

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK

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

**DEFENDANTS' JOINT REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT  
OF THEIR MOTION TO DISMISS PLAINTIFFS' SECURITIES ACT CLAIMS**

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The Securities Act Defendants<sup>1</sup> submit this reply in further support of their motion to dismiss the Securities Act claims and in response to Plaintiffs' Opposition ("OB").

**I. PLAINTIFFS LACK STANDING TO BRING CLAIMS UNDER THE SECURITIES ACT**

**A. A Named Plaintiff Must Have "Acquir[ed]" or "Purchas[ed]" "Such Security"**

The CAC aggregates over 660 different offerings. The named Plaintiffs, who purchased securities in barely 5% of them, nonetheless contend that the threshold jurisdictional inquiry of standing should be deferred to the class certification stage, at which point Plaintiffs would measure standing through a novel Rule 23 "typicality" standard – not whether the named Plaintiffs' claims are typical of others who bought the same securities, but whether absent parties who bought different securities issued pursuant to tens of dozens of different prospectuses and prospectus supplements underwritten by an ever-changing mix of some 70 different underwriters, have "similar" claims.<sup>2</sup> This does not square with controlling statutes or case law. Because the named Plaintiffs have suffered no injury caused by offerings in which they did not purchase, in which different securities were sold only to others, claims relating to over 600 offerings in which no named Plaintiff was an investor are not properly part of this action.

As a constitutional matter, named Plaintiffs cannot demonstrate the required injury-in-fact fairly traceable to Defendants' allegedly unlawful conduct, Lujan v. Defenders of Wildlife, 504 U.S. 555, 560, 112 S. Ct. 2130, 2136 (1992), because they "can allege no injury from the purchase or sale of [securities] they never invested in." In re AIG Advisor Group Sec. Litig., No. 06 CV 1625 (JG), 2007 WL 1213395, at \*4 (E.D.N.Y. Apr. 25, 2007). And as a statutory matter,

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<sup>1</sup> Terms defined in the Securities Act Defendants' opening brief ("DB") are similarly used herein.

<sup>2</sup> Otherwise, Plaintiffs complain, they would not be able to bring as big a class action as they would like. OB 17. But the desire to bring a bigger class action cannot trump substantive law. See 28 U.S.C. § 2072(b).

Section 11 and 12(a)(2) standing is, respectively, restricted to those who “acquir[ed]” or “purchas[ed]” “such security” issued pursuant to specific materials in an offering. DB 6-10.

Neither constitutional nor statutory standing requirements can be avoided simply because the complaint is denominated a “class action.” Lewis v. Casey, 518 U.S. 343, 357, 116 S. Ct. 2174, 2183 (1996) (“[t]hat a suit may be a class action . . . adds nothing to the question of standing”) (citation omitted). Where different securities are aggregated into a single complaint, either an appointed lead plaintiff, or another named plaintiff, must have purchased each “such security.” See, e.g., Kohen v. Pac. Inv. Mgmt. Co., --- F.3d ---, No. 08-1075 (RAP), 2009 WL 1919013, at \*4 (7th Cir. July 7, 2009) (“Before a class is certified . . . the named plaintiff[s] must have standing, because at that stage no one else has a legally protected interest in maintaining the suit”); W.R. Huff Asset Mgmt. Co. v. Deloitte & Touche LLP, 549 F.3d 100, 106 n.5 (2d Cir. 2008); Hevesi v. Citigroup Inc., 366 F.3d 70, 81-84 (2d Cir. 2003) (even though lead plaintiff only purchased common stock, because named plaintiffs purchased bonds, there was standing to assert class claims on behalf of bondholders); In re Parmalat Sec. Litig., No. 04 MD 1653 (LAK), 2008 WL 3895539, at \*3 (S.D.N.Y. Aug. 21, 2008) (common stock holders lack standing to bring claims on behalf of debt holders “notwithstanding the allegations that the same general course of conduct allegedly engaged in by defendants caused injury to all putative class members”).<sup>3</sup>

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<sup>3</sup> See also In re Global Crossing Ltd., Sec. Litig., 313 F. Supp. 2d 189, 207 (S.D.N.Y. 2003) (“it is not enough that plaintiffs seek damages only for a class that has standing; at least one named plaintiff must . . . have purchased shares traceable to the challenged offering”); In re Initial Pub. Offering Sec. Litig., 214 F.R.D. 117, 122 (S.D.N.Y. 2002) (“Courts in this circuit have repeatedly held” that “in order for a claim to be asserted on behalf of a putative class . . . the named plaintiffs – but not necessarily the lead plaintiff – must have standing”); Goldberger v. Bear, Stearns & Co., No. 98 Civ. 8677 (JSM), 2000 WL 1886605, at \*1 (S.D.N.Y. Dec. 28, 2000) (same); In re Paracelsus Corp., Sec. Litig., 6 F. Supp. 2d 626, 631 (S.D. Tex. 1998) (no standing to pursue offerings in which named plaintiffs did not purchase and ruling that assertion of standing because prospectus for offerings in which named plaintiffs did purchase had “virtually identical content” as others with class status was “without merit”).

Plaintiffs wrongly argue that Global Crossing only dealt with “individual standing,” OB 16 & n.21. Judge

Tellingly, Plaintiffs deem only two securities decisions in this District worthy of discussion in the text of their brief. The first approved an uncontested class settlement without ever discussing standing.<sup>4</sup> The approach followed in the second, In re Dreyfus Aggressive Growth Mut. Fund Litig., No. 98 Civ. 4318 (HB), 2000 WL 1357509 (S.D.N.Y. Sept. 20, 2000) (OB 11), and others espousing the same view (OB 12 n.10), has been decidedly rejected. “[T]hese decisions,” Judge Sand recently held, “have avoided ruling on standing” by examining typicality under Rule 23 – an issue that “has no place in the standing analysis.” Hoffman v. UBS-AG, 591 F. Supp. 2d 522, 532 (S.D.N.Y. 2008).<sup>5</sup> Plaintiffs “cannot meet the injury requirement for [Securities Act] claims relating to funds in which they have not purchased shares[.]” Id. at 530.<sup>6</sup> Beyond saying that it is wrong (OB 13 n.13), Plaintiffs ignore Hoffman. But a stream of cases follows it, rejects deferring and subsuming standing to a Rule 23 typicality analysis,<sup>7</sup> and applies the traditional rule that standing is a “threshold issue in every case that

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Lynch specifically found standing for an offering in which the lead plaintiffs did not purchase *because* another named plaintiff had done so. 313 F. Supp. 2d at 204-05.

<sup>4</sup> In re Prudential Sec. Inc. Ltd. P’ships Litig., 163 F.R.D. 200 (S.D.N.Y. 1995). Plaintiffs assert that Hevesi “approved” Prudential (OB 11), but it did so only in the sense of agreeing that some identified plaintiff – the PSLRA lead, a Rule 23 class representative, or a named plaintiff – must have standing to pursue claims on behalf of the offerings challenged in a case. Neither case permitted standing to be circumvented by having absent class members supply it.

<sup>5</sup> See also In re AllianceBernstein v. Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2005 WL 2677753, at \*9 (S.D.N.Y. Oct. 19, 2005) vacated in part on other grounds, 2006 WL 74439 (S.D.N.Y. Jan. 11, 2006) (holding that in the securities context, standing should be resolved before considering class certification; dismissing claims for lack of standing related to mutual funds never owned by named plaintiffs).

<sup>6</sup> The only other securities case Plaintiffs discuss in text on this point, In re Friedman’s, Inc. Sec. Litig., 385 F. Supp. 2d 1345, 1373 n.31 (N.D. Ga. 2005) (OB 12), relied exclusively on Dreyfus.

<sup>7</sup> AIG, 2007 WL 1213395, at \*3-6 (dismissing the complaint “insofar as it relates to funds other than the ones in which plaintiffs allege they actually invested”); In re Salomon Smith Barney Mut. Fund Fees Litig., 441 F. Supp. 2d 579, 607 (S.D.N.Y. 2006) (“With regard to the sixty-eight funds of which Plaintiffs own no shares, Plaintiffs do not have standing to assert any claims because Plaintiffs cannot satisfy the standing requirements”); In re Merrill Lynch Inv. Mgmt. Funds Sec. Litig., 434 F. Supp. 2d 233, 236 (S.D.N.Y. 2006) (recognizing the “more recent countervailing authority [to Dreyfus] in this district” and finding that plaintiffs did not have standing to represent shareholders of mutual funds other than the funds in which they invested); AllianceBernstein, 2005 WL 2677753, at \*9 (“Plaintiffs may not pursue Section 36(b) claims on behalf of the Funds in which they do not own

must be decided first.”<sup>8</sup> In short, “named plaintiffs in a class action ‘must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong’” and wish to represent. W.R. Huff, 549 F.3d at 106 n.5 (quoting Warth, 422 U.S. at 502, 95 S. Ct. at 2207).

Plaintiffs also argue that so long as at least one named Plaintiff has standing to sue each Defendant for one offering, it is a typicality question – to be deferred until the class certification stage – whether there is standing to pursue claims based on other offerings for which no named Plaintiff purchased “such security.”<sup>9</sup> In doing so, Plaintiffs put undue weight on an undisputed proposition expressed in an ERISA case, which merely held that “only one of the named Plaintiffs is required to establish standing in order to seek relief on behalf of the entire class.”<sup>10</sup> Plaintiffs seek to extend to the securities area principles established elsewhere in far different contexts, such as the civil rights and employment arenas, where “for policy reasons” standing is broader, AIG, 2007 WL 1213395, at \*6 n.9,<sup>11</sup> and where there is no comparable statutory provision limiting standing to purchasers of “such security.” In contrast, the “general rule” (id. at \*6) applicable “in the arena of securities litigation,” AllianceBernstein, 2005 WL 2677753, at

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shares.”); Nenni v. Dean Witter Reynolds, Inc., No. CIV A 98-12454 (REK), 1999 WL 34801540, at \*2 (D. Mass. Sept. 29, 1999) (dismissing Securities Act claims based on funds in which plaintiff did not purchase).

<sup>8</sup> In re Salomon, 441 F. Supp. 2d at 607 (“[T]he Article III standing determination should precede that of class certification.”); AllianceBernstein, 2005 WL 2677753, at \*9 (“[I]t would be inappropriate for the court to proceed directly to a class certification inquiry before resolving the issue of justiciability.”); see Warth v. Seldin, 422 U.S. 490, 498, 95 S. Ct. 2197, 2205 (1975); AIG, 2007 WL 1213395, at \*6.

