Given the plain meaning of the phrase "principal protection," Defendants repeated invocation of the phrase was misleading without adjacent disclosures that the notes were not secured or collateralized and that investors would have to look to Lehman alone for repayment. *See*, *e.g.*, *In re Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 439 (S.D.N.Y. 2009) (a defendant "has a duty to disclose any information that is 'necessary to make other statements not misleading.'"). As the Second Circuit has cautioned, "it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." *Gerstle v. Gamble-Skogmo*, *Inc.*, 478 F.2d 1281, 1297 (2d Cir. 1973); *see also Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 565 (E.D.N.Y. 1971) (even if the information the plaintiffs alleged was misleading was disclosed in a way that was "probably technically accurate," it was "hardly calculated to apprise" the investor of the actual risks).

While Plaintiffs do not concede that the pricing supplements issued by other investment banks that Defendants filed with their motion are models of "fair and balanced" communications with investors,[30] they do include qualifying statements that are at least somewhat "more direct, informative and candid" than Defendants' PPN pricing supplements. *Feit*, 332 F. Supp. at 565. Each of the pricing supplements states, often multiple times, that the notes are the unsecured debt of the investment bank issuing the note, and provides additional information about the risk to investors' principal. *See* Chepiga Decl., Exs. 28-32. For example, the RBS pricing supplement states: "The notes are unsecured. The notes are solely the unsecured obligations of Royal Bank . . . The business and affairs of Royal Bank may affect the market value of your Notes." *Id.*, Ex. 29 at 1965-66. The Barclay's pricing supplement features the statement, "*The Notes constitute our direct, unconditional, unsecured and unsubordinated obligations and are not deposit liabilities of Barclays Bank PLC* . . . ." *Id.*, Ex. 32 at 2033. Merrill Lynch disclosed: "The Notes will be a series of senior debt securities issued by ML&Co. . . . and will not be secured by collateral. The Notes will rank equally with all of our other unsecured and unsubordinated debt." *Id.*, Ex. 30 at 1973.[31] Only in the case of UBS-sponsored PPNs were investors directed to the "SEC reading room" to learn that they were investing in unsecured debt.

Defendants rely on a handful of statements scattered through the voluminous Offering Materials that refer to the investment as Lehman's unsecured debt, but they cannot escape liability by planting cautionary statements in documents other than the pricing supplements themselves – in many cases, contrary to their own admonition that the pricing supplement

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[30] *See* FINRA Regulatory Notice 09-73 (Principal Protected Notes), available at http://www.finra.org/Industry/Regulation/Notices/2009/P120597.

[31] *See also id.*, Ex. 31 at 2013 ("The Notes are a series of debt securities issued by Citigroup Funding . . . and any payments due under the Notes are fully and unconditionally guaranteed by Citigroup Inc. . . . The Notes . . . will constitute part of the senior debt of Citigroup Funding, and will rank equally with all other unsecured and unsubordinated debt of Citigroup Funding. As a result of the Citigroup Inc. guarantee, any payments due under the Notes will rank equally with all other unsecured and unsubordinated debt of Citigroup Inc.").

supersedes.[32] None of the isolated statements Defendants identify is sufficiently prominent or proximate to the references to principal protection to counteract the misleading impression created by the pricing supplements. *See*, *e.g.*, *In re Flag Telecom*, 618 F. Supp. 2d at 324-26. Instead, the pricing supplements "gloss[ed] over the relevant risk, focus[ed] investors' attention elsewhere, and thereby lead them down [a] primrose path." *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357, 360 (2d Cir. 2002) ("The touchstone of the inquiry is not whether isolated statements within a document were true, but whether defendants' representations or omissions . . . [would] mislead a reasonable investor").

Because the Securities Act was intended "to provide full and fair disclosure of the character of securities," Defendants are not absolved even if their disclosures are "full" unless they are also "fair." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727-28, 95 S. Ct. 1917, 1921-22 (1975); *see also Roby v. Corp. of Lloyd's*, 996 F.2d 1353, 1364 (2d Cir. 1993) ("The framers of the securities laws were concerned principally with reversing the common law rule favoring 'caveat emptor.' To this end, the securities laws are aimed at prospectively protecting American investors from injury by demanding 'full and fair disclosure' from issuers.").[33] But Defendants' disclosures were of course not "full," because they would not have warned a reasonable investor that his principal was at considerable risk due to Lehman's

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[32] *See, e.g.,* Chepiga Decl., Ex. 19 at 1530; Ex. 20 at 1537; Ex. 21 at 1545. *See also P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d at 96 ("A defendant may not be liable under § 12(a)(2) for misrepresentations in a prospectus if the alleged misrepresentations were sufficiently balanced by cautionary language ***within the same prospectus*** such that no reasonable investor would be misled about the nature and risk of the offered security.") (emphasis added); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 453 n.11 (S.D.N.Y. 2005) ("An investor should not be called upon to piece together buried information from distinct parts" of defendants' reports to investors.).

[33] The cases Defendants cite confirm that "[a] prospectus will violate federal securities laws if it does not disclose 'material objective factual matters,' or buries those matters beneath other information, or treats them cavalierly," but ultimately hold that—unlike here—the offering materials included "specific, prominent disclosures." *DeMaria v. Anderson*, 318 F.3d 170, 180-81 (2d Cir. 2003); *see also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5-6 (2d Cir. 1996) (finding that consecutive disclosures made in a single paragraph adequately disclosed investment risk and that "assurances of hedging" in the prospectus "were balanced by extensive cautionary language"); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 762 (2d Cir. 1991) ("we find the language remarkably direct").

financial condition and shifting business strategy in 2007 and 2008.[34] *See*, *e.g.*, *Credit Suisse First Boston Corp. v. ARM Fin. Group*, *Inc.*, 2001 WL 300733, at *8 (S.D.N.Y. Mar. 28, 2001) (holding that "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," and denying motion to dismiss). "[D]isclosures of risk provide 'no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.'" *Id.* (quoting *In re Prudential Sec. Inc. Ltd. P'shps. Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996)).

Defendants' motion to dismiss should be denied as to the PPNs for all the same reasons set forth elsewhere in Section III. As to the allegations arising out of Defendants' statements about "principal protection," Defendants have at most raised a factual issue as to the adequacy of the disclosures that cannot be resolved on a motion to dismiss.[35]

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[34] Defendants' argument that they "had no obligation to disclose the obvious fact that if Lehman became insolvent, investors would not receive full payment on the notes" might be persuasive if Defendants had directly told investors that by purchasing PPNs, they were lending money to Lehman. *See* Jt. Br. at 29. Without this foundational information, however, a reasonable investor could justifiably conclude that by investing in "principal protected" notes, he was purchasing protection from the loss of principal under any plausible scenario.

[35] *See*, *e.g.*, *Halperin*, 295 F.3d at 357 (holding that "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" is factual and not appropriately decided on a motion to dismiss); *In re Flag Telecom*, 618 F. Supp. 2d at 324 (denying summary judgment because "[w]hile defendants contend that the Prospectus was clear in its disclosure on these points, a reasonable investor may disagree"); *Credit Suisse*, 2001 WL 300733, at *9 (denying motion dismiss because "[i]t may be that the disclosures were substantial enough to render the risk unimportant to reasonable investors, and thus immaterial . . . but this is a matter properly resolved later in this litigation.").

### 2. Plaintiffs Have Standing To Bring Claims For All Of The Lehman/UBS Structured Product Offerings Identified In Appendix B Of The Complaint

Defendants argue that Plaintiffs do not have Article III standing to bring claims for the Lehman/UBS Structured Product offerings.[36] Defendants rely on *Lehman MBS* and *MissPers*, but those cases are inapplicable as they both involved the sale of mortgage-backed securities and the alleged misstatements and omissions related to details about the underlying collections of loan pools for each offering. *See In re Lehman Bros. Sec. and ERISA Litig. ("Lehman MBS")*, 684 F. Supp. 2d 485, 488-89 (S.D.N.Y. 2010); *Public Employees' Ret. Sys. of Miss. v. Merrill Lynch & Co. Inc. ("MissPers")*, 2010 WL 2175875, at *3 (S.D.N.Y. June 1, 2010).[37] The Structured Products are simply a type of Medium-Term Note that is linked to a derivative. ¶¶113-14. As Defendants point out, each PPN was issued pursuant to the same Base Prospectus and MTN Prospectus Supplement. Jt. Br. at 26 n.63. These common prospectuses incorporated the SEC filings that contained the misstatements and omissions. For the purposes of this litigation, the false or misleading statements were the same for each Offering. In addition, all of the Offerings were issued by Lehman and underwritten and sold by UBS. Because all investors in the Lehman/UBS Structured Product offerings were personally injured by the same false or misleading statements made by the same defendants, there is no basis for distinguishing the Offerings for standing purposes.

Plaintiffs also have statutory standing to pursue the Section 12 claim because Plaintiffs allege that they "purchased or otherwise acquired the Lehman/UBS Structured Products pursuant

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[36] Although Defendants refer to all of the offerings listed on Appendix B to the Complaint as "PPNs," only the bolded offerings purported to offer full or partial principal protection.

[37] The cases cited in *Lehman MBS* and *MissPers* also involved mortgage-backed securities or mutual funds, which vary by fund due to different investment objectives, different public disclosures of risks to investors, different investment managers and different distributors and underwriters. *See Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 658 F. Supp. 2d 299 (D. Mass. 2009) (MBS); *Hoffman v. UBS-AG*, 591 F. Supp. 2d 522 (S.D.N.Y. 2008) (mutual funds); *In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579 (S.D.N.Y. 2006) (mutual funds).

to the materially untrue and misleading Structured Note Offering Materials." ¶136. Plaintiffs further allege that UBS was a "seller, offeror, and/or solicitor of sales" of the Structured Products. ¶134. Finally, Plaintiffs' certifications identify the number of Notes they purchased and the dates of their purchases. *See* Complaint Appendix B; Plaintiff s'Certifications. No more is required. *See In re IndyMac Mortgage-Backed Sec. Litig.*, 2010 WL 2473243, at *3 (S.D.N.Y. June 21, 2010).

### D. Erin Callan Is A Proper Defendant Under Section 11

Defendant Callan contends that she cannot be liable as a signatory for any of the Offerings because she did not sign the Shelf Registration Statement. Jt. Br. at 31. However, SEC regulations specifically provide for liability for signatories to documents incorporated by reference into prospectuses and registration statements for delayed or continuous shelf offerings. As alleged in the Complaint, Lehman filed the Shelf Registration Statement in 2006 and conducted a series of Offerings based upon those documents. ¶¶1 n.1, 24, 25. The registration statement was continually updated by incorporating Lehman's SEC filings by reference; in this manner, every new Offering contained Lehman's latest public filings. ¶25. Erin Callan became CFO on December 1, 2007, and subsequently signed Lehman's SEC filings, which were incorporated by reference into Offerings after that date.

The statute and regulations governing the update of a shelf registration statement are contained in Section 10(a)(3) of the Securities Act, 15 U.S.C.A. § 77j(a)(3), and 17 C.F.R. § 229.512. Together, these rules obligate an issuer to update a prospectus with current information, and the SEC has stated that the statute may be satisfied by incorporating annual and quarterly filings by reference. *See* 17 C.F.R. § 229.512(a)(i-iii)(B);[38] *see also* SEC Release No. 33-8591, 70 Fed. Reg. 44722-01, 44729 n.61 (Aug. 3, 2005) (Section 10(a)(3) is satisfied by the

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

filing of a Form 10-K). Thus, the SEC filings signed by Callan were incorporated by reference to satisfy the requirements of Section 10(a)(3).

According to the regulation:

> ***Except for an effective date resulting from the filing of a form of prospectus filed for purposes of including information required by section 10(a)(3) of the Act*** or pursuant to Item 512(a)(1)(ii) of Regulation S-K (§ 229.512(a)(1)(ii) of this chapter), the date a form of prospectus is deemed part of and included in the registration statement pursuant to this paragraph shall not be an effective date established pursuant to paragraph (f)(2) of this section as to:
>
> * * *
>
> (ii) Any person signing any report or document incorporated by reference into the registration statement, ***except for such a report or document incorporated by reference for purposes of including information required by section 10(a)(3) of the Act*** or pursuant to Item 512(a)(1)(ii) of Regulation S-K (such person except for such reports being deemed not to be a person who signed the registration statement within the meaning of section 11(a) of the Act). [17 C.F.R. § 230.430B(f)(4)].

The SEC interpretive release explaining the regulation restates the rule:

> Therefore, under Rule 430B, ***except for an effective date resulting from the filing of a form of prospectus for purposes of updating the registration statement pursuant to Section 10(a)(3)*** . . . the prospectus filing will not create a new effective date for directors or signing officers of the issuer. Any person signing any report or document incorporated by reference in the prospectus that is part of the registration statement or the registration statement, ***other than a document filed for the purposes of updating the prospectus pursuant to Section 10(a)(3)*** or reflecting a fundamental change, is deemed not to be a person who signed the registration statement as a result. [70 Fed. Reg. at 44774.]

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

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

> The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant's annual report pursuant to section 13(a) or section 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan's annual report pursuant to section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement ***shall be deemed to be a new registration statement relating to the securities offered therein***, ***and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof***. [17 C.F.R. § 229.512(b) (emphasis added)].

For these reasons, Defendant Callan was a signatory of the registration statement once documents with her signature, including the 2007 Form 10-K, were incorporated by reference into the Shelf Registration Statement. Accordingly, she is liable under Section 11.[39]

### E. Affirmative Defenses Do Not Apply

#### 1. Affirmative Defenses Are Not Appropriately Considered On A Motion To Dismiss

Section 11 provides two affirmative defenses: (1) the due diligence defense, and (2) the reliance defense. *See WorldCom*, 346 F. Supp. 2d at 663-64.[40] In the Joint Brief, the Underwriter and Director Defendants inappropriately attempt to assert both at the pleading stage. However, as this Court has held, the application of such a defense is an intensely factual question, inappropriate for consideration on a motion to dismiss. *See Lehman MBS*, 684 F. Supp. 2d 485, 493-94 (S.D.N.Y. 2010) (Kaplan, J.) (defendants "are strictly liable for any misstatements in the Offering Documents that they signed unless they can establish the due

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[39] In a footnote, Defendants incorrectly argue that Rule 430B(f)(4) does not apply to issuers who update a shelf registration statement through Rule 424(b)(2) supplements, citing *In re Countrywide Fin. Corp. Sec. Litig.*, 2009 WL 943271, at *7 (C.D. Cal. Apr. 6, 2009). *Countrywide* contained no such pronouncement. To the contrary, in *Countrywide*, the court recognized that Section 10(a)(3) applied to any "post-effective amendment" of a registration statement, including subsequent Rule 424(b)(2) supplements and Rule 433 free writing prospectuses. 2009 WL 943271, at *6. The court merely determined in that case that the particular 424(b)(2) supplements and Rule 433 free writing prospectus were not filed for the purpose of including information required by Section 10(a)(3), which requires that prospectuses that are filed more than nine months after the effective date of the registration statement contain information that are "of a date not more than sixteen months prior to such use." *Id.*

[40] Under the due diligence defense, which applies to any ***non-expertised*** portions of a registration statement, a defendant will not be liable upon a showing that:

> he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

15 U.S.C. § 77k(b)(3)(A). The reliance defense is similar but applies to ***expertised*** portions of a registration statement. 15 U.S.C. § 77k(b)(3)(C). These are often referred to collectively as the "due diligence defense." *WorldCom*, 346 F. Supp. 2d at 662.

diligence defense, *an issue inappropriate for consideration on a motion to dismiss*.") (emphasis added); *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 360 n.7 (2d Cir. 2010) (same). This Court's decision is in accord with numerous other decisions. For example, in *Enron* the court held:

> Nor is the fact-specific determination of "the reasonableness" of a defendant's investigation or of his reliance on the opinion of an expert "a question properly resolved on a motion to dismiss." . . . There is good reason why such a decision should not be made on a motion to dismiss pursuant to Rule 12(b)(6). "Reasonableness" with respect to these defenses is not subject to a heightened pleading standard, and there are factual issues in determining what was reasonable under the circumstances alleged by Lead Plaintiff in this action.