<sup>9</sup> Even if that were the test, Plaintiffs do not meet it here. For example, no named Plaintiff alleges to have purchased securities underwritten by Calyon Securities (USA), Inc. See Revised Appendix A at 17 (bringing claims against Calyon based only on July 19, 2007 offering of 6% Notes Due 2012), and SAC ¶¶ 17-22 and Appendix B (no named Plaintiffs purchased this particular security).

<sup>10</sup> Cent. States Se. & Sw. Areas Health & Welfare Fund v. Merck-Medco Managed Care, L.L.C., 504 F.3d 229, 241 (2d Cir. 2007) (OB 9-10). In the same paragraph, Plaintiffs also cite to In re Grand Theft Auto Video Game Consumer Litig., No. 06 MD 1739 (SWK)(MDH), 2006 WL 3039993 (S.D.N.Y. Oct. 25, 2006), but – unlike here – Grand Theft “is not a case where the Named Plaintiffs are attempting to piggy-back on the injuries of the unnamed class members.” Id. at \*3 (quotation omitted).

<sup>11</sup> See OB 9-10 (predominately citing discrimination cases; none involving the Securities Act).

\*9, is that “a plaintiff who has been subject to injurious conduct of one kind [does not] possess by virtue of that injury the necessary stake in litigating conduct of another kind, although similar[.]” Blum v. Yaretsky, 457 U.S. 991, 999, 102 S. Ct. 2777, 2783 (1982). That is the rule applied by Judge Sand in Hoffman, by many other cases (noted above) within the Second Circuit, and by cases elsewhere specifically where, as here, there is a shelf registration statement. DB 10-11.<sup>12</sup>

Accordingly, constitutional and statutory standing remains a threshold inquiry, requiring that a named plaintiff have a personal stake that is fairly traceable to a defendant’s conduct. See Lujan, 504 U.S. at 560, 112 S. Ct. at 2136. Here, there was a vast array of different securities – common stock, preferred stock, and notes and bonds of all types, maturities and coupons, with a spectrum of different features, see SAC App. A – each sold by different underwriters through separate prospectuses, prospectus supplements and pricing supplements and with different

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<sup>12</sup> While Plaintiffs label these cases “unpersuasive,” OB 17, their approach continues to be followed. See Wash. Mut. Inc. Sec., Deriv. & ERISA Litig., Nos. 2:08-MD-1919 (MJP), C08-387 (MJP), 2009 WL 1393679, at \*14 & n.10 (W.D. Wash. May 15, 2009) (no Section 11 standing for “identical or substantially similar” offerings, from same shelf registration statement, in which no named plaintiff purchased) (see Am. Compl. ¶ 817, Dkt No. 67 in 2:08-MD-1919 MJP); see also M. McGarry Decl. Ex. 8 (filed in No. 08-CV-6762) (Tr. of Oral Arg. at 62, La. Mun. Police Employees Ret. Sys. v. Merrill Lynch & Co., No. 08 Civ. 9063 (JSR) (S.D.N.Y. Feb. 19, 2009)).

Plaintiffs nevertheless argue that they have standing to pursue Section 11 claims for *other* securities issued pursuant to the same shelf registration statement that issued the securities they did purchase. OB 17-18. They can find only one case so holding, In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132 (C.D. Cal. 2008). It conflicts with the cases from this and other courts cited above. Countrywide’s theory, essentially, is that standing should be subsumed by typicality, 588 F. Supp. 2d at 1167 -- *i.e.*, the repeatedly rejected Dreyfus rule. Here, there were hundreds of offerings with different underwriters and different temporal contexts, and each employed different offering documents. Like Plaintiffs, Countrywide also does not address how its typicality approach comports with the statutory language limiting standing to purchasers of “such security” – the security issued at a particular price in a particular offering – and therefore, cannot refer to all securities issued pursuant to a shelf registration statement. See DB 7-9 & n.7. Finally, prior to the enactment of the shelf registration rule, each offering included in the SAC would have required a different registration statement. There is no indication that the shelf registration process, designed to permit issuers to conduct offerings promptly, was intended to radically alter settled rules of standing. Even if the shelf registration rule was explicitly intended to have this effect, it “is settled that Congress cannot erase Article III’s standing requirement by statutorily granting the right to sue to a plaintiff who would not otherwise have standing.” Raines v. Byrd, 521 U.S. 811, 820 n.3, 117 S. Ct. 2312, 2318 n.3 (1997).

effective dates.<sup>13</sup> Securities Act standing requires that a named plaintiff have purchased “such security.” Here, because no named Plaintiff purchased “such security” in over 600 offerings included in the SAC, they lack standing to assert any claims based on the hundreds of securities that they did not purchase. As Judge Sand explained: if a party “is not personally injured by the alleged action of a defendant then he is not entitled to come into court and litigate that action, regardless of whether the disposition of his case necessarily requires the same result as the case of another.” Hoffman, 591 F. Supp. 2d at 532.

**B. All Section 12 Claims Should Be Dismissed For Lack of Standing<sup>14</sup>**

Section 12(a)(2) standing requires privity – the defendant must have sold to, or solicited, the plaintiff “in” an offering. DB 13-16. By definition, this is information that Plaintiffs need no discovery to obtain.<sup>15</sup> Conceding that they must supply this information at trial, Plaintiffs nevertheless insist that they are not required to allege it “at the pleading stage.” OB 20. Particularly in light of Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555, 127 S. Ct. 1955, 1965 (2007), and Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009), if that were ever true, it is not now.

Plaintiffs take false refuge in pre-Twombly cases accepting general allegations that one of the underwriters sold the securities to the named plaintiff where lead (or even all) underwriters are named defendants. OB 20 n.25. Here, LBI is not a defendant, and it was the largest underwriter in every offering; for most of them, it sold 85% or more of the securities. DB 13.

<sup>13</sup> Among the differing securities included in Appendix A are 42 securities that were called or matured months before Lehman filed for bankruptcy protection. See Schedule B; see also Bloomberg L.P. Call Notices (Ex. 32). As Lehman paid off these securities in full, purchasers of these products suffered no damages. In response, Plaintiffs vaguely allege that “damages exist” for purchasers of these securities who sold at a loss prior to maturity or call. OB 19 n.24. But, no named Plaintiff purchased any of these securities, and no named Plaintiff alleges that he or she sold at a loss. Consequently, Plaintiffs lack standing to pursue claims based on these securities.

<sup>14</sup> This argument does not apply to the PPN offerings in which UBSFS participated. See DB 13.

<sup>15</sup> See Jackson v. First Fed. Sav., 709 F. Supp. 863, 884 (E.D. Ark. 1988) (“[Plaintiff] must know who solicited him to buy the shares, if anyone, and who sold them to him, and discovery of these facts is not warranted. Plaintiffs’ protestations of what might be the case do not meet their obligation to plead a claim showing they are entitled to relief.”).

Conceding that any Underwriter Defendant at most sold only a *de minimis* amount of the securities offered, Plaintiffs cannot just rest on parroting statutory language and conclusory assertions. The one post-Twombly case Plaintiffs cite makes this point: where the primary underwriters are named defendants, there may well be “[a] reasonable inference” that plaintiffs “acquired their securities from [them].” In re Scottish Re Group Sec. Litig., 524 F. Supp. 2d 370, 400 (S.D.N.Y. 2007); see Iqbal, 129 S. Ct. at 1949 (“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.”) (citation omitted) (emphasis added). But where (as here) it is highly unlikely that the Plaintiffs acquired their securities from any Underwriter Defendant, no such reasonable inference is possible. See also id. at 1949 (“Where a complaint pleads facts that are merely consistent with a defendant’s liability, it stops short of the line between possibility and plausibility of entitlement to relief.”) (citation and internal quotation marks omitted).<sup>16</sup> Indeed, the allegation that the Underwriter Defendants – as a whole, undifferentiated – “transferred title to Plaintiffs and other members of the Class,” SAC ¶ 258, is simply not plausible in light of the conceded facts about the syndication of the offerings here.

Plaintiffs take a similar tack for their aftermarket purchases. As a matter of law, Section 12(a)(2) does not apply to such purchases. DB 15-16. Even though Plaintiffs have submitted PSLRA-required certificates showing (and for some, only) aftermarket purchases, see Schedule A; DB 16, Plaintiffs insist that these pleaded facts are trumped by the conclusory allegations in ¶ 258 of the SAC. OB 21. Not surprisingly, they cite no authority for the proposition.

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<sup>16</sup> Plaintiffs’ request to the contrary notwithstanding, Section 12 standing is properly addressed on a motion to dismiss, prior to discovery – especially given that Plaintiffs already know whatever facts they would purportedly seek. See In re Westinghouse Sec. Litig., No. Civ.A. 91-354 (DBS), 1998 WL 119554, at \*5 (W.D. Pa. Mar. 12, 1998) (requiring plaintiff to allege facts showing privity, and noting that the court “would be remiss in allowing this ill-defined theory of recovery to advance through discovery, summary judgment and possibly trial” because defendants “deserve a better-defined set of allegations” to challenge at the outset); In re WebSecure, Inc. Sec. Litig., 182 F.R.D. 364, 368-69 (D. Mass. 1998); Griffin v. PaineWebber, Inc., No. 99 CIV. 2292 (VM), 2001 WL 740764, at \*1 (S.D.N.Y. June 29, 2001).

## II. THE SAC FAILS TO STATE A PRIMARY CLAIM

### A. The SAC Fails To Comply With Rule 9(b) Or Rule 8

*Plaintiffs' Securities Act Claims Sound in Fraud.* The SAC's overarching theory (in both the Securities Act and Exchange Act sections) is that Defendants knew or had reason to know of the false and misleading nature of Lehman's filings and that Defendants concealed this truth so that Lehman could continue to raise capital, which, in turn, allowed underwriters to earn fees and commissions. See, e.g., SAC ¶ 5 ("concealed how close it was to insolvency" by "fail[ing] to properly write down its real estate related assets"); ¶ 6 (able to raise capital "because [of] misrepresentations about [its] true financial condition and results of operations"); ¶ 162 ("concealed its proximity to insolvency"). Concealment, of course, is not an element of any Securities Act claim and is precisely the type of allegation that sounds in fraud and necessitates the protection of Rule 9(b).<sup>17</sup> Even in their Opposition, Plaintiffs are unable to point to any facts alleged in support of a "negligence" mental state.<sup>18</sup> Thus, fraud is the only plausible theory based on the facts alleged in the SAC. See In re Portal Software, Inc. Sec. Litig., No. C-03-5138 (VRW), 2005 WL 1910923, at \*16 (N.D. Cal. Aug. 10, 2005) (rejecting plaintiffs' "artful attempt to avoid [Rule 9(b)] by carefully compartmentalizing the counts under the '33 Act and '34 Act" where "it is clear that the factual allegations upon which the entire complaint rests

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<sup>17</sup> See Meserole v. Sony Corp. of Am., Inc., No. 08 Cv. 8987 (RPP), 2009 WL 1403933, at \*4 (S.D.N.Y. May 19, 2009) ("Such allegations – that Defendants knowingly concealed material defects in a product from purchasing consumers – are grounded in fraud and are subject to the heightened pleading requirements of Rule 9(b).").

<sup>18</sup> The Opposition can only point to five SAC paragraphs to support their negligence theory. OB at 22. Three, ¶¶ 12, 92 and 245, contain irrelevant disclaimers of fraud. See In re Axis Capital Holdings Ltd., Sec. Litig., 456 F. Supp. 2d 576, 598 (S.D.N.Y. 2006) ("Courts have repeatedly noted that the insertion of a simple disclaimer of fraud is insufficient."). The other two, ¶¶ 249 and 260, merely contain a "formulaic recitation of the elements of a cause of action," and are therefore insufficient to establish a plausible theory of negligence. See Twombly, 550 U.S. at 555, 127 S. Ct. at 1965.

allege knowing, reckless and willful conduct”).<sup>19</sup>

Under Rule 9(b), Plaintiffs fail to plead fraud with particularity.<sup>20</sup> This failure is most apparent with respect to the SAC’s overwhelming reliance on anonymous sources previously employed at Lehman subsidiaries, none of whom can speak to: (1) the materiality of their allegations in the context of Lehman’s consolidated financial statements; or (2) whether the issues they raise were considered by the executives who valued Lehman’s assets – let alone by the director and officer defendants in this case. As a result, even if all of the allegations made by these loan-level sources are accepted as true, their allegations remain inadequate because the descriptions of their positions do not support the conclusions Plaintiffs draw from their statements.<sup>21</sup> See Cal. Pub. Employees’ Ret. Sys. v. Chubb Corp., 394 F.3d 126, 148-55 (3d Cir. 2004).<sup>22</sup>

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<sup>19</sup> In an attempt to convince the Court that the issue was decided at the January 2009 conference that took place before the SAC was even filed, Plaintiffs mischaracterize Defendants’ Rule 9(b) argument. At that conference, certain plaintiffs vying for lead appointments asserted that pleadings sound in fraud whenever they merely claim that offering materials were “quote, false and misleading.” As explained previously, DB 18-19, and here, Defendants are not contending that simply alleging violations of the Securities Act means a complaint sounds in fraud. Our point is that a complaint’s contents dictate the applicable pleading standard, a principle the cases on which Plaintiffs rely uniformly recognize. See In re NovaGold Res. Inc. Sec. Litig., No. 08 Civ. 7041 (DLC), 2009 WL 1575220, at \*14 (S.D.N.Y. June 5, 2009) (“in determining which pleading standard applies to a securities cause of action, a court must look . . . to the underlying conduct alleged”); In re Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 632 (S.D.N.Y. 2007) (a complaint sounds in fraud where “plaintiffs [do] not assert any claim of negligence on the part of the [Defendants] nor [do] they specify any basis for such a claim”).

<sup>20</sup> Rule 9(b) requires plaintiffs whose Securities Act claims sound in fraud to plead, *inter alia*, “why the statements were misleading.” See Rombach v. Chang, 355 F.3d 164, 170 (2d Cir. 2004). Plaintiffs must therefore “allege that defendants knew or were reckless in not knowing that the statements included in the registration statement were false or fraudulent.” Johnson v. NYFIX, Inc., 399 F. Supp. 2d 105, 122 (D. Conn. 2005) (applying Rule 9(b) to Section 11 claim). Some courts have likened this requirement to the scienter element for Exchange Act violations. See, e.g., In re JP Morgan Chase Sec. Litig., 363 F. Supp. 2d 595, 618 (S.D.N.Y. 2005). Whether coterminous with the scienter inquiry or not, our Circuit’s Rule 9(b) precedent compels Plaintiffs to explain why defendants would be motivated to commit fraud. Plaintiffs’ failure to do so is fatal to their Securities Act claims.

<sup>21</sup> In other words, whether a loan underwriter or administrator at a Lehman subsidiary is factually correct about the quality of underwriting standards he or she observed (or participated in) is entirely beside the point. For Plaintiffs to draw the conclusion that these loan-level judgments purportedly held by the anonymous sources rendered the Offering Materials actionably false, the sources must also be in a position to know that the underwriting standards the CWs perceived were so widespread as to be material to Lehman’s consolidated financial statements as a whole. And, even if one of their loan-level sources was alleged to possess an uncanny grasp on Lehman’s worldwide operations, Plaintiffs’ claims would only succeed if that employee was also in a position to know that

Even measured just against Rule 8, the Securities Act claims are insufficient.<sup>23</sup> Although Plaintiffs disclaim any allegation of fraud, they assert classes of misstatements and omissions that could only be actionable if Defendants possessed actual knowledge of the statements' falsity: challenges to forward-looking statements, judgments about valuations, and the failure to disclose "known trends." Plaintiffs' repeated assertions that these claims sound only in negligence render the claims untenable. See, e.g., NovaGold, 2009 WL 1575220, at \*19 (forward-looking statements are not actionable under Rule 8 where plaintiffs "go to great pains to allege that misstatements . . . resulted from negligence," because "Defendants by definition could not have been acting with negligence if they had actual knowledge that they were making false statements" and the "complaint thus fails to allege that defendants made objectionable statements . . . with knowledge of their falsity").

For example, Plaintiffs do not contest that for any allegation in the SAC based upon forward-looking statements they must allege that each Defendant had actual knowledge that such

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Lehman did not consider these underwriting standards in reaching valuation judgments. None of Plaintiffs' loan-level CWs is alleged to have been in a position to possess this kind of information.

<sup>22</sup> The Third Circuit's discussion of confidential sources in Chubb is instructive. The Chubb plaintiffs alleged that the defendants committed securities fraud through accounting manipulations and false statements and relied upon statements from anonymous former employees without alleging how those sources had access to such information. 394 F.3d at 134, 148. The Third Circuit found these allegations "problematic because . . . Plaintiffs heavily rely on former employees who worked in Chubb's local branch offices for information concerning Chubb's business on a national scale," id., and that allegations of accounting fraud "unquestionably lack[ed] in particularity" because they only attempted to substantiate these claims by "referenc[ing] a number of former employees [including two branch employees] who held positions that would not appear to render them privy to the company's bookkeeping practices, let alone the specific accounting that went into the company's financial reporting." Id. at 152. As a result, the Third Circuit held that "Plaintiffs have failed to plead the falsity of the Defendants' statements and accounting fraud" with the requisite particularity, and that "[t]he sheer volume of confidential sources cited cannot compensate for these inadequacies [because] [c]jobbling together a litany of inadequate allegations does not render those allegations particularized in accordance with Rule 9(b)[.]" Id. at 155.

<sup>23</sup> While Plaintiffs assert that their allegations "plainly satisfy Rule 8, and Defendants do not contend otherwise," OB 22, Defendants repeatedly highlighted the SAC's shortcomings under Rule 8. See, e.g., DB at 26 ("even measured under the standards of Rule 8 and Twombly, the valuation allegations are inadequate"); 28 ("Plaintiffs do not raise a right to relief" under Iqbal because they fail to amplify their claims with factual allegations linking loan-level allegations to Lehman's consolidated financial statements); 34 (Plaintiffs fail to allege facts showing that allegedly omitted facts existed and were known or knowable at the time of each offering); 44 (Plaintiffs fail to plead facts establishing actual knowledge of material trends).

statements were false and misleading when made. See 15 U.S.C. § 77z-2(c)(1). While Plaintiffs seek to avoid this statutory requirement (and NovaGold's dismissal of identical claims) by asserting that the statements they challenge are predicated on historical or current facts rather than projections about the future, OB 54,<sup>24</sup> they are incorrect: Plaintiffs' past tense descriptions of Lehman's forward-looking statements are misquotes (see text infra at 30 n.54) invented to support their argument that the challenged statements involve historical fact. It is not Plaintiffs' post hoc labels that determine whether the statements qualify for the PSLRA safe harbor. Rather, it is the text of the statements – and allegations involving “beliefs,” “intentions,” and “expectations” are clearly forward-looking, especially where, as here, the offering materials identified them as such. The following categories of challenged statements are forward-looking:

- Statements about general economic conditions. See, e.g., 2007 1Q Rep. at 44 (Ex. 4) (“we believe that these challenges [to the U.S. subprime residential mortgage market] will be relatively contained to this asset class”) (emphasis added).
- Statements about risk management and hedging strategies.<sup>25</sup> See, e.g., 2007 10-K at 69 (Ex. 8) (describing efforts to manage and hedge risk and warning “[o]ur business activities have inherent risks [and] risk cannot be completely eliminated”) (emphasis added).
- Statements about liquidity strategies. See, e.g., 2007 10-K at 75 (Ex. 8) (“Our liquidity strategy seeks to ensure that we maintain sufficient liquidity”) (emphasis added); 2008 2Q Rep. at 80 (Ex. 10) (“The Company maintains a liquidity pool available to Holdings that is primarily intended to cover expected cash outflows”) (emphasis added).

<sup>24</sup> See 2006 10-K at 3 (Ex. 3) (identifying statements that include words such as “expects,” “intends,” and “believes” as forward-looking statements); In re U.S. Interactive, Inc. Class Action Sec. Litig., No. 01-CV-522, 2002 WL 1971252, at \*9 (E.D. Pa. Aug. 23, 2002) (finding a statement protected under the safe harbor because it contained the word “belief” and that term was explained in the offering documents as one of several “generally intended to identify forward-looking statements”).