*In re Enron Corp. Sec., Deriv. and ERISA Litig.*, 258 F. Supp. 2d 576, 639 (S.D. Tex. 2003); *see also In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 211 (S.D.N.Y. 2003) (Section 11 expressly provides that defendants have the burden of proof to establish the due diligence defense, and plaintiffs need not negate such defense in their pleadings); *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268, at *11 (S.D.N.Y. 2005) ("A defendant's assertion of the due diligence defense requires an exquisitely fact intensive inquiry into all of the circumstances surrounding the facts upon which the Section 11 claim is premised.").[41]

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[41] The cases relied upon by the Underwriter and Director Defendants are unpersuasive. First, they involve the due diligence defense in the context of a motion for summary judgment, ***not*** on a motion to dismiss. *See, e.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1421 (9th Cir. 1994) (affirming summary judgment against underwriters based on due diligence defense); *Weinberger v. Jackson*, 1990 WL 260676, at *1 (N.D. Cal. Oct. 11 1990) (granting summary judgment to defendants based on due diligence defense); *In re Avant-Garde Computing Inc. Sec. Litig.*, 1989 WL 103625, at *1 (D.N.J. Sept. 5, 1989) (same); *Laven v. Flanagan*, 695 F. Supp. 800, 811 (D.N.J. 1988) (same). Second, the cases cited by Defendants that do involve motions to dismiss all unequivocally hold that the due diligence defense is a question of fact that should not be decided on a motion to dismiss. *See, e.g., Ark. Pub. Employee Ret. Sys. v. GT Solar Int'l, Inc.*, 2009 WL 3255225, at *7 (D.N.H. 2009) ("argument . . . based on due diligence . . . are clearly not properly raised [in] a 12(b)(6) motion") (citing *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 2005 WL 3704688, at *19 (S.D. Tex. Dec. 5, 2005); *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1175 (C.D. Cal. 2008) ("[r]easonableness is generally a fact issue, rarely suitable for summary judgment, let alone a motion to dismiss."); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 872 (S.D. Texas 2004) ("whether the Director Defendants reasonably relied on managements' presentations is a question of fact that cannot be decided on the pleadings alone.").

Notwithstanding this well-settled jurisprudence, the Underwriter and Director Defendants' claim that "it is incumbent upon Plaintiffs to make *some* showing of 'red flags' that might tend to undermine the Defendants' reasonable reliance on E&Y as accounting experts." Jt. Br. at 12 (emphasis in original).[42] However, Section 11, a strict liability statute, requires no scienter. *See In re CIT Group*, *Inc.*, 2010 WL 2365846, at *6 (to state a claim under Section 11, "a plaintiff need not plead scienter, reliance, or fraud."); *WorldCom*, 352 F. Supp. 2d at 494 ("Lead Plaintiff has no burden to show that WorldCom or [its auditor] acted with scienter in violating Section 11. The Lead Plaintiff need only show that a materially false statement was made.")[43] Thus, Plaintiffs need not plead knowledge or "red flags" that were apparent to Defendants.[44] As the Second Circuit recently stressed, "[t]o be clear, plaintiffs are not required under sections 11 and 12(a)(2) of the Securities Act to allege that defendants acted with scienter or intentionally omitted information from the Offering Documents." *Morgan Stanley*, 592 F.3d at 365. To state a *prima facie* case under Section 11 of the Securities Act, a plaintiff "need only show a material misstatement or omission" in the offering documents of a security she purchased or acquired. *Herman*, 459 U.S. at 382, 103 S. Ct. at 687; *Fuwei*, 634 F. Supp. 2d at 434-35.

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[42] Defendants rely upon *Glassman v. Computervision Corp*., 90 F.3d 617, 627 (1st Cir. 1996) for the argument that the due diligence defense applies on the motion to dismiss. Jt. Br. at 11, n.27. *Glassman*, however, specifically concerned underwriters' due diligence because it "center[ed] on the claim that Computervision affirmatively misrepresented that the offering price was set after the exercise of the due diligence by the underwriters." *Id.* at 624. Unlike *Glassman*, here, underwriters' due diligence is not the basis for Plaintiffs' claim. Moreover, *Glassman* is a pre-PSLRA case decided after "three years of litigation and full discovery." *Id.* at 628. Because the instant case is still at the pleading phase and the parties have not had an opportunity for discovery, *Glassman* is inapplicable.

[43] *See also*, *Griffin v. PaineWebber*, *Inc.*, 84 F. Supp. 2d 508, 512-13 (S.D.N.Y. 2000) (the complaint need not be pled in anticipation of affirmative defenses); *Turkcell*, 202 F. Supp. 2d at 12 (plaintiffs need not allege facts negating defendants' defense).

[44] In any event, several Underwriter Defendants were Repo 105 counterparties (ABN Amro, Mizuho and UBS were Repo counterparties) (*see* E.R. at 880-81, n.3382) or rejected Repo 105 trades with Lehman ("Daiwa . . . [was] contemplating a Repo 105 trade with us") (*see* E.R. at 943). At the very least, these Defendants' participation and knowledge of Lehman's Repo 105 program raises questions of fact about their due diligence and supposed reliance on E&Y's audit.

Moreover, Section 11 expressly provides that Defendants have the burden of proving the due diligence defense.[45] This is a high standard that cannot be met until after a record is developed. *See In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d at 677 (to prove due diligence, underwriter must demonstrate that they conducted an "unquestionably extensive" investigation, and could not simply rely on assurances that transactions were legitimate). Defendants have made no such showing.

### 2. The Director Defendants' Due Diligence Argument Fails

Although the Director Defendants admit that the due diligence defense is "not . . . an appropriate issue for consideration on a motion to dismiss" (Dir. Br. at 5, n.7)[46], they nevertheless devote 14 pages of separate briefing to "due diligence" and urge the Court to weigh evidence from documents outside the Complaint.[47] Absent a valid request for judicial notice – of which none has been made – matters extraneous to the Complaint should not be considered for their truth.[48]

The Director Defendants urge the court to interpret the Examiner's Report in their favor and weigh the facts. Dir. Br. at 13. "In deciding a motion to dismiss, [however, the court must] accept [] as true all well plead factual allegations and draw [] all reasonable inferences in the ***plaintiff's favor***." *Lehman MBS*, 684 F. Supp. 2d at 488. Moreover, Plaintiffs readily

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[45] 15 U.S.C. § 77k(b)(3). *See also*, *Enron*, 258 F. Supp. 2d at 639 ("Plaintiff does not have the burden of pleading and proving Defendants' affirmative defense of due diligence and/or reliance on an expert's opinion under § 11(b)(3), which expressly places the burden on Defendants."); *In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354, 359 (D.N.J. 1999) (same).

[46] "Dir. Br." refers to the Director Defendants' Memorandum of Law. Dkt. No. 300.

[47] *See* Declaration of Kathleen N. Massey, Exs. B-I (Dkt. No. 301) (attaching newspaper article, Lehman's Proxy Statements dating back to 2003, Lehman's Audit Committee Charter and Lehman's 10-K for period ending December 31, 1993).

[48] *See*, *e.g.*, *Staehr v. Hartford Fin. Servs. Group*, *Inc.*, 547 F.3d 406, 424-25 (2d Cir. 2008) (court must "accept[] as true all factual allegations in the complaint and construe[] all reasonable inferences in the non-movant's favor," and thus may not judicially notice extraneous materials for "the truth of their contents").

acknowledge that the Examiner's Report is not the final record against any of the Defendants, including the Director Defendants. To the contrary, the Directors' failure to conduct due diligence will be the subject of discovery in this case, as will the misconduct alleged against all other Defendants that is referenced in the Examiner's Report and identified in the Complaint. *See*, *e.g.*, *Cendant* (refusing to consider affirmative due diligence defense based on independent investigation report cited in complaint).

"Pleading a Section 11 claim is not difficult . . . 'the plaintiff need only plead a material misstatement or omission in a registration statement.'" *In re Giant Interactive Group*, *Inc. Sec. Litig.*, 643 F. Supp. 2d 562, 568 (S.D.N.Y. 2009).[49] Here, the Complaint alleges that each of the Director Defendants signed the materially false and misleading Shelf Registration Statement, as well as Lehman's 2007 10-K. ¶¶14, 50. The Complaint properly pleads a *prima facie* case under Section 11 against the Director Defendants. 15 U.S.C. § 77k(a).[50]

### 3. E&Y's "Negative Causation" Argument Is Unavailing

Loss causation is presumed in the context of a Section 11 claim. *See* 15 U.S.C. § 77k; *see also Levine v. AtriCure*, *Inc.*, 508 F. Supp. 2d 268, 272-73 (S.D.N.Y. 2007) (loss causation in a Section 11 claim is "presumed"). However, E&Y contends that the Complaint somehow demonstrates the absence of loss causation (*i.e.*, negative causation) because Lehman's bankruptcy occurred prior to the issuance of the Examiner's Report. E&Y Br. at 34-35. This contention is meritless.

Consideration of the negative causation defense is inappropriate on a motion to dismiss. *See Levine*, 508 F. Supp. 2d at 272-73 ("[b]ecause an analysis of causation is often fact-

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[49] *See also Fuwei*, 634 F. Supp. 2d at 434-35 (noting that "every person who signed the registration statement, the directors of the issuer, and the underwriters of the security" are liable under Section 11).

[50] Plaintiffs' Securities Act claims against the Director Defendants are solely strict liability and negligence claims. ¶23. Plaintiffs do not assert that the Director Defendants are liable for fraudulent or intentional conduct and disavow and disclaim any allegation of fraud. *Id.*

intensive, negative causation is generally established by a defendant ***on a motion for summary judgment or at trial***.") (emphasis added).[51] Indeed, courts within this District refuse to allow a negative causation defense at the motion to dismiss stage even where plaintiffs assert claims for losses suffered prior to any alleged corrective disclosure.[52] Thus, E&Y's reliance on *Akerman v. Oryx Commc'ns*, *Inc.* is misplaced, as that case involved the dismissal of a Section 11 claim at the summary judgment phase. 810 F.2d 336, 341 (2d Cir. 1987).

The few courts that have explicitly considered negative causation relating to Section 11 claims on a motion to dismiss have done so narrowly and under circumstances not present here. *See*, *e.g.*, *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig*., 272 F. Supp. 2d 243, 255 (S.D.N.Y. 2003). In *Merrill Lynch*, unlike here, the plaintiff alleged that she sustained a loss by pointing to declines in share price before any public disclosure of the concealed information.[53]

Here, E&Y has the "heavy burden" of ***proving*** that the loss in value to Lehman's securities was caused by other factors.[54] Even under 10(b), when Plaintiffs have an affirmative burden to plead loss causation, courts have denied motions to dismiss when faced with the type of reasoning in E&Y's negative causation argument. *See*, *e.g.*, *In re Parmalat Sec. Litig*., 376 F. Supp. 2d 278, 307 (S.D.N.Y. 2005) (finding loss causation for § 10(b) claims where reports

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[51] The affirmative defense of negative causation can only occur "where a defendant proves that the decline in the value of the security in question was not caused by the material omissions or misstatements in the registration statement [and that the] plaintiff is not entitled to recover any damages." *McMahan & Co. v. Wherehouse Entm't*, 65 F.3d 1044, 1048 (2d Cir. 1995). A defendant's burden in proving negative causation is a "heavy" one. *WorldCom*, 346 F. Supp. 2d at 659.

[52] *See*, *e.g.*, *In re WRT Energy Sec. Litig*., 2005 WL 2088406, at *2 (S.D.N.Y. Aug. 30, 2005) (sustaining Section 11 claim that included declines in share value prior to the first alleged disclosure because "[t]o conclude otherwise places a burden of pleading loss causation on the plaintiffs, and removes the burden of establishing negative causation from the defendants, where it properly lies.").

[53] *Id.* In *Levine*¸ Judge Howell recognized that the decision in *Merrill Lynch & Co*. is virtually unprecedented as it cites to no other cases in which a Rule 12(b)(6) motion to dismiss was granted based on the absence of loss causation in a Section 11 claim. *See Levine*, 508 F. Supp. 2d at 273.

[54] Although E&Y has the burden for its affirmative defense, Plaintiffs respectfully refer the Court to Section IV.D., *infra.* for additional facts demonstrating that the Complaint alleges loss causation when the risks concealed by the Repo 105 program materialized.

concealed that "Parmalat had massive undisclosed debt and was unable to service it . . . . That the true extent of the fraud was not revealed to the public until . . . after Parmalat shares were worthless and after the close of the Class Period – is immaterial . . ."). Thus, the same arguments under Section 11 should be swiftly rejected.

### F. The Complaint States A Claim Under Section 15 Of The Securities Act

The Complaint properly pleads a claim for control person liability under Section 15 of the Securities Act by alleging both a primary violation of the Securities Act, as set forth above, and that the Securities Act Control Person Defendants controlled the primary violators. *See In re Adelphia Commc'ns Corp. Sec. and Deriv. Litig.*, 2007 WL 2615928, at *10 (S.D.N.Y. Sept. 10, 2007); 15 U.S.C. § 77o. Here, this requirement is satisfied. ¶¶141-144.

Defendants Gregory (COO) and Lowitt (CFO and Co-Chief Administrative Officer) contend, without citation to authority, that because they individually are not alleged to have violated Section 11 (a primary violation of the Securities Act), they cannot be charged as control persons under Section 15 of the Securities Act. Jt. Br. at 31, n.76. This argument fundamentally misconstrues the nature of control person liability. Gregory and Lowitt are charged with control person liability because they are alleged to have *controlled* a primary violator, not because they personally *committed* a primary violation or signed the Offering Materials. *See Briarwood Inv. Inc. v. Care Inv. Trust Inc.*, 2009 WL 536517, at *5 (S.D.N.Y. Mar. 4, 2009) (liability attaches to one who *controls* a primary violator).[55] Plaintiffs have satisfied this pleading standard. *See* ¶¶120-31, 141-43.

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[55] Gregory and Lowitt along with Fuld, O'Meara and Callan, are included in the group referred to in the Complaint as the Insider Defendants, who "because of their senior positions at Lehman, were controlling persons of the Company and possessed the power and authority to control the contents of Lehman's reports to the SEC, press releases, and presentations to securities analysts, money and portfolio managers, and institutional investors – *i.e.*, the market." ¶¶10, 254. If it were necessary to have committed a primary violation for liability to attach under Section 15, it would be rendered meaningless and indistinguishable from Sections 11 or 12.

### G. The Claims Of New Plaintiffs Should Not Be Dismissed

Following the Court's order granting leave to amend and its decision in *Lehman MBS*, twenty-five additional investors stepped forward to ensure that their claims, and those of other investors in the same offerings, would continue to be prosecuted.[56] Defendants contend that these claims should be dismissed as time-barred because the filing of the Second Amended Complaint ("SAC") on February 23, 2009, put the new plaintiffs on notice that they had to file their own lawsuits to protect their claims. Jt. Br. at 2. But any of the new plaintiffs who read the SAC would have reasonably understood that their claims had already been asserted as part of the class action and that their interests were being represented. The class was defined as "all persons and entities . . . who purchased or otherwise acquired Lehman . . . securities identified on Appendix A attached hereto (collectively, the 'Offerings'), between February 13, 2007 and September 15, 2008, inclusive (the 'Relevant Period') pursuant or traceable to materially false and misleading registration statement and prospectuses and certain documents incorporated therein by reference, and who were damaged thereby." Complaint at p.1. Appendix A identified hundreds of offerings, including the offerings in which each of the new plaintiffs purchased securities. In addition, complaints filed previously in actions that are part of these MDL proceedings asserted claims on behalf of investors in nearly a dozen of the offerings Defendants contend are new to the Complaint.[57]

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[56] Contrary to Defendants' suggestion, the Court's March 17, 2010 Order did not restrict the nature or scope of any potential amendments. *See*, *e.g.*, *In re Atlas Air Worldwide Holdings*, *Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 500-01 (S.D.N.Y. 2004) (holding that an order generally granting leave to amend permitted the addition of new plaintiffs). Plaintiffs had good cause to add new plaintiffs after the Court's ruling in *Lehman MBS*, and Defendants have not identified any prejudice. *See*, *e.g.*, *Monahan v. New York City Dept. of Corrections*, 214 F.3d 275, 283 (2d Cir. 2000) ("[A]bsent evidence of undue delay, bad faith or dilatory motive on the part of [Plaintiffs], undue prejudice to [Defendants], or futility," courts should freely grant leave to amend.)

[57] The following CUSIPs were covered by complaints filed previously in actions that are part of this MDL: 524908J92, 5252M0AY3, 5252M0DH7, 5252M0BX4, 5252M0DK0, 5252M0CQ8, 52517P4Y4, 5252M0EH6, 52522L814, 52523J412, 52523J248. *See Azpiazu v. Fuld, et al.*, 08-cv-10058 (S.D.N.Y.), Dkt. No. 24 (filed 1/5/2009); *Peyser v. Fuld, et al.*, 08-cv-9404 (S.D.N.Y.), Dkt. No. 1 (filed 10/31/08).

Under *American Pipe*, the claims of any member of the class defined in the SAC (or previous related complaints) are tolled unless and until the court issues an order denying certification or limiting the scope of the class to exclude the class member's claim. *See In re IndyMac*, 2010 WL 2473243, at *4. The Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations ***as to all asserted members of the class*** who would have been parties had the suit been permitted to continue as a class action." *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 554, 94 S. Ct. 756, 766-67 (1974) (emphasis added); *see also Crown*, *Cork & Seal Co., Inc. v. Parker*, 462 U.S. 345, 350, 103 S. Ct. 2392, 2395-96 (1983) (quoting emphasized excerpt from *American Pipe* in holding that tolling extends to all class members, not just those who seek to intervene). The Second Circuit has held that "***members of the asserted class*** are treated for limitations purposes as having instituted their own actions, at least so long as they continue to be members of the class," and it is only "[o]nce they cease to be members of the class – for instance, when they opt out or when the certification decision excludes them – the limitation period begins to run again on their claims." *In re WorldCom Sec. Litig.*, 496 F.3d 245, 255 (2d Cir. 2007) (emphasis added).

The new plaintiffs are "members of the asserted class" in the SAC. The Court has not denied certification of their claims or ruled that their claims are excluded from the asserted class. The new plaintiffs' claims therefore continue to be tolled under the *American Pipe* doctrine and are not time-barred.

Applying *American Pipe* tolling to the new plaintiffs' claims is consistent with the purpose of the doctrine. "Class members are permitted – even encouraged – to rely on the class plaintiffs to advance their claims." *WorldCom*, 496 F.3d at 254; *see also In re Flag Telecom Holdings*, *Ltd. Sec. Litig.*, 352 F. Supp. 2d 429, 456 (S.D.N.Y. 2005) ("Rule 23 and the PSLRA tend to encourage investors who might otherwise bring lawsuits to refrain from filing a complaint or intervening in an action when those investors feel their interests are adequately protected in a proposed class action that has already been filed"). Requiring investors who are included in the asserted class to file their own lawsuits out of fear that the class may later be

narrowed to exclude their claims would result in "a needless multiplicity of actions – precisely the situation that Federal Rule of Civil Procedure 23 and the tolling rule of *American Pipe* were designed to avoid." *Crown*, *Cork*, 462 U.S. at 351, 103 S. Ct. at 2396; *see also In re Flag Telecom*, 352 F. Supp. 2d at 456 (holding that a newly added plaintiff "should not be punished simply because he failed to anticipate that plaintiff's §12(a)(2) claims would be dismissed because none of the named plaintiffs in the action had standing to sue on those claims").

Moreover, tolling in this case "is in no way inconsistent with the functional operation of a statute of limitations." *American Pipe*, 414 U.S. at 554.[58] As the Second Circuit has stated, "[i]t would not undermine the purposes of statutes of limitations to give the benefit of tolling to ***all those who are asserted to be members of the class for as long as the class action purports to assert their claims***." *WorldCom*, 496 F.3d at 255 (emphasis added). Since the new plaintiffs were "asserted to be members of the class" in the SAC and the class action still purports to assert their claims, Defendants are on notice of the claims and cannot claim any prejudice from the addition of the new plaintiffs at this stage of the case. *See American Pipe*, 414 U.S. at 554 ("The policies of ensuring essential fairness to defendants and of barring a plaintiff who has slept on his rights are satisfied.").[59] Although Defendants raised standing arguments in their previous motions to dismiss, both parties cited numerous cases that supported their positions[60] and the Court never ruled on the motions.

None of Defendants' cases support their argument that *American Pipe* tolling should not apply to the new plaintiffs' claims. This is not a case in which all of the original named plaintiffs

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[58] Defendants argue that the Supreme Court limited its holding in *American Pipe* to cases in which certification was denied for reasons other than standing. Jt. Br. at 3. But the Supreme Court did not hold that tolling would not apply in such a case or limit the application of the tolling doctrine on that basis. *See American Pipe*, 414 U.S. at 533.

[59] Similar policies support granting leave to add the new plaintiffs' claims and relation back of their claims under Rule 15(c)(2). *See, e.g., Slayton v. Am. Express Co.*, 460 F.3d 215, 228 (2d Cir. 2006).

[60] *See* Dkt. No. 160 (Plaintiffs' Opposition) at 8-18; Dkt. No. 137 (Defendants' Motion To Dismiss) at 6-12.

lacked standing to assert any claims, such that the district court never had jurisdiction in the first place.[61] Nor is it a case in which the plaintiffs seek to relitigate the denial of class certification[62] or to add new plaintiffs after the court has granted a motion to dismiss class claims on standing grounds.[63] The new plaintiffs reasonably relied "on the class action to advance their claims." *In re Initial Pub. Offering Sec. Litig.*, 617 F. Supp. 2d 195, 200 (S.D.N.Y. 2007) (holding that *American Pipe* tolling continued after denial of class certification where a narrower class could still be certified).

## IV. THE COMPLAINT STATES CLAIMS UNDER THE EXCHANGE ACT

### A. Legal Standard

To state a claim for a 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

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[61] *See Walters v. Edgar*, 163 F.3d 430, 432-33 (7th Cir. 1998) (affirming denial of motion to add new plaintiffs where the district court dismissed all of the named plaintiffs' claims for lack of standing after trial because "federal jurisdiction never attached"); *Kruse v. Wells Fargo Home Mortg., Inc.*, 2006 WL 1212512, at *4-9 (E.D.N.Y. May 3, 2006) (following dismissal on the merits—affirmed on appeal—of the intervenors' claims, "[t]he question here is precise: when can a district judge hold the doors to the courthouse open for intervenors in an otherwise non-existent lawsuit?").

[62] *See Korwek v. Hunt*, 827 F.2d 874, 879 (2d Cir. 1987) (holding that the Supreme Court "did not intend to afford plaintiffs the opportunity to argue and reargue the question of class certification by filing new but repetitive complaints"). Defendants also cite *In re Colonial Ltd. P'ship Litig.*, 854 F. Supp. 64, 82 (D. Conn. 1994), in which the court misinterpreted *Korwek* to reach its decision that the original plaintiffs' lack of standing did not toll the statute of limitations for other class members. *See In re Flag Telecom*, 352 F. Supp. 2d at 455 n.20; *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 529 F. Supp. 2d 644, 709 (S.D. Tex. 2006).

[63] *See MissPers*, 2010 WL 2175875, at *3 (granting motion to dismiss and denying leave to amend to add new plaintiffs, but neither the issue nor *American Pipe* was raised or briefed by the parties); *In re Crazy Eddie Sec. Litig.*, 747 F. Supp. 850, 856 (E.D.N.Y. 1990) (holding that a class member's individual claims were tolled until the court dismissed those claims on standing grounds, but that he could not be added as representative plaintiff to reassert the claims on behalf of a class); *Palmer v. Stassinos*, 236 F.R.D. 460, 465 (N.D. Cal. 2006) (denying leave to amend to add new plaintiffs at class certification to assert claims that had previously been dismissed on standing grounds). While not relevant to this case, other courts in this district have granted leave to add new plaintiffs and applied *American Pipe* to their claims when there has been a dismissal but no ruling on class certification. *See, e.g., In re Flag Telecom*, 352 F. Supp. 2d at 456; *In re Issuer Plaintiff Initial Pub. Offering Antitrust Litig.*, 2002 WL 31132906, at *3 (S.D.N.Y. Sept. 25, 2002).

fact in connection with the purchase of sale of a security; (2) defendants' scienter; (3) reliance; and (4) resulting damage. *ATSI Commc'n Inc. v. Shaar Fund*, *Ltd*., 493 F.3d at 105. 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).[64] However, "courts should not demand a level of specificity in fraud pleadings that can only be achieved through discovery." *Liberty Ridge LLC v. RealTech Sys. Corp.*, 173 F. Supp. 2d 129, 137 (S.D.N.Y. 2001) (citation omitted).

The PSLRA does not alter the rule that "the motion to dismiss for failure to state a claim is disfavored and is seldom granted." *In re Nortel Networks Corp. Sec. Litig*., 238 F. Supp. 2d 613, 621 (S.D.N.Y. 2003) (internal citations and quotation marks omitted). Instead, at the pleading stage, all factual allegations in the Complaint are to be accepted as true, and all reasonable inferences should be drawn in Plaintiffs' favor.[65] To survive a motion to dismiss, the facts alleged need only "be enough to raise a right to relief above the speculative level." *Twombly*, 550 U.S. at 555, 127 S. Ct. 1965.

### B. The Complaint Raises A Strong Inference Of Scienter

To plead scienter under Rule 10b-5, a plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314, 127 S. Ct. 2499, 2504 (2007). "Since *Tellabs*, the Second Circuit has held that recklessness can suffice to meet pleading requirements for

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[64] *See also In re Parmalat Sec. Litig*., 477 F. Supp. 2d 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.").

[65] *See In re Openwave Sys. Sec. Litig*., 528 F. Supp. 2d 236, 248 (S.D.N.Y. 2007); *see also Tellabs*, *Inc. v. Makor Issues & Rights*, *Ltd*., 551 U.S. 308, 322, 127 S. Ct. 2499, 2509 (2007) (under Rule 12(b)(6) motion, a court must "accept all factual allegations in the complaint as true").

scienter where the complaint sufficiently alleges that the 'defendants: (1) benefited in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information that they had a duty to monitor.'" *In re Pall Corp.*, 2009 WL 3111777, at *6 (E.D.N.Y. Sept. 21, 2009).[66]

Under *Tellabs*, a court must consider plausible opposing inferences in determining whether the pleaded facts give rise to a "strong" inference of scienter. 551 U.S. at 323, 127 S. Ct. at 2509; *see also Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 620 n.14 (S.D.N.Y. 2008). An inference of scienter is strong "if a reasonable person would deem the inference of scienter cogent and ***at least as compelling*** as any opposing inference one could draw from the facts alleged." *Tellabs*, 551 U.S. at 324, 127 S. Ct. at 2510 (emphasis added). In this regard, a court must consider "whether ***all*** of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* at 323 (emphasis in original). The requisite inference of scienter need not be the "most plausible of compelling inferences," nor does it need to be "irrefutable, *i.e.*, of the 'smoking gun' genre." *Id.* at 324. Moreover, a complaint should not be dismissed at the pleading stage if equally strong inferences exist for and against scienter. *Id.* Put otherwise, when evaluating scienter at the pleading stage, "a tie . . . goes to the plaintiff." *Sloman v. Presstek, Inc.*, 2007 WL 2740047, at *7 (D.N.H. Sept. 18, 2007). Plaintiffs' scienter allegations, when measured against this legal landscape, are sufficiently pled under the Exchange Act.

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[66] *See also Chill v. General Electric Co.*, 101 F.3d 263, 269 (2d Cir. 1996) ("[a]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness" sufficient to show scienter) (quoting *Goldman v. McMahan, Brafman, Morgan & Co.*, 706 F. Supp. 256, 259 (S.D.N.Y. 1989)) (ellipsis in original).

### 1. The Sole Purpose Of The Repo 105 Transactions Was To Artificially Reduce Lehman's Net Leverage Ratio

Lehman's Repo 105 transactions were sham transactions, lacking in economic substance, undertaken for the sole purpose of artificially reducing Lehman's net leverage ratio. As set forth in the Complaint, numerous Lehman officers and employees confirmed this fact to the Examiner. *See, e.g.,* ¶148(a) ("[T]he only purpose or motive for the [Repo 105] transactions was reduction in balance sheet" and "[T]here was no substance to the transactions."); ¶148(b) ("[U]nequivocally . . . no business purpose for Lehman's Repo 105 transactions existed other than obtaining balance sheet relief."); ¶148(d) (Repo 105 transactions intended to "reverse engineer" Lehman's net leverage ratio for its publicly filed financial statements.); ¶148(g) ("[N]o business purpose existed for Repo 105 transactions other than to reduce Lehman's net balance sheet."); ¶149 ("[I]t was universally accepted throughout the entire institution that Repo 105 was used for balance sheet relief at quarter end."); *Id.* ("[Repo 105] is basically window-dressing. We are calling repos true sales based on legal technicalities."). Even Herbert McDade, III, Lehman's "Balance Sheet Czar," explained that Lehman used Repo 105 transactions in situations where the Company needed to sell "sticky" assets in order to make balance sheet goals, but was unable to do so; the transactions allowed Lehman to remove "certain inventory temporarily through Repo 105 transactions while allowing other inventory to remain on the balance sheet." *See* E.R. at 815-16.[67]

Lehman's use of Repo 105 transactions for this purpose was well known at the highest levels of the Company. ¶206. Defendant Callan had conversations with Lehman's Global Financial Controller Martin Kelly in which Kelly discussed his discomfort with the Repo 105

[67] McDade was named "Balance Sheet Czar" in March 2008 and tasked with becoming the "point person for the firm's Executive Committee relative to the use of balance sheet and capital." E.R. at 807. He immediately undertook a campaign to end Lehman's dependence on Repo 105 transactions to meet quarterly balance sheet targets (*e.g., id.* at 814-16), which he referred to as "another drug we r on" (E.R. at 860) and, as set forth above, admits its improper use.

transactions for at least the following reasons: (1) "reputational risk" if the public learned what Lehman used the transactions for; (2) the volume of quarter-end Repo 105 transactions taken to reduce the balance sheet; (3) the "technical basis" by which Lehman was purportedly authorized to engage in Repo 105 transactions; (4) that none of Lehman's peer investment banks used Repo 105 transactions; and (5) the fact that Lehman's Repo 105 activity was "skewed at quarter-end." E.R. at 930-31. Callan also received a "Daily Balance Sheet and Disclosure Scorecard" that had "frequent" references to Repo 105 (¶212), and she served on Lehman's Executive Committee (¶11), which met on March 28, 2008, to discuss, *inter alia*, reducing the Company's reliance on Repo 105. E.R. at 814.[68]

Defendant O'Meara, who actively managed Lehman's Repo 105 program from the start of the Class Period to December 1, 2007, was charged with setting Repo 105 limits during that time, and was responsible for the requirement that Repo 105 "be maintained at approximately 80% of the amount at month-end." ¶¶207, 212.[69] He was also responsible for reporting "the impact of the [Repo 105] transactions on Lehman's balance sheet and the purpose for engaging in these transactions" to his superiors, including Fuld, Gregory, Lowitt and Callan (¶207); received a "Daily Balance Sheet and Disclosure Scorecard" that had "frequent" references to Repo 105 (¶212); and received, in May 2008, an email noting that Citigroup and JPMorgan did not use Repo 105 and that Repo 105 explained Lehman's period-end balance sheet fluctuations. *Id*.

Defendant Fuld had discussions with McDade in June 2008 about Lehman's Repo 105 transactions, and had previously received an agenda for an Executive Committee Meeting in

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[68] Attendance at meetings where the problems at issue are directly discussed evidences scienter. *Freudenberg*, 2010 WL 1904314, at *24-25 (citing *Akerman v. Arotech Corp.*, 608 F. Supp. 2d 372, 387 (E.D.N.Y. 2009) (same); *In re Moody's Sec. Corp. Litig.*, 599 F. Supp. 2d 493, 515 (S.D.N.Y. 2009) (same).