<sup>25</sup> General statements about risk management, hedging, and liquidity are inherently forward-looking because they contain an implicit representation that these strategies will be effective in the future. See In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 440 (S.D.N.Y. 2001) (statements concerning the health and viability of a company whose truth or falsity were discernible only after they were made necessarily referred to future performance).

Plaintiffs can only state a claim with respect to these statements and the other forward-looking statements challenged in the SAC,<sup>26</sup> DB 20-21, if they allege that Defendants had actual knowledge of their falsity at the time of the offerings. Since such an allegation would be entirely inconsistent with a theory of negligence, these claims must be dismissed. See NovaGold, 2009 WL 1575220, at \*19.<sup>27</sup> The same is true for other claims requiring actual knowledge of the alleged errors, such as alleged failures to disclose “known” trends (see infra at 28-29) or challenges to the disclosures regarding valuation estimates that require judgments (see infra at 16-17).

**B. The SAC Fails To Meet Plaintiffs’ Burden of Demonstrating that Offering Documents Were False Or Misleading**

The Defendants challenged the SAC’s failure to allege facts demonstrating that any Offering Material were false or misleading at the time of the specific offering. While naming scores of defendants and challenging hundreds of offerings over a nineteen-month period of unprecedented volatility, the SAC treats all the various Offering Materials as if they were all made at the same time, and as if then existing market conditions, information, and differing accounting rules did not matter. Rather than identifying any factual basis for alleging that any misstatement or omission was contained in any specific document, the SAC just points to

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<sup>26</sup> See, e.g., SAC ¶¶ 156-57, 163, 180-81, 185, 224-27, 230-31 (forward-looking statements regarding general economic conditions and Lehman’s risk management, hedging and liquidity strategies); ¶¶ 135, 147-54, 170, 177-79, 184-86, 189-91, 194-96, 197-200, 203-08, 211-13, 214-18, 222-23, 228-29 (valuation estimates for illiquid assets made using significant judgment); ¶¶ 144, 171-76, 182-83, 187-88, 192-93, 201-02, 209-10, 218, 223 (alleged failure to disclose “known trends”).

<sup>27</sup> Plaintiffs also advance an incomplete explanation of the law with respect to statements containing both forward-looking aspects and representations of present fact. OB 55. In such circumstances, “a mixed present/future statement is not entitled to the safe harbor with respect to the part of the statement that refers to the present.” Inst. Investors Group v. Avaya, Inc., 564 F.3d 242, 255 (3d Cir. 2009) (quoting Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 705 (7th Cir. 2008)) (emphasis added). Therefore, even if a forward-looking statement challenged in the SAC contains some representation of present fact, Plaintiffs’ claim should be dismissed where the alleged falsity relates to the forward-looking aspect. See In re Stone & Webster, Inc., Sec. Litig., 414 F.3d 187, 213 (1st Cir. 2005) (Leval, J. sitting by designation) (“We believe that in order to determine whether a statement falls within the safe harbor, a court must examine which aspects of the statement are alleged to be false.”).

statements made and pronounces them misleading, without regard to how then existing facts (i) made the disclosure misleading, and if so, (ii) establish the materiality of the misstatement. Plaintiffs' Opposition continues to rattle off allegations without regard to how they relate to any specific offering or point in time. But whether viewed under Rule 9(b) or 8, timing is everything: the truth of the statements made in the Offering Materials must be evaluated by the facts and disclosures as they existed at the time of the offerings. See DB 24, 26-27.

By scattering conclusory allegations without relating them to specific offerings, Plaintiffs try to create factual issues (and survive long enough to conduct costly discovery) about which allegations are applicable to which offerings – facts that they have put into dispute by failing to plead them in the first place. Lehman's financial disclosures, like those of all firms during this period of unprecedented turmoil, evolved over time to reflect market changes and shifting perspectives; initial write-downs were taken, further write-downs were taken when necessary, and assets continued to be bought and sold throughout the period. By contrast, Plaintiffs' allegations of false disclosures are premised on the implausible assumption that the composition of Lehman's assets and liabilities remained static throughout the entire period and that these disclosures were false for the same reasons throughout time.

Plaintiffs' refrain that merely because a fact is alleged to be true at one point in time it must have been true at an earlier one is equally implausible – especially since Plaintiffs concede that this was a time of great volatility.<sup>28</sup> As the Court aptly noted at the January 8 conference, “[Y]ou and I and everyone in this room and the entire world has, for the last seven, eight, nine, ten months, been witnessing, in relation to Lehman in particular, the economy in general, a slow

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<sup>28</sup> See, e.g., OB 49 (“Despite a calmer economic climate during the [second] quarter [2008]”); id. (quoting analyst that “credit market did not really deteriorate between February and May” 2008); OB 1 (alleging that Lehman's bankruptcy in September 2008, by many accounts, “trigger[ed] a global meltdown in the financial credit markets”); OB 4 (“commercial real estate market deteriorated during the Offering Period”); OB 5 n.6 (discussing “ongoing U.S. housing crisis”).

motion train wreck. And whatever may have appeared to have been the case in June [2008], most assuredly appears in an entirely different light today.” 1/8/09 Tr. at 26. It is for this reason that we address Plaintiffs’ arguments and the SAC’s allegations in chronological order.

**1. 2006 Year-End**

The financial statements contained in the 2006 10-K (Ex. 3) were audited. Ernst & Young certified that they “present[ed] fairly, in all material respects” Lehman’s consolidated financial positions and results of operations “in conformity with U.S. generally accepted accounting principles” (GAAP). 2006 10-K at 74 (Ex. 3). Under the Securities Act, 15 U.S.C. § 77k(b)(3)(C), Defendants are entitled to rely upon Ernst & Young’s unqualified audit opinion for the 2006 10-K and “are not liable for any part of a registration statement” made on such authority when they have demonstrated that they “had no reasonable ground to believe and did not believe . . . that the statements therein were untrue” or misleading. DB 30.<sup>29</sup> The SAC does not allege that Ernst & Young was negligent in any way in auditing the financial statements, much less that any Defendant believed that it was. *Id.* at 25. Nor do Plaintiffs allege that Defendants missed any red flags that might negate the defense.

Having expressly and repeatedly disclaimed in the pleadings that any Securities Act Defendant engaged in “fraud or any other deliberate and intentional misconduct,” or “knowing or reckless misconduct” (SAC ¶ 92 & ¶ 12), “by definition” Defendants “could not have been acting with negligence if they had actual knowledge” or belief that Ernst & Young’s unqualified audit opinions were untrue or misleading. NovaGold, 2009 WL 1575220, at \*19. Indeed, the Opposition mounts no argument against the application of this expertization defense on the

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<sup>29</sup> As Justice Powell explained, this “provision is in the [Securities] Act because, almost by definition, it is reasonable to rely on financial statements certified by public accountants.” John Nuveen & Co. v. Sanders, 450 U.S. 1005, 1010, 101 S. Ct. 1719, 1721 (1981) (dissenting).

specific facts pled in this case.<sup>30</sup> This reliance on expertised portions of the audited financial statements is therefore a complete defense to all of the alleged misstatements or omissions contained in the audited financial statements. See, e.g., SAC ¶¶ 160, 170-76, 223-30.

In any event, all of Plaintiffs' challenges to the disclosures in the Offering Documents independently fail.

(a) Valuation

The SAC contained no competent factual allegations that Lehman's valuation of its mortgage-related assets disclosed in the Offering Materials was false at the time of any offering. DB 29. Defendants do not argue that Lehman had "virtually unrestrained discretion to value its assets as it saw fit." OB 39. Rather, consistent with GAAP, Lehman disclosed that due to the illiquidity of hard-to-price mortgages and mortgage-related assets, in some cases it was required to render estimates and judgments of fair value of those assets, DB 29-30, and further warned that these valuations involved "significant estimates" and that "[a]ctual results could differ from these estimates." 2006 10-K at 62, 65-66 (Ex. 3). Plaintiffs disregard all these disclosures and warnings, arguing that Lehman must have failed to mark its mortgage-related assets to fair value because Lehman's disclosed estimates (and later announced write-downs) did not comport with two indices (the ABX and CMBX), which measure the cost of credit protection for residential and commercial mortgage securities, respectively, and because Lehman's valuations and decisions about when to write-down assets differed from those made by other banks during the Offering Period. OB 43-45.

Two threshold issues vitiate Plaintiffs' valuation claims altogether.

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<sup>30</sup> See Anti-Monopoly Inc. v. Hasbro, Inc., 958 F. Supp. 895, 907 n.11 (S.D.N.Y. 1997) ("[T]he failure to provide argument on a point at issue constitutes abandonment of the issue."); cf. Lipton v. County of Orange, 315 F. Supp. 2d 434, 446 (S.D.N.Y. 2004) ("This Court may, and generally will, deem a claim abandoned when a plaintiff fails to respond to a defendant's arguments that the claim should be dismissed.").

*Valuation Estimates Involve Judgments.* Plaintiffs describe valuation of mortgage-backed assets as if GAAP required a specific methodology; it does not. Under GAAP, both before and after the implementation of SFAS 157, there was no single “approved” method to value such assets. SFAS 157 discusses three levels of inputs to fair value measurements. Only for Level 1 does SFAS 157 require that such inputs (“quoted prices (unadjusted) in active markets for identical assets or liabilities”) be used as the sole basis for measuring fair value. There can be no dispute that during the Offering Period identical residential mortgage backed securities (“MBS”) and commercial real estate backed securities (“CMBS”) did not have quoted prices in active markets – they were illiquid. As such, as Plaintiffs concede, the assets in question here did not have available Level 1 inputs. OB 39, 43. In fact, there were few, if any, observable market prices, even for similar securities. SFAS 157 identifies observable inputs other than quoted prices in active markets as Level 2 inputs, and such observable inputs are to be used, when available, if Level 1 inputs are not. SFAS 157 itself identifies a variety of examples of Level 2 inputs, and notes that adjustments to such inputs may be required. See SFAS 157 ¶¶ 28-29.