[69] *See*, *e.g*., *In re Scottish Re Group Sec. Litig*., 524 F. Supp. 2d 370, 394 (S.D.N.Y. 2007) ("It is simply not a plausible opposing inference that the Company's officers – sophisticated executives actively engaged in the planning of these transactions – were ignorant of the transactions' consequences . . . .").

March 2008 to discuss "freezing" Lehman's Repo 105 program for which the list of topics included "Repo 105/108" and "Delever v Derisk," along with a presentation that referenced Lehman's $49.1 billion quarter-end Repo 105 usage for the first quarter 2008. Incredibly, the Insider Defendants contend that these allegations do not suffice to establish Fuld's knowledge because "Plaintiffs cite to no documents that corroborate such purported discussions [with McDade]," McDade's statements that Fuld was aware of Repo 105 transactions "reflect McDade's state of mind, not Fuld's . . . ." and "Fuld is not alleged to have read th[e March 2008] agenda . . ." Jt. Br. at 41.[70] This is nonsense. *See In re Ambac Fin. Group*, 2010 WL 727227, at *34 (an inference of scienter can be drawn when information is contained in key internal documents that contradict public statements). The fact that McDade unequivocally said that Fuld knew about Repo 105 is sufficient in and of itself to establish Fuld's scienter at the pleading stage. Further, Fuld has admitted to being focused on balance sheet and net leverage reduction in 2008. The sheer size and importance of Repo 105 transactions to Lehman's balance sheet at each quarter-end gives rise to a strong inference that Fuld (and the other Insider Defendants) knew about their existence, the effect they had on artificially reducing net leverage ratios, and that Lehman failed to disclose the outstanding repurchase obligations at quarter-end. *See In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 628 (S.D.N.Y. 2005) (information important to a company's business "may be properly ascribable to senior officers") (citation omitted).

Defendant Lowitt was "quite familiar" with Lehman's use of Repo 105 transactions to reduce its balance sheet at quarter-end and "understood [the] details" of the program by the time he became CFO in June 2008. *See* ¶209; E.R. at 1021. He also received reports concerning Lehman's Repo 105 program as a member of Lehman's Asset Liability Committee, which

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[70] In June 2008, McDade walked Fuld through Lehman's Balance Sheet and Key Disclosures document, and discussed with Fuld Lehman's quarter-end Repo 105 usage – $38.6 billion at year-end 2007; $49.1 billion at 1Q08; and $50.3 billion at 2Q08. E.R. at 821. Based upon their conversation, McDade understood that Fuld "was familiar with the term Repo 105," (*id.*) and "knew, at a basic level, that Repo 105 was used in the firm's bond business" and "understood that [reduction of Repo 105 usage] would put pressure on traders." (E.R. at 920-21).

included unsuccessful attempts to place real estate securities into the Repo 105 program. E.R. at 1021.[71] As Lehman's CFO, Lowitt knew of Repo 105 transactions and that Lehman omitted any discussion of their existence or the undisclosed repurchase obligation when he signed SOX certifications for the 2008 second quarter 10-Q. He also omitted any reference to the $50 billion in Repo 105 transactions when attributing the causes of net leverage ratio reductions during the June 16, 2008 conference call. ¶195. Only later, after Lehman's bankruptcy, did Lowitt admit that "Lehman used the transactions to meet balance sheet targets." ¶¶149, 212.

Finally, Defendant Gregory received materials related to Lehman's use of Repo 105 transactions to manage its balance sheet at a special meeting requested by McDade on March 28, 2008, the purpose of which was to obtain Gregory's "blessing in freezing Lehman's Repo 105 usage," (¶210) and specifically recalled discussing Repo 105 with Executive Committee members at the March 28, 2008 meeting. *See* E.R. at 814. He also assisted in setting balance sheet targets for Lehman as of March 2008 frequently checked with division heads in mid-2008 regarding their progress in meeting those balance sheet targets, and thereby gained knowledge of how undisclosed Repo 105 transactions affected Lehman's individual businesses and its net leverage ratios. E.R. at 812-13, 817.

The Insider Defendants' *ipse dixit* assertion that the most plausible inference from these facts is that the Insider Defendants held "an honest belief that the [Repo 105] transactions were legal, as well as accounted for and disclosed in accordance with GAAP, and were legitimate sales transactions for business units to obtain funding to stay within their balance sheet targets" can be swiftly rejected. Jt. Br. at 39. The Insider Defendants repeatedly omitted to disclose

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[71] Lowitt was informed by John Ferraca, Lehman's Head of Secured Funding of the volume of Repo 105 transactions with specific counterparties at the close of the first quarter 2008. He admits that at the close of the first quarter 2008 he attempted to gauge the materiality of Lehman's Repo 105 usage and asked Feraca for information to determine whether Lehman was increasing its Repo 105 activity, and was told during the second quarter of 2008 that Lehman's intra-quarter balance sheet increase of $95 billion in FID's rates business was due, in part, to a $22.4 billion reduction in Repo 105 since quarter-end. *See*, *e.g.*, E.R. at 1021-24.

either the existence of the Repo 105 transactions or their impact on Lehman's net leverage ratio in Lehman's SEC filings or during conference calls, even when responding to specific questions about how Lehman lowered its net leverage ratio. ¶¶190-93. There is a simple reason for this: disclosing the Repo 105 transactions would have eliminated their utility. As the Examiner observed, "***In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public***." E.R. at 853 (emphasis added). Such concealment raises a strong inference of scienter.[72]

Likewise, the Insider Defendants' contention that "[s]etting balance sheet targets is not evidence of scienter," and that "[i]t is normal business practice for financial firms to allocate their balance sheet capacity among their various business units," is meritless.[73] Defendants provide no plausible explanation for how temporary quarter-end Repo 105 transactions legitimately shifted balance sheet capacity for anything other than deceptive appearances. Moreover, Defendants did not use Repo 105 transactions to "set limits," but as a device to artificially lower the size of Lehman's balance sheet. *See* ¶¶147-151. As exemplified in a February 2007 internal Lehman document, "[e]xiting large CMBS positions in Real Estate and subprime loans in Mortgages before quarter end would incur large losses due to the steep discounts that they would have to be offered at and carry substantial reputation risk in the market. . . . A Repo 105 increase would help avoid this without negatively impacting our leverage ratios." In reality, Repo 105 transactions did not involve enforcing balance sheet limits

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[72] *See SEC v. Guenthner*, 212 F.R.D. 531, 534 (D. Neb. 2003) ("[D]efendants' attempt[] to conceal their activities raises the inference that they knew the activities were wrong. All of these allegations give rise to an inference of at least recklessness, if not a greater level of culpability."); *SEC v. Shanahan*, 2008 WL 5211978, at *5 (E.D. Mo. Dec. 12, 2008) (same); *Pozniak v. Imperial Chem. Indus. PLC*, 2004 WL 2186546, at *7 (S.D.N.Y. Sept. 24, 2004) (defendants' concealment of fact and affirmative statements to the contrary gives rise to a strong inference of deliberate or reckless misrepresentation); *Pathfinder Mgmt. v. Mayne Pharma PTY*, 2008 WL 3192563, at *12 (D.N.J. Aug. 5, 2008) ("acts of concealment and statements of fraudulent intent are sufficient to demonstrate a strong inference of scienter").

[73] Jt. Br. at 37. While Defendants cite to the Examiner's Report, they omit the next sentence, which states: "[B]alance sheet management done in a way that materially misrepresents the true financial position of the company, can, however, give rise to a colorable claim." E.R. at 823, n.3166.

on business units, as the Insider Defendants now contend, but rather, involved making Lehman's balance sheet appear stronger and better able to absorb losses in the deteriorating real estate market.

In addition, the unusual timing of Lehman's Repo 105 transactions completely undercuts any purported non-culpable inference that the Insider Defendants attempt to construct. Repo 105 transactions spiked at quarter-end and fell dramatically in the days thereafter, a pattern evincing manipulation for reporting purposes.[74] What is more, recognizing that such end-of-quarter activity would arouse suspicions, Lehman implemented policies designed to smooth such fluctuations by mandating that the amount of "Repo 105 transactions must be executed on a continual basis and remain in force throughout the month . . . . To meet this requirement, the amount outstanding at any time should be maintained at approximately 80% of the amount at month-end." ¶212; E.R. at 870-72. Euphemistically referred to as the "continuous use" rule or "80/20" rule, the policy was designed to minimize reported end-of-period Repo 105 fluctuations and thereby mask their true purpose.[75] As the Examiner noted,

> If Repo 105 transactions made good business sense on their own, there would be no apparent reason to arbitrarily restrict the amount of such transactions to 1x leverage or to impose intra-month limits to ensure that the amount of the transactions at reporting periods did not spike to more than 120% of average usage. ***No reason, that is, except to keep the transactions under the radar, by limiting their total and the amount of a quarter-end spike.***

E.R. at 873 (emphasis added).

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[74] ¶¶150-51. For example, as the close of the first quarter of 2008 approached, Lehman's Repo 105 usage increased from $24.217 billion on February 15, 2008, to $31.029 billion on February 22, 2008, to $40.003 billion on February 28, 2009; and then jumped to $49.102 billion on February 29, 2008 (quarter-end). Similarly, at the end of the second quarter of 2008, Repo 105 transactions exceeded $50 billion, whereas the intra-quarter dip as of April 30, 2008, was approximately $24.7 billion, and had been as low as $12.75 billion on March 14, 2008. ¶150.

[75] In fact, and despite Defendants' assertion that "Lehman strictly enforced the Accounting Policy for Repo 105 transactions" (Jt. Br. at 38), Lehman did not actually follow these self-imposed rules. *See* E.R. at 873. According to the Examiner, "That is not surprising, since no witness was able to explain a business rationale for the arbitrary 1x leverage, continual use, and 120% rules." E.R. at 873.

Finally, any notion that the Insider Defendants had an honest belief that the Repo 105 transactions were "legitimate" is undercut by the costs of Repo 105 transactions. They were more expensive than ordinary repos collateralized by the same assets. ¶¶36, 215. Counterparties charged higher interest than they would for ordinary repo loans. ¶215; E.R. at 880-82. By definition, the Repo 105 transactions required larger collateral "haircuts," providing counterparties with 5%-8% over-collateralization, as opposed to 2% over-collateralization used in ordinary repos. E.R. at 767. In addition to requiring a larger "haircut," Repo 105 transactions were far more complicated than ordinary repos as they involved shifting assets to LBIE, recording derivatives for the overcollateralization, executing intercompany transfers and recording related eliminations. *See* E.R. at 877-882 (citing high costs of Repo 105 relative to ordinary repos). As the Examiner explained:

> Nothing prevented Lehman from engaging in a traditional overnight repo transaction . . . . ***The more expensive route was taken because the traditional repo transaction would not have provided Lehman the balance sheet benefit that Repo 105 transactions provided to the firm – namely, Repo 105 transactions enabled Lehman to reverse engineer its externally reported net balance sheet and net leverage ratio for public consumption.***

E.R. at 877-78 (emphasis added).[76]

The Insider Defendants further claim that they are insulated from liability because co-defendant E&Y "vetted" the transactions is fundamentally flawed. E&Y's Lehman engagement partner, William Schlich, stated that E&Y did not approve Lehman's Repo 105 accounting policy and that it assessed Lehman's understanding of FAS 140 only "in the abstract" and did not

[76] The Insider Defendants' claim that Lehman used Repo 105 in lieu of outright asset sales because they were more lucrative is a red herring. *See* Jt. Br. at 38-39 (citing E.R. Appx. 17 at 32). The relevant question is not whether Repo 105 deals were preferable to outright asset sales, but whether there was any legitimate reason to use Repo 105 transactions ***over ordinary repo transactions for financing***. The Insider Defendants do not attempt to refute the Complaint's allegations in this regard.

opine on Repo 105 as a "balance sheet management tool." E.R. at 949-50. Moreover, the Insider Defendants' attempts to rely on the existence of the so-called "true sale" opinion from a foreign law firm merely raises issues of fact that are not appropriate for determination on a motion to dismiss. *See, e.g., Dougherty v. Town of N. Hempstead Bd. of Zoning Appeals,* 282 F.3d 83, 92 (2d Cir. 2002). Tellingly, the foreign law firm was asked to provide its opinion ***only after*** Lehman found itself unable to obtain a true sale opinion from a U.S. law firm, or under U.S. law. The fact that Lehman was unable to get a true sale opinion from any law firm in this country is highly probative of scienter. *See SEC v. Alexander*, 2004 WL 1468528, at *10 (S.D.N.Y. June 28, 2004) (complicated and multi-faceted nature of the scheme to defraud . . . indicate a high degree of scienter).

### 2. E&Y Ignored Glaring "Red Flags"

E&Y was specifically informed about Lehman's use of Repo 105 transactions on several occasions, and E&Y "was made aware that [Lehman's] financial information may be materially misleading because of the failure to disclose the effect and timing and volume of Lehman's Repo 105 activities." ¶226. Consciously disregarding red flags raises an inference of scienter against an auditor.[77]

Here, the Complaint alleges in detail how Lehman failed to disclose approximately $38.6 billion of repurchase obligations at 2007 fiscal year-end. The true purpose behind the Repo 105 transactions, and the failure to disclose the year-end obligation, would not have taken an

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[77] *See In re Winstar Comm'cns*, 2006 WL 473885, at *11-12 (S.D.N.Y. Feb. 27, 2006) ("Red flags" including pattern of "suspicious [end-of-quarter] transactions" and where company "sought [auditor's] professional advice regarding the manner in which to account for the bogus transactions" were sufficient to support strong inference of auditor's scienter.); *Varghese v. China Shenghuo Pharm. Holdings, Inc.*, 672 F. Supp. 2d 596, 610-611 (S.D.N.Y. 2009) (auditor's awareness of ongoing problems and its deliberate disregard of red flags were sufficient to plead strong inference of scienter); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 379 (S.D.N.Y. 2006) (litany of "red flags" concerning suspicious transactions, such as a pattern of significant end-of-quarter transactions sufficient to allege scienter); *Whalen v. Hibernia Foods PLC*, 2005 WL 1799370, at *4 (S.D.N.Y. Aug. 1, 2005) ("[W]hen all the 'flags' are run up the same pole, it seems inescapable that a reasonable auditor was on notice, and acted recklessly when it disregarded all the 'flags.'").

especially keen or skeptical eye from E&Y to discover. On the contrary, anyone with access to Lehman's internal financial records could (and would) have recognized that Lehman's financial statements materially misrepresented Lehman's financial condition, specifically its net leverage ratio. Indeed, with the same access to information that E&Y had, the Examiner became aware of Lehman's Repo 105 off-balance obligation as part of his "investigation of internal Lehman audits of risk management controls." E.R. at 764. *Argent Classic Convertible Arbitrage Fund L.P.*, 315 F. Supp. 2d at 686 ("[t]hese flaws were so obvious that an outside consultant identified some "[i]n a matter of days"). Based on interviews of Lehman employees and a review of Lehman's financial records, the Examiner determined that because "Lehman did not disclose the accounting treatment of these transactions, [it] rendered Lehman's Forms 10-K and 10-Q (financial statements and MD&A) deceptive and misleading." E.R. at 913, n.3497. Had E&Y not ignored glaring "red flags" – that if properly investigated would have alerted it to the improper manipulation of Lehman's balance sheet and the 2007 year-end repurchase obligation – it would have reached a similar conclusion.

These red flags included (1) warnings from Matthew Lee, a whistleblower who was the Senior Vice President in the Finance Division ***in charge of Global Balance Sheet and Legal Entity Accounting*** (¶229); (2) E&Y's awareness of, and use of, a "Netting Grid" which identified and described Lehman's Repo 105 transactions (¶227; E.R. at 951); and (3) E&Y's knowledge that Lehman was unable to receive a "true sale" opinion from any U.S. law firm regarding Repo 105 transactions (and thus had turned to a foreign law firm to obtain a so-called "true sale" opinion under foreign law). ¶228. These facts, and others described *infra*, presented E&Y with strong warnings. Instead of properly investigating, which would have revealed Lehman's failure to include tens of billions of dollars in Repo 105 commitments in its financial footnotes, E&Y deliberately turned a blind eye and affirmatively withheld information from Lehman's Audit Committee.

**a) The Whistleblower Warnings**

On June 12, 2008, Matthew Lee, the Senior Vice President in charge of Lehman's Global Balance Sheet and Legal Entity Accounting, was interviewed by E&Y concerning his allegations of financial impropriety at Lehman. ¶230. Prior to that meeting, the Audit Committee specifically instructed E&Y to report back on any allegations of financial improprieties raised by Mr. Lee. In that meeting, Lee specifically told E&Y about Lehman's Repo 105 practice, including the enormous volume of Repo 105 activity that Lehman engaged in at quarter-end. *Id.* Lee specifically noted that Lehman had just moved $50 billion of inventory off its balance sheet using Repo 105 transactions at the end of the second quarter of 2008. *Id.* Notwithstanding the requirements of GAAS, and the explicit instruction of the Audit Committee, E&Y neither informed the Audit Committee of the allegations, nor took any steps to investigate Lee's assertions. E&Y's failure to do so is overwhelming evidence of its scienter.[78]

In response to Lee's admissions, E&Y was, at a minimum, required under GAAS to conduct a bona fide investigation of Lee's allegations, make inquiries, perform additional tests, and inform management and the audit committee of the issue. *See* AU § 316.79 ("Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential . . . . Fraud involving senior management and fraud . . . that causes a material misstatement of the financial statements should be reported directly to [the

[78] E&Y's contention that these allegations, made by a senior corporate officer, were not red flags (E&Y Br. at 23-25) is absurd, and contrary to the law. *See In re AOL Time Warner, Inc. Sec. Litig.,* 381 F. Supp. 2d 192, 240 (S.D.N.Y. 2004) (complaint pled E&Y's scienter by alleging GAAS and GAAP violations, as well as fact that E&Y ignored end-of-quarter transactions and repeated, large-magnitude transactions lacking in substance, both red flags as to company's fraud). E&Y's reliance on *Nappier*, 227 F. Supp. 2d 263, for the proposition that red flags must be closer to a "smoking gun," is misplaced. *Nappier* is distinguishable because there the plaintiffs did not allege that the auditor actually saw documents, but, instead, alleged that PwC "must have known" about its client's fraudulent practices by virtue of its role as auditor. *Id.* at 276. In any event, it is difficult to imagine a more probative fact than being told by the senior officer responsible for global balance sheet accounting that Lehman was shifting tens of billions of dollars of assets off its balance sheet for reporting purposes.

audit committee]").[79] Instead, E&Y turned a deaf ear and purposefully ignored the Audit Committee's request to be kept informed of the accusations. William Schlich, E&Y's audit engagement partner, met with Lehman's Audit Committee on June 13, 2008, just one day after Schlich interviewed Lee. ¶230. The purpose of the meeting was to provide the Audit Committee with an update on the Lee investigation. The Audit Committee specifically asked to be told about each allegation, yet Schlich did not inform the committee about Lee's Repo 105 accusations. ¶231; E.R. at 959.[80] Then, on July 22, 2008, Schlich attended an Audit Committee presentation by Lehman's Head of Corporate Audit regarding the Company's investigation into Lee's whistleblower allegations.[81] When an internal audit presented the results of the investigation into each of the accounting related claims that Lee raised in his whistleblower letter, Schlich again remained silent about the Repo 105 accusations, even though several Audit Committee members later told the Examiner that they would have expected to have been told about the allegations. E.R. at 960. *See SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d. 708, 717 (D.N.J. 2005) ("[C]ommon sense dictates that actions taken after the fraud occurred can be circumstantial evidence that the defendant had acted with the requisite state of mind. As an example, that a person takes certain steps to cover up a misdeed is certainly relevant evidence that the person knew he had made a mistake").

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[79] *See also* AU § 317 (if auditor becomes aware of possible violations of laws of regulations which may have a direct or indirect effect on the financial statements, he or she must make inquiries, perform additional tests, and inform management and the audit committee of the issue); *In re Allou Distribs., Inc.*, 395 B.R. 246, 272-73 (Bankr. E.D.N.Y. 2008) (finding that auditing firm committed malpractice by failing to report suspicious circumstances and material discrepancies to the audit committee).

[80] E&Y met with the Audit Committee again on July 8, 2008, to review the second quarter financial statements, and again failed to mention Lee's allegations regarding Repo 105. ¶231; *see also* E.R. at 959-60.

[81] Lee's May 16, 2008 whistleblower letter contained numerous accounting allegations, including that Lehman had "tens of billions of dollars in unsubstantiated balances, which may or may not be 'bad' or non-performing assets or real liabilities"; and that Lehman had tens of billions of dollars or illiquid inventory and did not value its inventory in a "fully realistic or reasonable" way. When Schlich and Hansen interviewed Lee on June 12, 2008, Lee specifically identified Repo 105 transactions. *See* E.R. at 1034, n.3913.

Even though Lee later described to the Examiner that the Repo 105 transactions were intended to "reverse engineer" its net leverage ratio, E&Y remarkably contends that "Lee is not alleged to have stated that the accounting or disclosures for Repo 105 transactions were improper. E&Y Br. at 25; *compare* ¶148(d). Even assuming that Lee did not make any accusations about the *impropriety* of Repo 105 transactions to E&Y – an inference that is particularly implausible given his whistleblower letter and comments to the Examiner – it would certainly have put E&Y on notice of, at a minimum, Lehman's failure to disclose in its financial statements the tens of billions of dollars of outstanding repurchase agreements, which E&Y was required to bring to the attention of the Audit Committee.

**b) <u>Lehman's Netting Grid</u>**

Lehman's Netting Grid identified and described various balance sheet netting mechanisms employed by Lehman, including Repo 105. *See* ¶227; E.R. at 951. E&Y used the Netting Grid in its audit. *Id.* Schlich told the Examiner that E&Y "as part of its review of Lehman's Netting Grid, approved of Lehman's internal Repo 105 Accounting Policy only, and did not pass upon the actual practice." E.R. at 952.

E&Y's contention that "nothing in the grid indicated that the underlying accounting for these transactions was wrong in any way" (E&Y Br. at 24) is belied by the information contained therein about the suspicious volume and timing of the transactions. The Netting Grid discloses almost $30 billion in Repo 105 transactions for February 28, 2007, and almost $25 billion for November 30, 2006, two of the largest entries by dollar amount in the entire document. *See* Ex. 16 to Turner Decl., at 26. Schlich told the Examiner that E&Y did not test the Netting Grid's stated conclusion that "current practice [for Repo 105] is correct," but instead merely "reviewed how Lehman applied the control provisions of the accounting rules." E.R. at 953. Rather than simply accept the client's bald representation, where there are entries amounting to tens of billions of dollars occurring at the end of accounting periods that have an impact on the reported financial results, an independent auditor must investigate. *See* ¶237 (citing General Standard No.

3 and AU § 230, *Due Professional Care in the Performance of Work*, requiring E&Y to exercise "due professional care" and "professional skepticism" in its quarterly reviews and annual audit of Lehman's Class Period financial results).

E&Y's review of the Netting Grid alerted it to the magnitude of the Repo 105 program, and put the firm on notice that Repo 105 had a potentially material impact upon Lehman's balance sheet. *See* ¶239 ("GAAS also requires an auditor to sufficiently assess audit risk, defined as 'the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.' AU § 312.02 . . . . In assessing audit risk, AU § 312 and AU § 722 require analytical procedures be performed especially when an auditor becomes aware of information leading it to question whether the company's financial results comply with GAAP, or if/when it otherwise believes that audit risk is too high, and that particular attention be paid to materiality."). The Netting Grid should have alerted E&Y that Lehman increased Repo 105 transactions at the end of reporting periods – itself a significant red flag – yet again, E&Y turned a blind eye.

#### c) Lehman's Inability To Obtain A "True Sale" Opinion From Any U.S. Law Firm

Lehman's Repo 105 Accounting Policy, which E&Y reviewed only "theoretically" in becoming "comfortable" with the transactions (E.R. at 949), relied upon a so-called "true sale" opinion from the UK law firm Linklaters to purportedly satisfy the "sale" treatment in view of the technical requirements of FAS 140. ¶65. E&Y was aware that no U.S. law firm would provide such an opinion. *Id.* In fact, Martin Kelly, Lehman's Global Financial Controller, told the Examiner that he specifically discussed Repo 105 and the fact that Lehman could not obtain a true sale opinion under U.S. law for Repo 105 transactions with William Schlich on December 1, 2007. ¶228.

Contending that the Linklaters letter was not a red flag, E&Y attempts to make a *post hoc* justification for use of a UK opinion that is outside the record and contradicted by the well-pled allegations. E&Y Br. at 24. Lehman did not use a UK law firm because it had operations in the

UK; rather, no U.S. firm would give Lehman the "true sale" opinion. E&Y further argues that "[e]ven the Examiner has not questioned the legal opinion Lehman received from the Linklaters law firm in the UK . . . ." E&Y Br. at 24. Nonetheless, Schlich told the Examiner that E&Y never reviewed the Linklaters letter. E.R. at 950 & n.3665. Indeed, the Examiner concluded "Ernst & Young solely assessed Lehman's understanding of the requirements of SFAS 140 in the abstract and as reflected in its Accounting Policy; Ernst & Young did not opine of the propriety of the transactions as a balance sheet management tool." E.R. at 949-50. Consequently, E&Y could not have reached an informed conclusion regarding whether any individual Repo 105 transaction satisfied SFAS 140's true sale requirement.

Moreover, E&Y's failure to review the Linklaters letter – evidential matter necessary for its analysis under FAS 140 – further supports a strong inference of scienter. *See* ¶240 ("AU §§ 336 and 9336 address an auditor's use of a legal opinion as evidential matter supporting, for instance, a management assertion that a financial asset transfer meets the isolation criterion in FASB 140. AU § 9336 states that a legal letter that includes conclusions using certain qualifying language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of FAS . . . . [T]he Linklaters opinion [was] replete with the kinds of qualifying statements discussed as examples in AU § 9336 . . . .").

In light of the foregoing, the Complaint alleges numerous red flags that put E&Y on notice of the material misrepresentations contained in Lehman's financial statements with respect to the undisclosed Repo 105 commitments at the end of fiscal 2007, and at each quarter-end during the Class Period.

### 3. The Insider Defendants Were Aware That Lehman Exceeded Its Stated Risk Policies

Even a cursory reading of the Complaint establishes each Officer Defendant's scienter with respect to the false statements regarding risk management. In addition to the fact that each and every one of the Insider Defendants sat on the committee that approved or executed each of

the stated risk management limit violations,[82] Plaintiffs have alleged that Defendants had access to information concerning those violations and were specifically tasked with ensuring that Lehman did not exceed its risk limits. ¶216. For example, Plaintiffs have specifically alleged that the Executive Committee – including Fuld (Chair), Gregory, O'Meara, Callan, and Lowitt (during their respective tenures as CFO) – actually established Lehman's overall risk limits and risk management policies and that Lehman's Risk Committee, which expressly included the Executive Committee as set forth in the 2007 10-K, reviewed "our risk exposures, position concentrations and risk-taking activities" on a weekly basis; determined "overall risk limits and risk management policies, including establishment of risk tolerance levels;" reviewed the firm's "risk exposures, position concentrations and risk-taking activities on a weekly basis, or more frequently as needed;" and allocated "the usage of capital to each of our businesses and establishes trading and credit limits for counterparties with a goal to maintain diversification of our businesses, counterparties and geographic presence." *See,* 2007 10-K at 69 (Chepiga Decl. Ex. 8).[83]

Furthermore, Plaintiffs have alleged that the Company's Global Risk Management Group disclosed information regarding risk appetite to senior management, creating a weekly "Firm Wide Risk Snapshot" report, which contained "Risk Appetite limits and usage by business unit"

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[82] According to Lehman's filings, the Risk Committee reviewed Lehman's risk exposure, concentrations and risk taking activities on a weekly basis. *See*, *e.g.*, 2007 10-K at 69 ("The Risk Committee, which includes management's Executive Committee, the Global Head of Risk Management and certain other members of senior management, reviews our risk exposures, position concentrations and risk−taking activities on a weekly basis, or more frequently as needed") (Chepiga Decl. Ex. 8); 1Q08 10-Q at 77 (same) (Chepiga Decl. Ex. 9); 2Q08 10-Q at 94 (same) (Chepiga Decl. Ex. 10).

[83] According to Callan, the Executive Committee addressed "any risk that passes a certain threshold, any risk that we think is a hot topic" and "anything else during the course of the week that's important." Further, Callan stated that the Executive Committee was "intimately familiar with the risk that we take in all the different areas of our business. And [Fuld] in particular . . . keeps very straight lines into the businesses on this topic." ¶¶221-22.

and summarized "VaR by business unit and Top Market Risk positions."[84] In addition, Lehman circulated a "Daily Risk Appetite and VaR Report" to upper management, which included a cover e-mail detailing the firm's overall daily risk appetite and VaR usage figures and the day-over-day change in those figures. The Risk Committee also received the "Firm-wide Risk Drivers" report, which contained detailed information regarding the firm's aggregated risks, reflected firm-wide risk appetite and VaR usage data, and explanations regarding week-over-week changes in the data. As a result, it is difficult to comprehend how Defendants can credibly argue that Plaintiffs have failed to allege how Defendants knew or recklessly disregarded that their statements regarding risk management were materially false and misleading when made. In fact, Fuld and Gregory made the deliberate decision to disregard risk limits over the objection of members of Lehman's management, including Alex Kirk, then head of Lehman's Credit Business, and Madelyn Antoncic, then Lehman's Chief Risk Officer. ¶217.

The Examiner's conclusions further support a strong inference of scienter. As the Examiner found:

> Lehman was significantly and persistently in excess of its own risk limits. ***Lehman management decided to disregard the guidance provided by Lehman's risk management systems.*** Rather than adjust business decisions to adapt to risk limit excesses, management decided to adjust the risk limits to adapt to business goals.

¶162. Further, the Examiner also found that Lehman's management, *inter alia*: ***chose*** to disregard or overrule the firm's risk controls ***on a regular basis***; ***decided*** to exceed risk limits with respect to Lehman's principal investments, namely the "concentration limits" on Lehman's leveraged loan and commercial real estate businesses, including the "single transaction limits" on the leveraged loans; ***excluded*** certain risky principal investments from its stress tests; and

[84] VaR is a statistical measure of the potential loss in the fair value of a portfolio due to adverse movements in underlying risk factors. *See* 2007 10-K at 70 (Chepiga Decl. Ex. 8).

***decided*** to treat primary firm-wide risk limit – the risk appetite limit – as a "soft" guideline. ¶163. All of these allegations involve knowing activity or conscious disregard by the Insider Defendants that their statements regarding risk management were materially false and misleading.[85]

Rather than address Plaintiffs' detailed scienter allegations, the Insider Defendants instead invoke a broad reading of the business judgment rule and assert that their risk excesses were not "reckless or irrational." Jt. Br. at 42. The business judgment rule cannot excuse materially misleading statements in SEC filings, press releases and investor conference calls.[86] Here, the routine and systematic exposure to levels of risk (*see* ¶¶70-84) that far exceeded any semblance of compliance with Lehman's stated risk policies and limits is hardly excusable under some notion of business judgment.[87]

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[85] The Insider Defendants contend that the Examiner's Report exonerates them with respect to their risk management statements. Jt. Br. at 42. Not so. Although the Examiner found that Lehman's management did not breach its fiduciary duties to the Board under Delaware law, the disclosure requirements under the federal securities laws to public investors are far different. Here, Defendants specifically talked about, and misrepresented, its risk management practices to investors. This misconduct is actionable under the securities laws.