Thus, even if the SAC’s allegations about Lehman’s disclosed valuations for these illiquid mortgage assets were true, no claim is stated for the simple reason that GAAP does not require that Lehman value its illiquid mortgage-related assets in one particular way – for example, by relying exclusively upon inputs from the ABX or CMBX to the exclusion of any other.<sup>31</sup> Under both SFAS 157 (which only became effective in November 2007, as discussed

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<sup>31</sup> None of the litany of cases cited by Plaintiffs (OB 36, 39 n.60) supports the suggested conclusion that mere invocation of a “GAAP” violation creates “fact issues” precluding Rule 12(b)(6) relief. In each, the pleadings made factual allegations that, if true, supported the conclusion that a GAAP violation had occurred. See, e.g., In re RAIT Fin. Trust Sec. Litig., No. 07-cv-03148-LDD, 2008 WL 5378164, at \*7 (E.D. Pa. Dec. 22, 2008) (declining to dismiss claim where plaintiffs made “several factual allegations supporting the conclusion that [defendants] knew about” impairments but failed to discount them under FAS 115); In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1421 (3d Cir. 1997) (defendant’s response failed to demonstrate that “alleged earnings overstatements can be

below) and pre-existing fair value reporting rules, the appropriate application of GAAP required reporting firms to use their judgments to estimate hard-to-value assets<sup>32</sup> by incorporating information from a range of different inputs – just as Lehman did.<sup>33</sup> Because valuation of illiquid assets necessarily involves judgments and opinions, the only way that Plaintiffs can state a claim is to allege that Lehman did not “truly hold” those valuation opinions when they made them (and that the Securities Act Defendants somehow had knowledge of this belief). See In re Global Crossing, 313 F. Supp. 2d at 210. Not only are there no such allegations here, but Plaintiffs have explicitly disclaimed any knowing or intentional conduct by the Securities Act Defendants. Under these facts, none of the criticisms leveled at Lehman’s valuation judgments states a claim.

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fully explained by” defendant’s use of “different accounting methods”). Here, assuming the existence of facts pled in the SAC, there would be no violation of GAAP.

<sup>32</sup> See SFAS 157 ¶ 22 (“Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.”); id. App. C ¶ 54 (“Determining the appropriateness of valuation techniques in the circumstances requires judgment.”); SFAS 107 App. C ¶ 59 (“The Board realizes that estimating fair value when quoted market prices are unavailable may, in some cases, require considerable judgment.”).

<sup>33</sup> As this Court noted in Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC, 376 F. Supp. 2d 385, 396 (S.D.N.Y. 2005), valuation of illiquid instruments like MBS and CMBS during the Offering Period “was not a matter of looking up closing prices on the *Wall Street Journal*, but involved the exercise of judgment.” While Plaintiffs attempt to sidestep this Court’s reasonable observation, the fact that SFAS 157 later implemented a defined three-level hierarchy of inputs did not alter the GAAP requirement that firms continue to use judgments to evaluate available market inputs and to estimate the value of illiquid assets, which are the only assets at issue in this case. Similarly, Plaintiffs attempt to dodge Judge Lynch’s decision in In re Salomon Analyst Level 3 Litig., 373 F. Supp. 2d 248, 251-52 (S.D.N.Y. 2005), that since valuation models depend “heavily on the discretionary choices of the modeler—including the choice of method (e.g., discounted cash flow vs. market based methods), [a disclosure of such a valuation opinion] does not omit a material fact by failing to note that others may have different opinions.”

Plaintiffs assert wrongly that after the enactment of SFAS 157, companies like Lehman did not have a choice whether to use different valuation methods. While SFAS 157 called for the use of observable inputs – where available – FASB repeatedly recognized that the use of valuation methods still required judgments. See, e.g., SFAS 157 B19 (“The selection of Method 1 or Method 2 [valuation techniques] will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available, and the judgments applied.”); id. App. C ¶ 54 (“Determining the appropriateness of valuation techniques in the circumstances requires judgment.”); id. C ¶ 64 (“However, the fair value hierarchy focuses on the inputs, not the valuation techniques, thereby requiring judgment in the selection and application of valuation techniques.”) (emphases all added).

*Materiality.* As Plaintiffs concede, “both quantitative and qualitative factors must be analyzed in order to determine materiality[.]” OB 51 (emphasis added). But the SAC provides no facts that would allow the Court to assess the quantitative aspects of Lehman’s alleged overvaluations (or allegedly deficient write-downs). There are no facts pled about how many mortgages or mortgage-related assets were overvalued, or if they were overvalued, how much they were overstated, or whether this would be material to Lehman’s consolidated financial statements at the time of each (or any) challenged Offering. In the absence of predicate factual allegations, Plaintiffs cannot plead materiality by merely repeating the legal conclusion that the overvaluations or other misstatements were “material” at all times.<sup>34</sup> See DB 32. Instead, they must plead facts showing the extent to which mortgages were overvalued, at the time, and in the context, of each Offering. Merely pointing to facts disclosed about Lehman’s leverage ratio and falsely<sup>35</sup> implying that a miniscule decrease in the value of Lehman’s mortgage assets could render the company insolvent is insufficient. Defendants need not disprove an argument that Plaintiffs do not adequately allege. Iqbal, 129 S. Ct. at 1949 (“Nor does a complaint suffice if it

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<sup>34</sup> The SAC’s conclusion of materiality rests on multiple inferences but failing to allege facts to establish each link in this chain of inferences is fatal to the conclusion. For example, Plaintiffs argue that “the inadequate mark-to-market write-downs taken by Lehman on its mortgage-related positions caused many of Lehman’s remaining financial metrics to be materially overstated during the Offerings Period.” OB 50. Yet the SAC fails to provide any quantification of the size of the appropriate write-downs much less the timing of such write-downs in comparison to Lehman’s disclosed write-downs. Nor do Plaintiffs plead facts about the extent to which “financial instruments and inventory positions owned, and total assets metrics for each of the quarters during the Offerings Period” or “net revenues, net income, and earnings per share” were all overstated other than by asserting that they were. OB 50.

<sup>35</sup> Plaintiffs argue that Lehman had “balance sheet exposure to more than \$89.1 billion in mortgages and mortgage-related assets by the 2007 year-end” and that such “assets were highly leveraged, such that ‘a mere 3.3% drop in the value of the assets wipes out the entire value of equity and makes the Company insolvent.’” OB 35. This is grossly misleading. In fact, the source for Plaintiffs’ quote, Professor Luigi Zingales (SAC ¶ 162), stated that the value of all of Lehman’s assets – not just the real estate-related ones – would need to drop by 3.3% to make this happen. There are simply no facts pled in the SAC that establish that Lehman was operating under these allegedly “razor- thin” margins (OB 52 n.69) at the time of any relevant offering, or that Professor Zingales’ opinion, as of September 2008 (a period of specific economic stress generally and for Lehman in particular), had any relevance to the state of Lehman’s assets during the entire nineteen-month period. For example, as Plaintiffs acknowledge elsewhere in their Opposition, Lehman had assets as of the first quarter of 2008 of \$786 billion. OB 51. At that time, Lehman’s total U.S. real estate assets were under \$21 billion. 2008 1Q Rep. at 56 (Ex. 9). Even if all those assets were completely worthless – a 100% reduction in their value – that would still leave Lehman with billions in equity even under Prof. Zingales’ analysis.

tenders naked assertions devoid of further factual enhancement.”) (citation and internal question marks omitted).

Plaintiffs also point to the SEC’s Staff Accounting Bulletin 99 (“SAB 99”) to support their qualitative materiality showing, noting that whether an alleged misstatement “masks a change in earnings or other trends” should be considered. OB 52. Plaintiffs argue that Lehman’s “overvaluation” of its mortgage-related assets “masked the Company’s true exposure to the worsening real estate and mortgage markets and suggested that Lehman’s assets were not subject to the same risks and devaluations plaguing other financial institutions,”<sup>36</sup> and that if Lehman had “properly marked at their fair market values” those assets, investors would have been made aware of Lehman’s vulnerability to the “real estate and mortgage market crisis throughout 2007.” OB 52. First, this argument cannot be reconciled with the SAC’s allegations that the MBS/CMBS market was illiquid so that valuations could not be precise because there were few observable prices. Second, Plaintiffs ignore SAB 99’s corollary that the “amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases.” SAB 99, Concepts Statement No. 2, 130. Thus, the valuation of illiquid MBS/CMBS instruments during the “real estate and mortgage crisis” of 2007 (OB 52) were, by definition, not subject to “precision” and the SEC staff specifically noted that any deviation that might be material in the case of an item that could be “estimated more accurately,” such as accounts payable, “may be quite trivial” where the asset/liability valuation is not susceptible to precision. *Id.* Even if there were deviations between what Plaintiffs believe the marks should have been (which amount is not alleged) to those Lehman actually disclosed, to be material such a hypothetical deviation

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<sup>36</sup> No reasonable investor could have understood that Lehman was representing that it, alone among all financial institutions, was invulnerable to the effects of the devastating collapse of the housing markets and credit meltdown. Lehman repeatedly told investors that due to the downturn in the real estate market its origination and securitization businesses were negatively and “significantly” impacted and warned that future real estate market deterioration would continue to hurt the Company. *See, e.g.*, DB 37, 40, 49, 51, 54, 55, 57, 58, 60.

would have to have been even more substantial than in other circumstances. Third, there can be no misstatement, much less a material one as judged by SAB 99, unless Plaintiffs first establish that Lehman's assumptions or judgments about such hard-to-value illiquid instruments were not truly held. They do not do so here.

Nevertheless, Plaintiffs still brand Lehman's valuations as "false." As "evidence," they point generally and without regard to the timing of any particular Offering to (1) allegations by anonymous sources that Lehman failed to take timely (without specifying exactly when) write-downs as its mortgage-related positions became impaired; (2) movements of the ABX and CMBX indices; (3) write-downs taken by Lehman's competitors; and (4) news reports in the days before filing bankruptcy in September 2008. OB 36-37. Again, even accepting the truth of these "facts," no claim is stated.

*Anonymous Sources.* Whether considered under Rule 9(b) or Rule 8, loan-level allegations by unidentified employees at subsidiaries about increased repurchase requests and loan defaults (OB 41-42) do not show, by their mention in the SAC and repetition in the Opposition, a material impact on Lehman's consolidated financial statements as a result of the application of valuation processes and procedures to an array of individual mortgage assets. DB 27-28. Plaintiffs do not dispute that there must be a link between the loan-level default<sup>37</sup>/repurchase allegations, on the one hand, and Lehman's disclosed valuations and estimates in the consolidated financial statements on the other. Nothing exists here that establishes, or makes it even plausible, that these granular "sentiments" (OB 42), even if true,

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<sup>37</sup> Plaintiffs also argue there was a "marked increase in defaults on BNC and Aurora loans" that supposedly supports the allegation that the MBS suffered sharp declines prior to the announced write-downs (but the SAC includes no specific allegations about whether such defaults were for whole loans held by Lehman or securitized loans, or any facts to establish the materiality of such defaults on the consolidated financials). OB 42. As evidence of these defaults, Plaintiffs refer to SAC ¶ 105, which as discussed infra at 28, is taken from the publicly available filings of Lehman's subsidiary. To the extent that any of this information would have been relevant to investors, it was available to them.

were shared with or known by Lehman at the parent-level or that anyone at the parent-level believed these loan-level developments were not properly and fully taken into account in estimating the fair value of mortgage-related assets at the time of the 2006 10-K or any relevant Offering. Without these critical facts, Plaintiffs' claims (e.g., SAC ¶¶ 98-114) flunk Twombly and Iqbal as unduly speculative.

Plaintiffs also ignore that the two primary sources cited in the Securities Act portion of the SAC who allegedly worked at Lehman, CW 7 and CW 23, both gave only conclusory opinions that commercial real estate assets should have been "marked down further" and were "overvalued on the books," without specifying facts about which "books," when, and by how much. SAC ¶ 131-32; DB 28.<sup>38</sup> Neither of these Lehman sources speak to residential mortgage assets.<sup>39</sup>

*Indices.* Plaintiffs wrongly argue (e.g., SAC ¶¶ 126-28, 133, 142) that the spreads reported on the ABX and CMBX indices during the Offering Period establish that the disclosed valuation estimates and methodologies used by Lehman to calculate its residential and commercial mortgage assets were not "at fair value." First, there was no GAAP requirement that

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<sup>38</sup> See Druskin v. Answerthink, Inc., 299 F. Supp. 2d 1307, 1334 (S.D. Fla. 2004) (dismissing opinions of former employees who either "disagreed with management's decisions or held beliefs unsupported by particularized factual allegations"); Caiafa v. Sea Containers Ltd., 525 F. Supp. 2d 398, 410-11 (S.D.N.Y. 2007) (dismissing allegations where plaintiff failed to plead with particularity how defendant's write down establishes why defendant's valuations of its assets were false and failed to state the basis for its "book-value allegations" and "to specify the amounts by which the ferries and containers were allegedly overvalued").

<sup>39</sup> Moreover, as Plaintiffs concede, CW 7 was only involved in the relevant loan program from mid-2007 until early 2008 (SAC ¶ 334) and CW 23 was in the Real Estate Group from late 2007 until the fall of 2008. OB 47. Therefore it is not possible, much less plausible, that either had information that any of the alleged valuations of commercial assets were misstated in early 2007 when the 2006 10-K was prepared and filed (and on that basis, by definition, neither of them could have been talking about conditions that existed at the time of any of the dozens of offerings that occurred before mid-2007). Underscoring that timing is critical, even Plaintiffs concede (OB 41) that Lehman took write-downs on its real estate-related assets starting in the Third Quarter of 2007, consistent with when these CWs assert it should have. This failure to connect disclosures with context, repeated throughout the SAC, highlights the SAC's complete failure to relate specific factual allegations to conditions that existed at the time of specific offerings.

Lehman value its assets by relying exclusively upon ABX and CMBX inputs.<sup>40</sup> See supra at 15-16. Indeed, exclusive reliance on such inputs would itself have been a violation of GAAP since those indices are intended only to provide insight into market expectations of credit default, and not to any other input relevant to the valuation of mortgage assets such as collateral value, liquidity, or prepayment. Thus, there is no reasonable basis to assume, as Plaintiffs do, that Lehman's valuation of its mortgage assets should somehow mirror either index.

Second, Plaintiffs do not allege any correlation between these credit-default indices and Lehman's specific assets. The indices are based upon a sample of 20 deals covering only part of the capital structure of the index (i.e., AAA, AA or BBB, etc.).<sup>41</sup> Therefore, even the default risk they reflect could not be a reliable proxy for Lehman's mortgage assets. DB 34. Accordingly, GAAP requires firms to consider the need to make adjustments to market inputs from such indices in order to reflect their own assets and data. See, e.g., SFAS 157 ¶ 29.<sup>42</sup> In addition, other inputs would need to be considered to provide information on risks and factors not considered by the indices. In fact, in later reporting periods, Lehman disclosed that its valuation estimates included the use of both indices as market inputs, in conjunction with other inputs.<sup>43</sup>

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<sup>40</sup> Even Plaintiffs' own citation to accounting literature on fair value states that the pricing "indicated by the ABX credit derivative index for subprime mortgage bonds may be a Level 2 input when used as an input to the valuation of a security backed by subprime mortgage loans" (OB 43-44 (emphasis added)) but does not say that it must be an input or imply at all that it should ever be the sole and exclusive input.

<sup>41</sup> See Ryan Avent, *How the Subprime ABX.HE Index Works*, Portfolio.com, Jun. 21, 2007, available at <http://www.portfolio.com/views/blogs/market-movers/2007/06/21/how-the-subprime-abxhe-index-works> (noting that the ABX index "comprises just 20 names, all of which are mortgage-backed securities with the same credit rating" and that level of index "reflects not the price at which those names are trading, but rather the price at which credit default swaps on those names are trading" as the "MBSs themselves barely trade").

<sup>42</sup> See, e.g., FASB Staff Pos. No. FAS 157-3 ¶ 9(b) (Oct. 10 2008) ("For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.") (emphasis added).

<sup>43</sup> SFAS 157 became effective on November 2007, and Lehman adopted the SFAS 157 standard beginning in the first quarter of 2007. Although Plaintiffs generally allege that Lehman's reported fair value estimates for mortgages and related assets were not compliant with SFAS 157 (OB 37-40), that standard did not even apply to the

The SAC does not allege that the use of any of these market inputs was improper or that Lehman failed to use the inputs that it had disclosed. The mere fact that the indices are alleged to have suggested declines in the value of securities at different times during the Offering Period, even if true, does not render Lehman's disclosed valuation estimates false or misleading. To state a claim, Plaintiffs would need to allege facts that establish Lehman knew that its judgments to use the market inputs it did were wrong, which again the SAC expressly, by design, does not.

*Write-downs by other firms.* Similarly, Plaintiffs wrongly charge that because other firms reported broader write-downs of their mortgage-related assets prior to Lehman's own write-downs in 2007, Lehman's valuation judgments must have been false and misleading at the time of each relevant Offering. Without defending the appropriateness of the comparison,<sup>44</sup> Plaintiffs again assume that because other firms wrote down their real estate assets earlier and reached different conclusions about the value of their assets is determinative of when and by how much Lehman should have written down its assets (OB 45) – despite the absence of any factual basis to infer that Lehman's assets were materially identical to those firms' assets and that Lehman knew it. DB 35.

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16 challenged offerings prior to the filing of the 1Q 2007 Report on March 14, 2007. For those offerings, as disclosed in the 2006 10-K, "fair value" calculations for the assets were based on "listed market prices, if available" and where such prices were not available, "fair value" was determined based "on valuation pricing models that take into account relevant factors," and also "considers comparisons to similar market transactions." 2006 10-K at 92 (Ex. 3). There is no allegation that any of these disclosures as to how Lehman valued its assets was incomplete or inaccurate.

<sup>44</sup> Plaintiffs take a pass on responding to Defendants' arguments that the SAC's comparisons of Lehman to other firms (OB 45 n.65) are fundamentally flawed because of differences between the firms and the types of mortgage-related assets they held, the failure by Plaintiffs to account for the relative success of hedging in the reported figures, differing reporting cycles, and the crucial point that for valuations of such illiquid products, the FASB recognized that "variations in the methods used to estimate the fair value of liabilities with no quoted prices might reduce the comparability of fair value information among entities." SFAS No. 107, App. C ¶ 68 (emphasis added); see also *Campo v. Sears Holdings Corp.*, --- F. Supp. 2d. ---, No. 06 Civ. 4053 (LAK), 2009 WL 2151289, at \*5 (S.D.N.Y. July 21, 2009) (rejecting as "entirely too speculative" plaintiffs' conclusion of fair market value of K-mart's real estate since it "presupposes that Kmart's stores as a whole were comparable to the 'average' store nation-wide"). Each of these arguments cuts down Plaintiffs' right to relief to a speculative level and absent any amplification of facts necessary to make such allegations "plausible," the claim must be dismissed. *Iqbal*, 129 S. Ct. at 1949.

The consideration of inputs necessary to value mortgage assets can lead to different judgments about the fair value of those assets. DB 28-29, 34-35. As the SEC noted, when addressing the fair value estimates of employee stock options – instruments that are far less complex than MBS – there is a “range of conduct that a reasonable issuer might use to make estimates and valuations” and that “[d]ifferent conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably.” SEC Staff Accounting Bulletin No. 107 at 5 (Mar. 29, 2005) (emphasis added). In the absence of any joinder on this issue, Plaintiffs cannot stand merely on their allegations and rest when, even if true, those allegations do not state a claim as a matter of law.