[86] *See*, *e.g*., *In re Sadia*, 643 F. Supp. 2d at 532, in connection with allegations that defendants entered into currency hedging contracts that exceeded Sadia's internal hedging policy, the court found:

> there is considerable authority for the proposition that a company's failure to follow an internal policy can form the basis for an inference of recklessness Additionally, *In re Citigroup, Inc*. *Securities Litigation*, upon which Sadia relies, is distinguishable from the case at bar because Sadia's alleged failure to adhere to Company policy was intended to deceive its own shareholders, not investors in the securities of other companies.

*Id.* at 532 (citing *Scholastic Corp.*, 252 F.3d at 77, and *Novak*, 216 F.3d at 311).

[87] *Cf. Moody's*, 599 F. Supp. 2d 493, 509-10 (S.D.N.Y. 2009) (Moody's disclosures concerning its internal ratings methodologies were false because the Company was disregarding an important component of its stated methodologies at the time statements were made; "Plaintiffs have provided ample allegations to demonstrate the Company's scienter. They have alleged specific statements indicating that various top officials knew that Moody's independence, ratings, and methodology had been comprised. Consequently, the allegations of the AC sufficiently plead Moody's scienter."); *In re Dynex Capital, Inc. Sec. Litig*., 2009 WL 3380621, at *8 (S.D.N.Y. Oct. 19, 2009) ("At some point, statements by a defendant that it "generally" adheres to a particular policy become misleading when in fact there is no such policy or the policy is something else altogether…. [T]he SAC sufficiently alleges that the Underwriting Statements are misleading to the extent that they claim that some standards pertaining to borrower documentation or creditworthiness were followed when in fact such requirements were regularly or routinely disregarded or were based upon falsified loan documentation.").

### 4. The Insider Defendants Were Aware Of Lehman's Undisclosed Liquidity Risks

The Insider Defendants contend that scrutiny by the FRBNY, SEC and Office of Thrift Supervision ("OTS"), starting in March 2008 (nine months after the start of the Class Period), somehow "negates any inference that Lehman tried to misrepresent the estimated value of the liquidity pool during the Class Period." Jt. Br. at 48-49. However, in testimony to the U.S. House of Representatives (cited by Defendants (*see* Jt. Br. at 48, n.91)), SEC Chairman Mary Schapiro said:

> As discussed in the Examiner's Report, it appears that Lehman did not fully report to the Commission significant changes affecting assets in its liquidity pool in the period leading up to Lehman's bankruptcy.

*See* Chepiga Decl. Ex. 46, at 7. Further, as the Examiner explained in his Congressional testimony:

> In June 2008, one of Lehman's clearing banks, Citibank, required that Lehman post $2 billion as a "comfort deposit" as a condition for Citi's continued willingness to clear Lehman's trades. Lehman was technically free to withdraw the deposit, but it could not do so as a practical matter without shutting down or disrupting the business it ran through Citi. Later in June, Lehman posted $5 billion of collateral to JPMorgan, Lehman's main clearing bank, in response to an earlier demand by JPMorgan. Lehman continued to count virtually all of these deposits in its reported liquidity pool – nearly $7 billion of a reported $40 billion, 17.5% of the total.

¶159.[88]

According to the Examiner, a snapshot of Lehman's liquidity pool taken on the evening of September 9, 2008, showed that collateral pledges included in the pool materially reduced Lehman's "ability to monetize" that pool. E.R. at 1459. The snapshot showed that the total size

[88] Fuld and Lowitt argue that the JPMorgan collateral call was "only a request," that Lehman had not decided how to respond to the request, and did not bear on their state of mind. Jt. Br. at 49. On September 5, 2008, Lowitt spoke with JPMorgan's Chief Risk Officer, Barry Zubrow, who informed Lowitt of the impending $5 billion collateral call. E.R. at 1131. Lowitt assured Zubrow that he understood the basis for the call. *Id.* Moreover, on September 9, 2008, the day before the September 10 conference call (which mentioned nothing of this), Fuld offered JPMorgan's Steven Black between $3 and $4 billion in additional collateral. E.R. at 1138-43. In total, by September 11, 2008, Lehman had posted an additional $4.6 billion in collateral to JPMorgan. E.R. at 1143.

of the pool was approximately $40.6 billion, and the Examiner found that "Lehman managers had determined that they had a high ability to monetize approximately $25 billion of the pool, a mid ability to monetize approximately $1 billion of the pool, and only a low ability to monetize approximately $15 billion, or 37%, of the total pool." *Id.* Nonetheless, on September 10, 2008, Defendants Fuld and Lowitt publicly stated that Lehman's liquidity pool was $42 billion, and that the Company maintained a "very strong" liquidity position, but concealed that approximately 24% of this liquidity pool consisted of encumbered assets. ¶202. By September 12, 2008, Lehman's reported $41 billion liquidity pool was overstated by 95%. ¶204.[89]

The Insider Defendants contend that the SEC and the FRBNY knew about the additional collateral requests, and that they did not "direct" Lehman to remove these encumbered assets from its liquidity pool, which somehow defeats an inference of scienter. Jt. Br. at 48. However, the Insider Defendants omit several critical facts. First, the FRBNY staff was concerned that Lehman's liquidity pool actually ***included $7 billion in collateral*** the Company posted with repo clearing banks and was concerned that Lehman did not have the ability to access these assets. As FRBNY Examiner Angulo told the Examiner: "it 'would have been very difficult' to monetize this collateral for other liquidity purposes." E.R. at 1470-72. FRBNY's Jan Voigts described the basis for Lehman's liquidity pool calculations as a "three-card monte routine." E.R. at 1470. Second, the SEC was unaware that Lehman and JPMorgan had entered into agreements giving

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[89] Defendants cite *Elam v. Neidorff*, 544 F.3d 921, 930 (8th Cir. 2008), for the proposition that "inferring scienter from [] temporal proximity . . . is nothing more than speculation." Jt. Br. at 49. The *Elam* court stated immediately before that passage: "[T]he close proximity between defendants' June statements and the mid-July announcement that resulted in the 35 percent decline in stock value ***is relevant to scienter***. . . . ***Without more***, inferring scienter . . ." (emphasis added). Moreover, in *Elam* the time between defendant's statements and the revelation of truth was one month, which the court did find to be "troubling," just not a sufficient basis on its own to support scienter. *Id*. Nor is *Fulton County Employees' Ret. Sys. v. MGIC Inv. Corp.*, 2010 WL 601364 (E.D. Wis. Feb. 18, 2010), on point. There, defendants stated they had "substantial" liquidity to cover margin calls, adding that they could not guarantee it would be sufficient. *Id.* at *15. Here, Lowitt and Fuld omitted to disclose the Company's changed liquidity circumstances, affirmatively stating: "We have maintained our strong liquidity and capital profiles even in this difficult environment." ¶202. Defendants also concealed JPMorgan's $5 billion collateral call, received the previous day. ¶203.

JPMorgan expanded power over Lehman's posted collateral. E.R. at 1475. Third, both agencies removed the assets from their internal calculations of Lehman's liquidity pool. E.R. at 1472 (FRBNY discounted the value of Lehman's liquidity pool to account for the collateral transfers); E.R. at 1475 (SEC discounted value of repo collateral from Lehman liquidity pool). Fourth, the FRBNY assumed no role in dictating Lehman's public filings. E.R. at 1472. Fifth, to the extent these encumbered assets were available to Lehman, withdrawing them from the collateral banks "would have affected Lehman's ability to clear through those banks." E.R. at 1467. As a result, no plausible inference of non-culpable misconduct can be drawn from the fact that the SEC and FRBNY did not direct Lehman to exclude the encumbered assets from Lehman's liquidity pool.

Similarly cogent and compelling are Plaintiffs' allegations that the Insider Defendants knew or recklessly disregarded that their statements regarding Lehman's liquidity risk were materially false and misleading when made. In this respect, the Complaint alleges, for example, that:

- On July 20, 2007, Nagioff emailed Lowitt, stating that his Co-COO and Head of Fixed Income Strategy were "panicky" about Lehman's liquidity position. Lowitt responded that he was "anxious" about Lehman's liquidity position. ¶218(c).

- On July 20, 2007, Lowitt shared his liquidity concerns with O'Meara, tracing Lehman's difficulty in funding its commitments directly to its failure to abide by its risk limits. ¶218(d).

- In July 2007, Defendants Lowitt and O'Meara – together with Paolo Tonucci, Lehman's Global Treasurer, Alex Kirk, Co-COO of Fixed Income Division, and Kentaro Umezaki, Head of Fixed Income Strategy – set up ALCO as a result of their liquidity concerns, to "manage [the firm's] liquidity on a daily basis." ¶218(f).

- On July 30, 2007, ALCO members, including Defendants Lowitt and O'Meara, exchanged an analysis showing that, contrary to the firm's policy to always have a cash capital surplus of at least $2 billion, Lehman was projecting large deficits of cash capital. ¶218(g).

- In late October 2007, Defendant O'Meara prepared a presentation on the firm's equity adequacy for the Executive Committee. The presentation concluded that the firm's capital adequacy over the last 5-6 quarters had "materially deteriorated"; that Lehman was at the bottom of its peer range with respect to the regulatory requirement of a minimum 10% total capital ratio imposed by the SEC;

and that the firm's capital position decreased from a $7.2 billion surplus in the beginning of 2006 to a $42 million deficit at the end of the third quarter of 2007. ¶218(j).

- On March 12, 2008, Callan received an email from Eric Felder expressing concerns about dealer liquidity and shrinking leverage, and forwarding an email from a Lehman trader that warned that dealers were demanding increased haircuts and refusing to take assignments of any Bear or Lehman trades even if the trades were "in-the-money." Five days later, Felder warned Defendants Lowitt and Callan that collapsing equity values eventually would compel Lehman to sell assets, and that the distressed prices available would create a need for additional capital, forcing further sales. ¶218(n).

Further evidencing Defendants' scienter, individuals who complained about a growing liquidity crisis were terminated from Lehman. For example, in 2007, Fuld and Gregory removed Michael Gelband, head of Lehman's Fixed Income Division, and Madelyn Antoncic because of their opposition to management's growing accumulation of risky and illiquid investments. ¶219. These allegations further support the strong inference of the Insider Defendants' scienter with respect to misstatements concerning Lehman's liquidity risks.

### C. The Complaint Pleads Material Misstatements And Omissions

In addition to the false and misleading Offering Materials, Defendants made false statements during conference calls and at investor conferences. ¶¶172-205.

#### 1. Defendants' Statements Concerning Deleveraging Were False

Defendants claim that because Lehman reduced some exposure to troubled mortgages, asset-backed securities and real estate held for sale between the first and second quarters in 2008, and provided break-downs of Lehman's assets in its SEC filings, its reported (but artificially deflated) net leverage ratio was irrelevant to whether Lehman was deleveraging. Jt. Br. at 33. This argument is wrong.

First, Defendants misconstrue Plaintiffs' allegations regarding Lehman's purported deleveraging. The Class Period begins June 12, 2007, and it is plainly evident that Lehman

expanded its Repo 105 program in 2007 and early 2008 at the same time when it was increasing net assets and real estate exposure.[90] This early expansion of Repo 105 helped create the false appearance that Lehman's balance sheet strength was healthier and better able to sustain a possible downturn in the real estate markets.[91] As the Examiner concluded:

> Lehman's expansion of its Repo 105 program mitigated, in part, the adverse impact its increasingly "sticky"/illiquid inventory – comprised mostly of the leveraged loans and residential and commercial real estate positions Fuld wanted to exit – was having on the firm's publicly reported net leverage and net balance sheet.
>
> Many of Lehman's inventory positions had by [January 2008] become increasingly "sticky" or difficult to sell without incurring substantial losses. It is against this backdrop of increased market focus on leverage that Lehman significantly increased its quarter-end use of Repo 105 transactions.

E.R. at 737; 800-01.

Second, that Lehman recorded the greater part of its write-downs on June 9, 2008, roughly a year after the start of the Class Period, does nothing to undo Plaintiffs' falsity allegations with respect to using Repo 105 transactions to artificially reduce the appearance of Lehman's exposure to the deteriorating real estate markets at 1Q 2008. Indeed, as the Bankruptcy Examiner found:

> [U]nbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse engineered the firm's net leverage ratio for public consumption. Notably, during Lehman's 2008 earnings calls in which it touted its leverage reduction, analysts frequently inquired about *the means* by which Lehman was reducing its leverage. Although CFO Callan told analysts [during the 2008 1Q conference call on March 18, 2008] that Lehman was "trying to give the group a great amount of transparency on the

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[90] *See* 2Q08 10-Q (reporting net assets of $337.6 billion) (Chepiga Decl. Ex. 6 at 63); *compare* 2007 10-K (reporting net assets of $372.9 billion) (Chepiga Decl. Ex. 8 at 30).

[91] The purpose of Repo 105 to create the false appearance of increased balance sheet strength is particularly highlighted in an internal document from 2007 which noted that "Repo 105 offers a low cost way to offset the balance sheet and leverage impact of current market conditions." E.R. at 738. The same document also noted another one of the program's principal purposes: "to help the Company avoid "[e]xiting large CMBS positions in Real Estate and subprime loans in Mortgages," which would have caused the Company to "incur large losses due to the steep discounts that they would have to be offered at." *Id*. The document concluded that a "Repo 105 increase would help avoid this without negatively impacting our leverage ratios." *Id*.

> balance sheet," she reported that Lehman was reducing its leverage through the sale of less liquid asset categories but said nothing about the firm's use of Repo 105 transactions.

E.R. at 739.

Third, Defendants note that during the June 9, 2008 conference call, Callan attributed the $60 billion reduction in net assets from sales of less liquid asset categories, including "residential and commercial mortgages and leveraged finance exposures." Defendants overlook that during the same call Callan touted that Lehman had reduced its net leverage to "less than 12.5x." In truth, had Lehman not engaged in quarter end Repo 105 transactions to manipulate its balance sheet, or had the Repo 105 transactions been disclosed to investors and included in its leverage calculation, Lehman's reported net leverage ratio would have been 13.9x at the end of the second quarter, not 12.5x (or 12.1x as Lowitt later claimed). ¶195. For Lehman to have actually lowered its net leverage ratio to 12.1x during 2Q08 by selling troubled assets, it would have had to sell an additional $50 billion in "sticky" positions.[92] Under this light, it is clear that Lehman's artificially deflated net leverage allowed it to avoid selling "sticky" assets.

Fourth, despite the unmistakable link between Lehman's Repo 105 program and its ever-growing portfolio of "sticky" assets, which ultimately required the Company to record tens of billions of dollars in write-downs, Defendants contend that they are unrelated, and that an investor interested in the Company's "illiquid assets" would have looked to "the line items disclosing the assets held in each category" as opposed to overall net leverage. *See* Jt. Br. at 33. This argument disregards the fact that the Company's portfolio of high-risk illiquid assets can be meaningfully assessed only within the context of Lehman's overall financial position. By artificially decreasing the net leverage ratio, Defendants misrepresented Lehman's financial condition and overstated its ability to absorb losses and write-downs on its "sticky" assets. As a

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[92] Not surprisingly, once Lehman's use of Repo 105 transactions leveled off in the second quarter of 2008 and then declined markedly in the third quarter, its sale of "sticky" assets increased dramatically. *See* Jt. Br. at Appx. B (showing marked decline in commercial and residential mortgages in the second and third quarters of 2008).

result, the market could not have meaningfully assessed the Company's ability to absorb losses on its illiquid positions, even with the purported "line item" disclosures cited by Defendants.

### 2. Defendants' Liquidity Statements Were False

The Insider Defendants contend that their statements regarding Lehman's liquidity in each of the three quarters in 2008 were immaterial puffery. *See* Jt. Br. at 34-35. Viewed in context (in the midst of a financial crisis where liquidity was critical), characterizing Lehman's liquidity as "robust" and "strong" was hardly puffery. Such statements dispelled doubts of a solvency crisis at the Company. ¶189. Moreover, misstatements concerning the amount of the liquidity pool are unquestionably actionable.[93] *See* ¶194 (Lehman's liquidity positions had "never been stronger" due to the Company's $45 billion liquidity pool); ¶202 (press release announcing liquidity pool of $42 billion, which Fuld characterized on a conference call as "strong").