*News Reports Following Bankruptcy and Disclosure of Prior Write Downs.* Plaintiffs next rely upon news articles discussing “events leading to Lehman’s September 15, 2008 bankruptcy filing” to further “substantiate” their claim “that the Company’s commercial real estate and mortgage holdings were overvalued during the Offerings Period.” OB 48; see, e.g., SAC ¶¶ 135-39, 154-55, 158-59, 164. Plaintiffs also later repeat allegations that Lehman’s write-downs in November 2007 and the first two quarters of 2008 leading up to the bankruptcy establish that Lehman’s assets were all “overvalued during the Offerings Period.” OB 49-50. These allegations are the definition of impermissible fraud by hindsight pleading;<sup>45</sup> the last Offering in which any of the Underwriter Defendants were alleged to have participated was in May 2008 – four months before Lehman declared bankruptcy in September 2008 (DB 33), and

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<sup>45</sup> Plaintiffs cite *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158 (S.D.N.Y. 2003), and *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72 (2d Cir. 2001), in support of their “then-as-before” arguments. But neither permits pleading fraud by hindsight. In *Vivendi*, for example, the primary post-class information came from news articles that incorporated two pieces of intra-class period evidence that Plaintiffs had already cited. Here, there is no contemporaneous evidence cited in the Securities Act section of the SAC that establishes any basis to conclude that news articles in September 2008 demonstrated that the valuations reportedly discussed for the potential sale of Lehman’s assets in September were in any way applicable to valuations of assets (even assuming that the assets were the same) at the specific time of any offering – much less every offering – during the Offering Period.

merely because a write-down was taken in one period does not ipso facto mean it was required earlier.<sup>46</sup>

To avoid dismissal Plaintiffs essentially ask this Court to ignore that the economic conditions that existed before the Summer of 2008 (or at any prior point) were far different than they were in mid-September 2008, when Lehman, as alleged by Plaintiffs, was under tremendous financial pressure (SAC ¶¶ 7, 136-37) and “frantically”<sup>47</sup> attempted to liquidate certain of its real estate assets before ultimately being forced to file for bankruptcy. See Iqbal, 129 S. Ct. at 1950 (determining whether complaint states a “plausible claim for relief” is a “context-specific task that requires the reviewing court to draw on its judicial experience and common sense”). As this Court has already noted about the condition of the economy generally and Lehman in particular, “whatever may have appeared to have been the case in June [2008], most assuredly appears in an entirely different light today.” 1/8/09 Trans. at 26.<sup>48</sup>

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<sup>46</sup> See In re CIT Group, Inc. Sec. Litig., 349 F. Supp. 2d 685, 690-91 (S.D.N.Y. 2004) (“That defendants later decided to revise the amount of loan loss reserves that it deemed adequate provides absolutely no reasonable basis for concluding that defendants did not think reserves were adequate at the time the registration statement and prospectus became effective.”). The last offering involving UBSFS occurred in June 2008. See App. A.

<sup>47</sup> See OB 48. It was during this “frantic” period that the potential suitors reportedly determined that Lehman’s commercial real estate portfolio was allegedly overvalued. But the SFAS 157 standard, which is relied upon throughout the OB, makes clear that pricing inputs from such “forced” or “distressed sales” are inaccurate and cannot be relied upon for valuation purposes. See SFAS 157 ¶ 7 (“A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. . . . it is not a forced transaction (for example, a forced liquidation or distress sale)”) (emphasis added). Thus, on the basis of Plaintiffs’ own allegations, by definition any “distressed” valuation in September 2008 would have no bearing (assuming even the identical composition of assets) in earlier reporting time periods.

<sup>48</sup> Equally improper is Plaintiffs’ attempt to cite to subsequent disclosures about write-downs of mortgage-related assets as “evidence” that write-downs must have been required earlier or in greater amounts, in the absence of any specific factual allegation that such write-downs were required in a material amount as of a particular offering date. Courts have soundly rejected pleading with such 20/20 hindsight. See, e.g., Panther Partners, Inc. v. Ikanos Commc’ns, Inc., 538 F. Supp. 2d 662, 669 (S.D.N.Y. 2008) (dismissing allegations that have “been craftily drafted to imply that what only became clear due to subsequent events was somehow known to [defendant] far earlier in time, well before the confirming event occurred or other evidence came to light” as “pleading with 20/20 hindsight”); Hinerfeld v. United Auto Group, No. 97 Civ. 3533 (RPP), 1998 WL 397852, at \*7 (S.D.N.Y. July 15, 1998) (holding that allegations that defendants knew or should have known about the inadequacy of the reserves are conclusory and that no facts were alleged to “support an inference that this failure was the result of anything but inaccurate forecasting or unforeseen circumstances”).

(b) Amount of Mortgage-related Assets

Even though the 2006 10-K disclosed that Lehman was a leading originator and underwriter of MBS and that revenues from mortgages and MBS had decreased overall primarily due to “a softer housing market” and “lower margins” and that it owned approximately \$57.7 billion worth of mortgages and mortgage backed positions (DB 37), Plaintiffs maintain that the 2006 10-K (and subsequent filings) omitted material information because Lehman “failed to disclose the extent to which these positions were concentrated in subprime or Alt-A loans, residential or commercial loans, or whole loans or mortgage-backed securities.” OB 29.<sup>49</sup> The sole basis for Plaintiffs’ argument that this constitutes an actionable omission is the text of SFAS 107, which “requires companies to disclose ‘all significant concentrations of credit risk from all financial instruments.’” Id.; SAC ¶¶ 170-72.

But the SAC pleads no facts to establish that Lehman actually had a significant concentration of credit risk in any of these mortgage sub-categories. Nor can Plaintiffs point to any rule or regulation requiring this level of detail.<sup>50</sup> Instead, Plaintiffs only reference later

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<sup>49</sup> Plaintiffs ignore numerous other disclosures in the 2006 10-K that provided information about the relative balance of Lehman’s mortgage-related businesses. For example, immediately after identifying its combined mortgage positions, Lehman disclosed that it originated about \$60 billion of residential and \$34 billion of commercial mortgage loans in 2006. 2006 10-K at 90 (Ex. 3). Lehman also disclosed that it securitized about \$146 billion of residential and \$19 billion of commercial mortgages into mortgage-backed securities during the previous year. Id. at 92. Similarly, Lehman stated that it had about \$7.0 billion of outstanding residential mortgage commitments and \$5.2 billion of commercial mortgage commitments as of November 30, 2006. Id. at 102. Lehman also disclosed that approximately \$4.3 billion of its total mortgage loan inventory, primarily consisting of commercial loans, were valued on the basis of management estimates because they were securitized infrequently. Id. at 66. Also, the difference between the amount of commercial mortgage loans originated and securitized disclosed the volume that remained as whole loans.

<sup>50</sup> See In re MoneyGram Int’l, Inc. Sec. Litig., --- F. Supp. 2d ---, Civ. No. 08-883 (DSD/JJG), 2009 WL 1451582, at \*17 (D. Minn. May 20, 2009) (dismissing alleged SFAS 107 violation where “there is no indication that GAAP required more specific disclosures”); Nolte v. Capital One Fin. Corp., 390 F.3d 311, 316-17 (4th Cir. 2004) (acknowledging that “subprime lenders are discouraged from publicly reporting the size of their subprime portfolios” because the lack of a standard industry-wide definition of “subprime” could mislead investors comparing two institutions). The conclusion of these authorities is not surprising since the FASB staff has explained that “[j]udgment is required to determine whether loan products have terms that give rise to a concentration of credit risk.” Terms of Loan Products That May Give Rise to a Concentration of Credit Risk, FASB Staff Position SOP 94-

events and subsequent Lehman disclosures, and baldly assert that GAAP required the same level of detail to be provided earlier. OB 30 (stating that Lehman specified amounts of residential whole loans, asset-backed securities and subprime loans in the 2007 Form 10-K). Such cursory pleading is insufficient. Crucially, as Defendants argued and Plaintiffs ignore, Ernst & Young audited the 2006 10-K and found that its presentation of financial information, including the disclosures of then existing concentrations of credit risks and the presentation of mortgage-related holdings, was consistent with GAAP. DB 38 n.40.

(c) Underwriting Practices

Plaintiffs complain that Lehman's 2006 10-K (and subsequent financial statements), which reported results at the consolidated parent-level, did not advise investors about the "high-risk lending programs" by two of Lehman's subsidiaries. OB 60. Defendants pointed to the detailed and specific disclosures contained in the SEC filings of one of its subsidiaries, which contained granular disclosures about Lehman's underwriting practices. While Plaintiffs now concede those disclosures reflected precisely the "type of disclosures about Lehman's high-risk lending practices" that they claim were missing from the Offering Documents, OB 61,<sup>51</sup> they still contend that the existence of these publicly available filings is irrelevant because their claims are not based upon a "fraud on the market" theory and that Defendants have confused Section 11 claims with those under Section 10(b). Id.

Defendants labor under no such confusion. For there to be an actionable omission under the Securities Act, Plaintiffs must demonstrate that Lehman was under some duty to disclose the

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6-1 (Dec. 19, 2005). As a judgment, Lehman's opinion, at that time, that its mortgages did not give rise to a significant concentration of credit risk cannot be actionable unless that opinion was not truly held, which Plaintiffs do not allege.

<sup>51</sup> There is thus no dispute that these Lehman subsidiary MBS filings contained detailed disclosures about no documentation loan programs, stated income loans, and geographical concentrations of loans. Id.

allegedly omitted information.<sup>52</sup> Defendants “cannot be held liable for failing to disclose . . . information [that] was already public,” because Sections 11 and 12(a)(2) do not require the disclosure of such information. In re Merrill Lynch & Co. Research Rep. Sec. Litig., 272 F. Supp. 2d 243, 249-50 (S.D.N.Y. 2003). Here, just as in Merrill Lynch, Plaintiffs put into their complaint information lifted directly from publicly filed documents – a fact that the Opposition does not deny. Compare SAC ¶ 105 (table) with Structured Asset Securities Corp. Pro. at 84 (table) (Ex. 13). It is disingenuous for Plaintiffs to argue that investors could not “cobble together” information about underwriting guidelines for a “different issuer” prior to making their investments even though Plaintiffs described the guidelines as “the most important information looked to by investors” (OB 28 (citation omitted and emphasis added)), when they cannot deny that they were able to locate this information (which was filed with the SEC, just as the Offering Documents were) when it came time to prepare for this lawsuit.

(d) Trend in Repurchase Requests

Plaintiffs also allege that, under Item 303 of Regulation S-K, the 2006 10-K was misleading because it “failed to disclose the rising trend in repurchase requests to and from Lehman.” SAC ¶ 176. Item 303 requires registrants to “[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material” impact. Id. (emphasis added). Because a registrant must have actual knowledge of a trend to violate this

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<sup>52</sup> Plaintiffs cite no authority for the proposition that a financial conglomerate like Lehman was required to list the underwriting guidelines used by subsidiaries in its consolidated financial statements. Indeed, the inclusion of such granular details of subsidiary operations in financial statements would be impractical and would undoubtedly give rise to lawsuits by plaintiffs complaining that these very same disclosures were “boilerplate corporate disclosures buried within hundreds of pages of SEC Filings.” OB 60.

provision, Plaintiffs' allegations either sound in fraud,<sup>53</sup> in which case they fail for lack of particularity, or fail to state a plausible claim in light of the SAC's disclaimer of fraud.