The Insider Defendants also ignore the Complaint's allegations that Lehman provided substantial "comfort deposits" to other financial institutions and yet continued to improperly include this collateral in its reported liquidity pools beginning in June 2008, thereby overstating Lehman's liquidity. ¶159; *see also* E.R. at 1082-84. In light of these allegations, it strains credulity for the Insider Defendants to contend that statements about the amount of the liquidity pool "were objectively true." Jt. Br. at 35. Likewise, the contention that the (misleading) liquidity amounts reported at 3Q2008 "were substantially larger than figures reported in the prior year" carries no weight when the underlying reported numbers were materially misleading.[94]

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[93] *Freudenberg*, 2010 WL 1904314, at *15 ("[M]isstatements . . . are not "puffery" where, as alleged here, they were "misrepresentations of existing facts.") (citing *Novak*, 216 F.3d at 315) (statements that inventory situation was "in good shape" or "under control" when defendants knew the contrary was true were false and misleading).

[94] Lehman's reported liquidity pool was also materially misleading because of the tens of billions of dollars in undisclosed repurchase agreements existing at the end of each quarter. If liquidity refers "to the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash" (*see* Jt. Br. at 34), Lehman's need to repay the repurchase obligation affected its liquidity. Any claim that the collateral underlying Repo 105 transactions is "highly liquid" ignores that a material portion of the

### 3. Defendant Gregory Made False Statements

Defendant Gregory contends that the Rule 10b-5 claims against him should be dismissed because the Complaint does not allege that he signed any of the SEC filings at issue in the Exchange Act claims. *See* Jt. Br. at 32. However, 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.[95] 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."[96]

Defendant Gregory was the Company's second most senior officer throughout most of the Class Period, serving as Lehman's President and Chief Operating Officer. ¶10. He was responsible for Lehman's day-to-day management, and was a member of Lehman's Executive Committee, responsible for assessing Lehman's risk exposure and related disclosures. ¶¶10, 75, 221, 262. Specifically, the Executive Committee reviewed "risk exposures, position concentrations and risk-taking activities on a weekly basis, or more frequently as needed," and "allocate[d] the usage of capital to each of our businesses and establishes trading and credit limits for counterparties." ¶¶216(b), 221.

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collateral were not Level 1 assets. According to the Examiner, on November 30, 2007, 71% of Lehman's Repo 105 securities were classified as Level 1 assets. E.R. Appx. 17 at 13. Likewise, at the end of the first and second quarters of 2008, 82% and 86% of Repo 105 assets, respectively, were classified as Level 1 assets. *Id*. Accordingly, any claim that that Lehman could easily monetize all of their Repo 105 assets must be rejected, particularly at the motion to dismiss stage.

[95] *See*, *e.g.*, *In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 266 (S.D.N.Y. 2008); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC*, 376 F. Supp. 2d 385, 394 n.60 (S.D.N.Y. 2005); *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 438 (S.D.N.Y. 2005).

[96] *BISYS*, 397 F. Supp. 2d at 440. *See also 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."); *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).

Consequently, under the group pleading doctrine, the Complaint alleges Rule 10b-5 claims against Defendant Gregory for misrepresentations in Lehman's corporate documents during his tenure, including the Forms 10-K, 10-Q and 8-K identified in the Complaint.

### D. The Complaint Adequately Pleads Loss Causation

Only a "short plain statement of the claims showing that the pleader is entitled to relief" is required for loss causation.[97] "[L]oss causation will be satisfied if [defendants'] conduct had the effect of concealing the circumstances that bore on the ultimate loss." *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 510 (S.D.N.Y. 2005); *accord In re Enron Corp. Sec. Deriv. & "ERISA" Litig.*, 439 F. Supp. 2d 692, 724 (S.D. Tex. 2006). Pleading "that the loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement" suffices. *In re OmniCom Group, Inc. Sec. Litig.*, 597 F.3d 501, 513 (2d Cir. 2010). A misrepresentation is "the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations." *Id*.

While "an allegation that a corrective disclosure caused the plaintiff's loss may be sufficient to satisfy the loss causation requirement . . . [i]t is not, however, necessary." *Parmalat*, 375 F. Supp. at 305. Moreover, fact-for-fact, or "mirror image," disclosures are not required for loss causation, as such an approach would enable defendants to easily avoid liability by refusing to admit to the fraud. *Freudenberg*, 2010 WL 1904314, at *28.[98] Rather, as the

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[97] Fed. R. Civ. P. 8(a)(2). *See*, *e.g*., *In re Tower Auto. Sec. Litig.*, 483 F. Supp. 2d 327, 348 (S.D.N.Y. 2007) ("[t]he Dura Court assumed, *arguendo*, that the notice pleading standards of Rule 8 govern the pleading of loss causation, and nearly all courts addressing the issue since have also applied Rule 8, rather than the heightened pleading standard of Rule 9") (*citing Dura Pharms.*, *Inc. v. Broudo*, 544 U.S. 336, 125 S. Ct. 1627 (2005)); *Freudenberg*, 2010 WL 1904314, at *27 ("There is no heightened standard for pleading loss causation"); *King County v. IKB Deutsche Industriebank AG*, 2010 2010 WL 1702196, at *3 (S.D.N.Y. Apr. 26, 2010) ("[P]laintiffs need only meet the lesser Rule 8(a) standard when pleading loss causation"); *In re Bristol Myers Squibb Co. Sec. Litig.*, 586 F. Supp. 2d 148, 163 (S.D.N.Y. 2008) ("Allegations of loss causation, however, are not subject to the heightened pleading requirements of Rule 9(b) and the PSLRA").

[98] *See also*, *e.g*., *In re Motorola Sec. Litig.*, 504 F. Supp. 2d 501, 542-546 (N.D. Ill. 2007) (rejecting argument that loss causation can be established only by showing a corrective disclosure that, on its face,

Supreme Court explained in *Dura*, loss causation is satisfied when the "relevant truth" is disclosed – *i.e.*, when the facts as to the finances of the corporation become generally known and as a result share depreciates. 544 U.S. at 344, 125 S. Ct. at 1633; *accord*, *Freudenberg*, 2010 WL 1904314, at *28.

### 1. **The Complaint Alleges The <u>Materialization Of Concealed Risks</u>**

The Complaint's allegations of loss causation are straightforward. Between June 12, 2007, and September 15, 2008, the price of Lehman common stock was artificially inflated. The artificial inflation dissipated through a series of partial disclosures which represented the materialization of previously-concealed risks about Lehman's financial condition. ¶242. The Complaint identifies the date of each Company-specific disclosure and event (i.e., June 9, September 8-10, and September 15, 2008); quantifies the stock-price reaction; and provides "some indication" of the causal connection to the misrepresentations. No more is required. *See Dura*, 544 U.S. at 346-47, 125 S. Ct. at 1633-34.[99]

The Complaint readily alleges how Defendants' conduct had the effect of concealing the circumstances that bore on investors' losses. Defendants' positive statements about adherence to risk management and the Repo 105 transactions concealed the risks created by Lehman's over-concentration and accumulation of illiquid real estate assets, which assets ultimately required enormous write-downs that contributed to Lehman's liquidity crisis. ¶¶146, 248. Through Repo

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specifically identifies or explicitly corrects a prior representation or expressly discloses the particular fraudulent scheme); *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 230 (5th Cir. 2009) ("If fact-for-fact disclosures were required to establish loss causation, a defendant could defeat liability by refusing to admit the falsity of prior statements.").

[99] Further, loss causation "is a fact-based inquiry" often requiring expert testimony. *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 174 (2d Cir. 2005) ("Loss causation is a fact based inquiry . . . ."); *In re Vivendi Universal, S.A., Sec. Litig.*, 634 F. Supp. 2d 352, 364 (S.D.N.Y. 2009) ("Sorting out which declines were caused by such extraneous factors and which were caused by a materialization of the concealed risk is generally the province of an expert.").

105, Defendants artificially reduced Lehman's reported net leverage, preserved its credit ratings and created the appearance that Lehman was more financially sound than it really was, and had a strong balance sheet that was better able to absorb losses from the deteriorating real estate and credit markets. Likewise, Lehman's misrepresentations about liquidity risks concealed the true extent of Lehman's ability to satisfy its obligations. Lehman's substantial write-downs and credit-rating downgrades in the second and third quarters of 2008, as well as the liquidity crisis and bankruptcy in September 2008, were the materialization of the risks that had been concealed by Defendants' machinations.[100]

In their motions, Defendants attempt to isolate their interrelated misstatements about Lehman's financial condition and challenge loss causation separately. As explained below, however, the Complaint easily satisfies *Dura's* pleading standard.

#### a) **The Materialization Of Risk From <u>Undisclosed Repo 105 Transactions</u>**

Concealed risks may materialize in many different ways. For example, the "risk" associated with an accounting fraud may materialize when the fraud ceases and the company reports lower earnings compared to earlier (fraudulently inflated) periods. *See*, *e.g*., *Fraternity Fund Ltd.*, 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

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[100] On June 9, 2008, Lehman reported $4 billion in net write-downs and announced that it would raise $6 billion through a combined offering of preferred and common shares. ¶243. Lehman's shares declined 8.7% on this news, and fell an additional 19.44% over the next two days as rating agencies Fitch and Moody's downgraded Lehman's credit rating. *Id*. On September 8, 2008, Lehman's stock price dropped 12.7% when Lehman announced that it would release third quarter results on September 18, 2008, and analysts predicted additional write-downs between $4 billion and $5 billion. On September 9, 2008, S&P and Fitch placed ratings for Lehman on review for downgrade, specifically citing concerns over Lehman's ability to raise capital, upon which Lehman's shares dropped 45%. ¶202. Then, on September 10, 2008, Lehman pre-announced that it expected its largest quarterly net loss ever of $3.9 billion, fueled by writedowns of $1.7 billion on commercial mortgage positions and $5.3 billion in residential mortgage-related positions, upon which Lehman's stock price dropped an additional 7%. ¶246.

materialized – namely, that disclosure of the company's true financial condition would cause the market to devalue its stock.[101] Other examples of undisclosed risk that materialize include, but are not limited to, credit ratings downgrades,[102] or when a company collapses.[103]

Here, the risks concealed by Lehman's sham Repo 105 transactions materialized through a series of partial disclosures. Specifically, the massive write-downs that Lehman took in June and September 2008, and the rating agency downgrades that naturally followed, were the materialization of the risks that had been concealed by the Repo 105 transactions in fiscal 2007 and early 2008. The clear purpose of the Repo 105 transactions was to "mitigate[], in part, the adverse impact [that Lehman's] increasingly "sticky"/illiquid inventory . . . was having on [its] publicly reported net leverage and net balance sheet." ¶154; E.R. at 737-38. In other words, undisclosed Repo 105 transactions lowered Lehman's reported net leverage to create the artificial appearance of enhanced balance sheet strength, which in turn made Lehman appear financially stronger than it was. These concealed risks began to materialize on June 9, 2008, when Lehman recorded massive real estate-related write-downs, resulting in credit rating agency downgrades, the need to raise additional capital, and substantial investor losses.

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[101] *See*, *e.g*., *In re Global Crossing, Ltd., Sec. Litig*., 471 F. Supp. 2d 338, 348 (S.D.N.Y. 2006) (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 NT, Inc. Sec. Litig*., 2006 WL 330113, at *8 (S.D.N.Y. Feb. 14, 2006), *objections overruled*, 2006 WL 568225 (S.D.N.Y. Mar. 9, 2006) (gradual disclosure about the "truth of NTL's underlying problems"); *Teamster Local 445 Freight Div. Pension Fund v. Bombadier, Inc*., 2005 WL 2148919, at *12 (S.D.N.Y. Sept. 6, 2006) (truth revealed through unfavorable financial results).

[102] *In re Dynex Capital, Inc. Sec. Litig*., 2006 WL 314524, at *11 (S.D.N.Y. Feb. 10, 2006) (holding that a concealed risk materialized when the ratings agencies downgraded certain bonds, and defendants had previously misrepresented the quality of the bonds' collateral), *vacated on other grounds*, *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc*., 531 F.3d 190 (2d Cir. 2008); *see also In re Vivendi Universal, S.A*., *Sec. Litig.,* 605 F. Supp. 2d 586, 598 (S.D.N.Y. 2009) (credit downgrade constituted the materialization of a concealed liquidity crisis).

[103] *Parmalat*, 375 F. Supp. 2d at 307 ("The concealed risk materialized when Parmalat suffered a liquidity crisis on December 8, 2003 and was unable to pay bonds as they came due.").

The February 10, 2007 Lehman document, titled "Proposed Repo 105/108 Target Increase for 2007," directly supports the allegation that the write-downs were within the "zone of risk" concealed by Repo 105 transactions. ¶¶155, 244. As this document makes clear, "Repo 105 offers a low cost way to offset the balance sheet and leverage impact of current market conditions," and ***large CMBS positions in Real Estate and sub prime loans in Mortgages before quarter end would incur large losses due to the steep discounts*** that they would have to be offered at and carry substantial reputation risk in the market . . . . ***A Repo 105 increase would help avoid this without negatively impacting our leverage ratios***."[104] E.R. at 738 n.2868. Repo 105 transactions dramatically increased after this document was created. ¶37, Table 1. In other words, rather than decrease net leverage by selling "sticky" assets – which would have required the Company to take enormous losses – Lehman engaged in sham Repo 105 transactions. Thus, the write-downs that the Company eventually took in June and September 2008 – and the downgrades and liquidity crisis that inevitably followed – comprised the materialization of the risk that the Repo 105 transactions concealed.

In response, Defendants make a fact-intensive argument that might be appropriate at trial but not now. Defendants contend that when they recorded asset sales and write-downs in 2Q08, and Lehman's reported net leverage decreased from 15.4x at the end of 1Q08 to 12.1x at the end of 2Q08 (or, in truth, 17.3x to 13.9x), the decrease occurred irrespective of Repo 105 transactions, which were "relatively constant between those quarters." Jt. Br. at 55. Similarly, Defendants contend that Lehman actually reduced its mortgages, asset-backed securities and real estate held for sale from $87.3 billion at 1Q08, to $71.1 billion at 2Q08. Jt. Br. Appx. B, *see also* E&Y Br. at 27. However, this is irrelevant, and the fact that Lehman's Repo 105 transactions approximated $50 billion at both 1Q and 2Q 2008 and that Lehman reduced some assets does nothing to erode Plaintiffs' loss causation allegations. Repo 105 transactions were inherently constrained by (1) the limited availability of relatively "liquid" assets to collateralize

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[104] ¶155; *see also* E.R. at 738 (emphasis added).

and (2) the willingness of counterparties to participate in such transactions. Apart from Repo 105 transactions, the only other way Lehman could reduce net leverage at the end of 2Q08 was to sell assets and record writedowns, ***thereby comprising the materialization of the risk that had been concealed by Repo 105***. Because Repo 105 did not increase between 1Q and 2Q 2008, Lehman was unable to further deflate its net leverage ratio through sham Repo 105 transactions, and thus was forced to sell billions of dollars in "sticky" assets and write down the values of other assets to make its balance sheet targets.

That Lehman's multi-billion dollar write-downs in 2Q08 coincided with the maximum level of undisclosed Repo 105 transactions (*see* ¶37, Table 1) is consistent with loss causation in this case because the Complaint alleges that the June 9, 2008 disclosure was a ***partial*** disclosure. ¶243.[105] The risk further materialized on September 10, 2008, when Lehman pre-announced that it expected its largest quarterly net loss ever of $3.9 billion, with writedowns of $1.7 billion on commercial mortgage positions and $5.3 billion in residential mortgage-related positions. ¶246. Significantly, between 2Q08 and 3Q08, Lehman had reduced its reliance on Repo 105 transactions from $50.38 billion to $26.38 billion.[106] To offset the increase in net leverage that

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[105] As Defendants construe the 2Q08 write-downs, Plaintiffs would be able to allege loss causation only through one corrective "disclosure" of the Repo 105 transactions, which is not the law. *See Dura*, 544 U.S. at 342, 125 S. Ct. at 1631 (a loss may occur after "the relevant truth begins to leak out.").

[106] Bart McDade characterized the Repo 105 Program as "another drug we r on" and mandated that Lehman reduce reliance on Repo 105 transactions from $50 billion at 2Q08 to $25 billion by 3Q08, and then to zero by 4Q08. *See* E.R. at 819. Numerous Lehman employees cautioned that Lehman could not continue its operations without the use of Repo 105 transactions – concerns which soon proved prophetic. *See* E.R. at 820 ("Morton complained that the proposed balance sheet target for FID in third quarter 2008 was identical to the second quarter target, but with the Repo 105 limit cut in half, the Rates business of FID would not survive"); *Id*. at 900-01 ("Amin protested that a $55 billion net balance sheet limit for the firm's Rates business, with $22 billion less of Repo 105 capacity available at quarter‑end, was unsustainable: 'We can't run the business under those parameters'"); *Id*. at 901 ("Similarly, Jeff Michaels complained to Amin in July 2008 that given the reduction in FID's Repo 105 capacity for third quarter 2008, and the complete curtailment of Repo105 usage in fourth quarter 2008, "there are not many places we can reallocate balance sheet from if Repo 105 is gone for the inflation book") *Id*. at 901-02. ("In another email, Michaels wrote: "[Repo] 105 is going to zero in Q4, which means we either need more balance sheet from FID or we need to make significant reductions in Europe, which has not happened until now. There is no way we can make Q4 balance sheet without Repo 105 unless our inflation inventory is cut by 60‑75% from current levels"); *Id*. at 900 ("Munir warned that "RUNNING A FIRM

otherwise would have resulted from this undisclosed reduction of Repo 105 usage, Lehman was forced to book massive writedowns in 3Q08 on its "sticky" assets. Accordingly, such disclosure was a further materialization of the risk concealed by Repo 105 transactions. It is not necessary that the market recognize that prior representations about net leverage were false, so long as the stock price drop represents the materialization of risk concealed by the fraud. *See Vivendi*, 634 F. Supp. 2d at 367 ("part of plaintiffs' burden [is] to [plead] a causal connection between the materialization of the risk and the stock price declines, *not* the causal connection between the allegedly false and misleading statement and the materialization of the risk"). While Defendants may believe that the June 9 and September 8-10, 2008 announcements were somehow not detailed or vigorous enough to reveal Lehman's true net leverage and financial condition, this is not grounds for dismissal.[107] *See, e.g., In re Initial Pub. Offering Sec. Litig*., 544 F. Supp. 2d 278, 289 (S.D.N.Y. 2008) (corrective disclosure need not "take a particular form or be of a particular quality"); *Vivendi* 634 F. Supp. 2d at 364 (analyst's downgrade may constitute the materialization of a concealed risk).

On September 15, 2008, Lehman filed for bankruptcy, effectively destroying the value of its common shares. ¶247. The Complaint alleges how the bankruptcy was within the "zone of risks" concealed by the Repo 105 program. 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*

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WIDE BALANCE SHEET OF 15.3X LEVG IS NOT GOING TO BE A SUSTAINABLE BUSINESS MODEL FOR THE FIRM") (all capitals in original).

[107] Defendants contend that the September 8 reports predicting additional write-downs is an insufficient disclosure. *See* Jt. Br. at 56, citing *Omnicom*, 541 F. Supp. 2d at 552. In *OmniCom*, ruling on ***defendants' motion for summary judgment following expert discovery***, Judge Pauley began his discussion of loss causation: "This is not a case about materialization of an undisclosed risk." *Id*. at 551. Here, by contrast, this case is about the materialization of risk.

> *materialized during that time and arguably caused the decline in shareholder and bondholder value.*

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

E&Y's arguments can also be dismissed. E&Y argues that the Repo 105 transactions did not conceal the fact that Lehman held sticky assets, because the Repo 105 transactions generally involved liquid assets and Lehman's mortgage-backed securities and real estate for sale were reflected as separate line items on Lehman's 2007 10-K. But this argument misses the mark. As the Examiner found, Repo 105 concealed the truth about Lehman's balance sheet and liquidity, because the sham deals allowed the Company to avoid taking massive write-downs on assets it otherwise would have had to sell. Moreover, simply listing the amount of assets held in no way revealed how liquid they were or their true value. Finally, E&Y ignores that the rating agencies told the Examiner that they were unaware of, and would have wanted to know about, Lehman's use of Repo 105 transactions because they impacted the Company's liquidity risk. *See* E.R. at 902-09.

E&Y attempts to rely on *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 158 (2d Cir. 2007). However, *Lattanzio is* inapposite. There, the panel relied on three circumstances, none of which are present here, to conclude that Deloitte's misstatements were not a cause of Warnaco's bankruptcy. *See Id.* at 157. First, Warnaco disclosed its risk of bankruptcy in the financial results at issue by stating that its total shareholder equity declined 94% ($563 million to $35 million) in one year. Here, by contrast, no such disclosure was made. Second, the misstatements attributed to Deloitte were immaterial, whereas here, the Repo 105 practices were unquestionably material. Third, the panel found persuasive that Deloitte warned the market that Warnaco was "not in compliance with certain covenants of its long-term debt agreements," and that there was "substantial doubt" regarding its "ability to continue as a going concern." Here, E&Y gave no such warning.

**b) The Materialization Of Risk**
**Related To Risk And Concentration Limits**

Throughout the Class Period, the Insider Defendants misrepresented the strength and adherence to Lehman's risk management practices. ¶¶171, 173, 175, 178, 181, 187. Such statements dispelled market concerns about Lehman's financial condition. For example, following Callan's presentation during the 1Q08 conference call, analysts reported that "virtually no one listening to this call could have concluded that this company was in financial trouble." ¶189. In truth, however, the disregard for Lehman's risk management practices led to Lehman's accumulation of tens of billions of dollars of highly-risky illiquid assets that ultimately required enormous write-downs and triggered the liquidity crisis that ended Lehman's existence.

On June 9, 2008, following the reported $4 billion in mark-to-market net write downs, Fitch downgraded Lehman and Moody's changed its outlook from "stable" to "negative." ¶243. Moody's expressly stated that it had ***"concerns over risk management decisions that resulted in elevated real estate exposures and the subsequent ineffectiveness of hedges to mitigate these exposures" in the recent quarter.***[108] Likewise, Fitch and Dunn & Bradstreet downgraded Lehman's credit rating in response to the September 9, 2008 announcement, citing concerns about Lehman's ability to raise capital. ¶246. The ratings downgrades resulting from Lehman's write-downs – and the express criticism of the Company's risk management practices – reflected a materialization of the risks concealed by Defendants' statements regarding risk management. *See Vivendi*, 634 F. Supp. 2d at 364.

On September 10, 2008, Lehman reported $7 billion in gross write downs on its residential and commercial real estate positions due to Lehman's disregard of risk concentration limits for Alt-A loans. ¶246. The full extent of Lehman's undisclosed risks materialized on

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[108] *Id.*; E.R. at 46-47, n.124. Prior to the Moody's announcement, Lehman senior managers called Moody's, seeking to "soften" Moody's "extreme" press release. During the call, they asked Moody's to delete, among other things, a reference stating that ongoing losses would raise "serious concerns about the effectiveness of Lehman's risk management." E.R. at Appx. 13 at 8.

September 15, 2008, when the Company filed for bankruptcy due to "significant liquidity problems." Lehman was incapable of monetizing the vast portfolio of illiquid assets it had accumulated through its continued disregard for internal risk and concentration limits. ¶246. *See Vivendi*, 634 F. Supp. 2d at 363-64; *Parmalat*, 375 F. Supp. 2d at 307; *In re Initial Pub. Offering Sec. Litig.*, 260 F.R.D. 81, 107 n.224 (S.D.N.Y. 2009).

**c) The Materialization Of Risk <u>Related To Liquidity And Liquidity Pool</u>**

Fuld and Lowitt claimed on September 10, 2008, that Lehman's liquidity pool was estimated to be $42 billion and represented that the Company "maintained [its] strong liquidity and capital profiles even in this difficult environment." ¶202. In truth, at least 24% of the reported liquidity pool consisted of encumbered assets. ¶¶202-03. Thus, when Fuld and Lowitt announced on September 10 that Lehman had a liquidity pool of approximately $40.6 billion, this was false and concealed Lehman's true liquidity condition. ¶202. Ultimately, Lehman's bankruptcy was the materialization of the concealed liquidity problem at Lehman.

Defendants argue that no other corrective disclosures revealed liquidity problems at Lehman. Again, they ignore that Defendants' conduct concealed foreseeable risks that materialized. On June 9, 2008, and September 10, 2008, Lehman reported large losses resulting from writedowns on Lehman's real estate related assets. The losses plainly caused investors to question the sufficiency of Lehman's liquidity, and comprised a materialization of liquidity risk concealed by prior false statements. Moreover, they ignore the fact that Lehman's write-downs led Lehman's counterparties to require more collateral, triggering the liquidity crisis. For example, Citi requested that Lehman provide it with a multi-billion dollar "comfort deposit" in direct response to Lehman's large write-downs in June 2008. *See* E.R. at 1235-1239.

Defendants further contend that Repo 105 transactions were collateralized by "highly liquid" securities and thus could not have concealed liquidity problems. Jt. Br. at 57-58. This argument rings hollow on many levels. As a threshold matter, Repo 105 enabled the Company to avoid selling billions of dollars worth of illiquid assets, which in turn would have required

Lehman to take massive losses and suffer severe liquidity issues. Moreover, not all assets collateralizing Repo 105 transactions were "highly liquid." According to the Examiner, just 71% (or $27.4 billion) of the $38.6 billion securities collateralizing Repo 105 transactions were Level 1 assets at 2007 fiscal year-end; no more than 82% (or $40.6 billion) of the $49.1 billion in Repo 105 assets were Level 1 assets at first quarter 2008; and only 86% (or $43.2 billion) of the $50.3 billion in Repo 105 assets were Level 1 assets at second quarter 2008. *See* E.R. at Appx. 17 at 13. Furthermore, Repo 105 transactions involved more than merely exchanging liquid securities for cash. Cash generated from the Repo 105 transactions was used to pay down existing short-term liabilities ($50 billion as of 2Q 2008), and as a result of the transactions, Lehman carried an undisclosed but existing obligation to repurchase the underlying assets just days after the end of the reporting period. *See* ¶34.

#### 2. Defendants' "Market Phenomenon" Defense Is Not Grounds For Dismissal

The Complaint identifies Company-specific disclosures and events and Company-specific stock movement. Nevertheless, Defendants attempt to advance the timeworn "market phenomenon" defense at the pleading stage.[109] This argument runs counter to well-established authority holding that whether a loss "was caused by an intervening event," like a general market decline, "is a matter of proof at trial and ***not*** to be decided on a Rule 12(b)(6) motion to dismiss."[110] Although not all losses in a poor market result from fraud, it simply does

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[109] This case is easily distinguished from *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763 (2d Cir. 1994). That court explicitly rejected the notion "that in all cases a fraud plaintiff will be unable to plead proximate cause when the claim follows a market collapse." *Id.*, 27 F.3d at 772. Furthermore, *First Nationwide* was not a securities fraud case, and its loss causation analysis was based on "the cumulative effect" of factors that are wholly inapplicable here. *Id.*

[110] *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (emphasis added); *see also 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 IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 486 (S.D.N.Y. 2008) (refusing to credit defendants' arguments regarding possible intervening events at pleading stage); *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

not follow that Defendants are somehow blameless merely because their fraud coincided with a market downturn.

Contrary to E&Y's contentions, Plaintiffs are not required to quantify the portion of losses attributable to fraud or apportion them among Defendants. *See* E&Y Br. at 28. *Lentell*, 396 F.3d at 177 (Plaintiffs are not required to "allege the precise loss attributable to [the] fraud."). Plaintiffs need only provide "some indication of the loss and the causal connection [he or she] has in mind," and is not required to establish that no other event could have possibly caused its losses. *IMAX*, 587 F. Supp. 2d at 486 (*citing Dura*, 544 U.S. at 346-47, 125 S. Ct. at 1633-34); *King County v. IKB Deutsche Industriebank AG*, 2010 WL 1702196, at *4 (S.D.N.Y. Apr. 26, 2010) (noting that prevailing Second Circuit case law does not require plaintiff to exclude non-fraudulent explanation at pleading stage). Later, loss causation will be the subject of expert discovery.[111]

As set forth herein, the Complaint alleges a causal connection between Plaintiffs' losses and Defendants' fraudulent conduct. That Defendants intend to argue at trial that some portion of Lehman's share price decline during the Class Period may have been caused by general market forces cannot serve as a basis for dismissing Plaintiffs' claims. *DeMarco v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 110, 114 (S.D.N.Y. 2004) ("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.").

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losses is a matter for trial); *In re Converium Holding AG Sec. Litig.*, 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").

[111] *See, e.g., Lentell*, 396 F.3d at 174 ("Loss causation is a fact based inquiry . . . ."); *Dougherty*, 282 F.3d at 92 (issues of fact not to be determined on a motion to dismiss); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) (determining causation and damages in a securities fraud action "is often done, as it was here, with the help of an expert witness").

Also, while the share price of Lehman's competitors may have declined during the Class Period, Lehman's share price ***fell to zero***, thus evincing a strong difference between Lehman and its supposed competitors. Moreover, comparing Defendants' Appendices C (chart reflecting Daily Closing Value for the S&P 500 Financials Index) and D (chart reflecting Lehman Daily Closing Stock Price) reveals that the S&P 500 Financials lost little (if any value) between June 9, 2008, and September 15, 2008, whereas Lehman stock lost all its value as the concealed risks materialized.

### E. The Complaint States A Claim Under Section 20(a) Of The Exchange Act Against The Insider Defendants

The Complaint alleges both a primary violation of the Exchange Act and that each Insider Defendant controlled the primary violator. *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (Kaplan, J.). Culpable participation is not an element of a plaintiff's *prima facie* case under Section 20(a). *CSX Corp. v. Children's Inv. Fund Mgmt (UK)*, 562 F. Supp. 2d 511, 558 (S.D.N.Y. 2008) (Kaplan, J.). The Insider Defendants have not challenged the allegations of control. Rather, they contend that the Complaint fails to state a claim for a primary violation. Jt. Br. at 59-60. However, the Complaint states claims for violations 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 be denied.[112]

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[112] Lehman would have been named as a defendant in the action but for its voluntary petition for bankruptcy protection. ¶7. 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 United States Interactive, Inc.*, 2002 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 (S.D. Ind. 2007) (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.");

### F. The Complaint States A Claim For Insider Trading Under Section 20A Of The Exchange Act Against Defendant Fuld

A defendant violates Section 20A of the Exchange Act, 15 U.S.C. § 78t-1, "by purchasing or selling a security while in possession of material, nonpublic information . . . to any person who, contemporaneously with the purchase or sale of securities that is the subject of [a violation of the Exchange Act], has purchased . . . or sold . . . securities in the same class." 15 U.S.C. § 78t-1(a); *see also Openwave*, 528 F. Supp. 2d 236; *In re KeySpan Corp.*, 2003 WL 21981806 (E.D.N.Y. 2003) (denying motion to dismiss Section 20A claims on the basis that primary claims adequately pled).

The Complaint states a claim against Fuld under §§ 10(b) and 20(a), both of which satisfy the requirement for a "predicate violation" under § 20A.[113] In addition, the Complaint identifies Fuld's insider sales of Lehman stock (¶268), and establishes that Plaintiffs purchased Lehman stock contemporaneously with certain of Fuld's sales. *Id.* Further, the Complaint adequately alleges that Fuld was in possession of material nonpublic information concerning the adherence to Lehman's risk management at the time he sold his Lehman stock. ¶266. Accordingly, the Complaint states a claim against under § 20A.

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*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").

[113] *See Refco*, 503 F. Supp. 2d 611 at 664-66 (S.D.N.Y. 2007) (rejecting defendants' argument that a control person claim under § 20(a) cannot serve as a predicate violation for an insider trading claim under § 20A).

## V. CONCLUSION

For all of the foregoing reasons, Defendants' motions to dismiss should be denied. If the Court grants any part of Defendants' motions, Plaintiffs respectfully request leave to amend pursuant to Fed. R. Civ. P. 15.

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