The claim also fails because the SAC does not allege facts establishing that any Defendant was aware of this "trend." See Panther Partners, 538 F. Supp. 2d at 669-70 (dismissing claim where plaintiffs did not allege that defendants were aware of the trend); Campo, 2009 WL 2151289, at \*8 (dismissing securities fraud case, in part, because none of the anonymous witnesses had contact with defendants and two of them had left company prior to class period). Instead, the SAC relies on statements made by confidential sources, none of whom are alleged to have had contact with any Securities Act Defendant. Moreover, Plaintiffs fail to establish the materiality of these repurchase requests to Lehman's consolidated financial statements because the SAC's allegations rely almost exclusively on statements made by loan-level sources "who held positions that would not appear to render them privy to the company's bookkeeping practices, let alone the specific accounting that went into the company's financial reporting." Chubb, 394 F.3d at 152.

(e) Risk Management

Plaintiffs challenge Lehman's disclosures about the adequacy of its risk management practices (OB 35, 53-54) throughout the Offering Period without regard to any specific Offering or time period. Lehman's statements about "various risks, including market, credit, liquidity, operational and reputational exposures" (SAC ¶ 227) or its statement that its "hedging strategies and other risk management techniques may not be fully effective in mitigating [Lehman's] risk exposure" (2006 10-K at 19 (Ex. 3)) are generalizations regarding fiscal discipline, risk management and corporate integrity. Plaintiffs do not contest that Lehman's discussions of its

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<sup>53</sup> See Belodoff v. Netlist, Inc., No. SA CV 07-00677 (DOC), 2008 WL 2356699, at \*6 (C.D. Cal. May 30, 2008) (applying Rule 9(b) to Section 11 claim involving Item 303 because failure to disclose known trend could only be result of "intent to deceive").

own risk management systems were no different from statements courts have repeatedly held immaterial as a matter of law as “no more than puffery.” DB 45 (citing cases). No reasonable investor could have understood these generalized statements (e.g., SAC ¶¶ 156-57, 163, 179, 185-86, 213, 224-27, 230-31) as guarantees that Lehman’s risk management systems were infallible.

In addition to being immaterial puffery, such statements are also protected by the PSLRA’s safe harbor for forward-looking statements and under the bespeaks caution doctrine. As an initial matter, see supra at 10-12, Plaintiffs cannot argue against application of the safe harbor because they disclaim that any Defendant had actual knowledge that such forward-looking statements were false and misleading when made. See 15 U.S.C. § 77z-2(c)(1). In order to avoid clear application of the safe harbor, Plaintiffs attempt to recast the Offering Documents’ disclosures and warnings about Lehman’s risk management practices (and other disclosures) as statements of present and historical facts. But while the Opposition highlights a number of past-tense phrases that ostensibly appear in the Offering Documents, e.g., “‘actively managed’ mortgage-related positions,” “‘measured’ quantifiable risks,” and “‘identified’ emerging risks,” OB 54, Plaintiffs are quoting the SAC paragraphs in which they have inserted the past-tense verbs: none of the re-written phrases quoted in the SAC or repeated in the Opposition appear anywhere in the Offering Documents.<sup>54</sup> Plaintiffs’ re-writing of the actual disclosures aside, these statements are protected by the PSLRA’s safe harbor, even though they are rooted in a description of present conditions,<sup>55</sup> and statements that focus on the future performance of a

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<sup>54</sup> The phrases “quoted” as a series of misstatements allegedly by Lehman all appear as present-tense sentences within a single paragraph that describes generally the methods that Lehman used to structure risk management. See 2007 10-K at 65, 69 (Ex. 8); compare OB 54 with SAC ¶¶ 156, 230, 224.

<sup>55</sup> See NovaGold, 2009 WL 1575220, at \*17 (“Any projection or forward-looking statement necessarily has its basis in current conditions[.]”).

business are considered forward-looking, even where they contain statements of current conditions.<sup>56</sup>

The statements are also not actionable under the bespeaks caution doctrine.<sup>57</sup> While Plaintiffs argue that Lehman's disclosures were insufficiently tailored to provide investors with adequate information about the risks of investment, they fail to allege what facts were omitted. But Lehman was also under no duty to predict the ineffectiveness of its hedges or its own demise.<sup>58</sup> To assert that Lehman's statements on risk management in 2006 and 2007 could and should have anticipated Lehman's losses in 2008 (and the subsequent unavailability of effective hedges to Lehman's Alt-A portfolio) would require clairvoyance.

Plaintiffs argue that once Lehman put the issue of hedging "into play," it had a duty to disclose all information about the subject. OB 36. For example, Plaintiffs allege that Lehman ought to have disclosed that hedging activities could actually increase losses. But Lehman was under no duty to make a list of all the different things that could go wrong with respect to its hedging or risk management strategies simply because it included generalized statements on risk practices. See NovaGold, 2009 WL 1575220, at \*19 ("The Registration Statement need not predict all the details . . . that came to pass. Requiring it to do so would force companies warning of capital cost risks to detail every single capital expenditure they planned to make and

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<sup>56</sup> See Ehlert v. Singer, 245 F.3d 1313, 1318 (11th Cir. 2001); see also In re Avon Prods., Inc. Sec. Litig., No. 05 Civ. 6803 (LAK) (MHD), 2009 WL 848017 (Rep. & Recomm.), adopted by, 2009 WL 884687 (S.D.N.Y. 2009) (granting motion to dismiss).

<sup>57</sup> See Rubin v. MF Global, Ltd., No. 08 Civ. 2233 (VM), 2009 WL 2058590, at \*5-6 (S.D.N.Y. July 16, 2009) (holding that bespeaks caution doctrine applies to statements that "deal[] with historical or present facts" despite plaintiffs' attempt to "characterize" statements "regarding the risk of future negative events as statements that simply concern discrete present or historical fact") (collecting cases).

<sup>58</sup> See Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000) (Mere "allegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud").

their expected costs. Such an approach would be impractical.”).<sup>59</sup> Rather, Lehman’s duty “depend[s] largely on the itemized disclosures required by the securities laws and the regulations promulgated thereunder,” and Plaintiffs failure to assert any statutory basis for the requested disclosure is fatal to the claim. Rubin, 2009 WL 2058590, at \*4 n.3 (citation and quotation marks omitted). In any event, to the extent that Lehman had a duty to make such disclosures, it did: the 2007 10-K states, “[i]n the past, including during the recent mortgage and credit market downturn, these types of market movements have at times limited the effectiveness of our hedging strategies and have caused us to incur significant losses, and they may do so in the future.” 2007 10-K at 22 (Ex. 8).

Finally, Lehman’s Offering Documents also included substantial warnings about its risk-management practices that Plaintiffs refuse to acknowledge. Lehman warned that its risk management techniques might “not predict future risk exposures, which could be significantly greater than the historical measures indicate,” 2006 10-K at 19 (Ex. 3), and that “the effectiveness of our approach to managing risks can never be completely assured. For example, unexpected large or rapid movements or disruptions in one or more markets or other unforeseen developments could have an adverse effect on the results of our operations and our financial condition.” Id. at 57. These are precisely the sort of “meaningful cautionary statements” contemplated by the PSLRA safe harbor and the bespeaks caution doctrine.

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<sup>59</sup> None of the string of Section 10(b) cases Plaintiffs cite stands for the proposition that, without regard to materiality, an issuer’s Securities Act disclosures about a subject somehow put every aspect of that subject “into play.” OB 36 n.56; see Caiola v. Citibank, N.A., 295 F.3d 312, 330-31 (2d Cir. 2002) (“lack of an independent duty is not . . . a defense to Rule 10b-5 liability because upon choosing to speak, one must speak truthfully about material issues”); Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 267-68 (6th Cir. 1998) (concerns only *attorney’s* duty to provide “complete and non misleading information with respect to subjects on which he undertakes to speak”); Ackerman v. Schwartz, 947 F.2d 841, 848 (7th Cir. 1991) (setting forth general standards for materiality of omissions under Rule 10b-5 and finding that “lack of an independent duty does not excuse a material lie.”); Robbins v. Moore Med. Corp., 788 F. Supp. 179, 184 (S.D.N.Y. 1992) (finding that misleading omissions, when coupled with alleged unfounded optimistic statements, cannot be dismissed as immaterial); South Ferry LP #2 v. Killinger, 399 F. Supp. 2d 1121, 1136-38 (W.D. Wash. 2005) (Defendants’ generic warnings did not speak to the issue on which Plaintiffs focused in complaint, therefore no meaningful cautionary language could protect the statements under the PSLRA safe harbor).

(f) Sufficiency of Capital and Liquidity

While the SAC alleges that Lehman's periodic filings, including the 2006 10-K, contained false statements that "Lehman was well-capitalized and possessed capital in excess of all applicable minimum capital requirements" ¶ 230,<sup>60</sup> the SAC did not plead any facts to support a legal conclusion that Lehman failed to satisfy the particular regulatory requirements associated with being characterized as "well capitalized" or having capital in excess of the "minimum capital requirements." Nor did the SAC allege a specific point in time at which Lehman failed to possess the requisite capital – let alone in 2006 (nearly two years before Lehman suffered the run on the bank). DB 48. Plaintiffs address this argument in a one-sentence footnote that is, like the SAC, devoid of factual support and temporal allegations. OB 52 n.69.<sup>61</sup> At its core, Plaintiffs rely on hindsight to argue that because Lehman went bankrupt in September 2008, it should have known months and years earlier that it would eventually fail. The Securities Act does not require advanced predictions of corporate death.<sup>62</sup>

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<sup>60</sup> Plaintiffs also ignore the disclosures that Lehman made about liquidity and lending; for example, "[O]ur ability to repay maturing indebtedness could be significantly impaired . . . by factors that are not specific to Lehman Brothers, such as a severe disruption of the financial markets," 2006 10-K at 16 (Ex. 3); "We anticipate that this part of the U.S. mortgage market . . . will face challenges in the second half of 2007." 2007 2Q Rep. at 47 (Ex. 5). These forward-looking statements about potential liquidity crises are precisely the sort of disclosures that "bespeak caution." See P. Stolz Family P'ship v. Daum, 355 F.3d 92, 97-98 (2d Cir. 2004) (bespeaks caution doctrine applied to remove liability from statements about potential need for capital, and investors' inability to liquidate investments); Rombach v. Chang, 355 F.3d at 176 (claim would "be defeated . . . by the bespeaks caution doctrine," where the company disclosed that the company had experienced losses and would need additional capital that was not assured).

<sup>61</sup> Plaintiffs also allege that Lehman's periodic filings beginning with the 2007 3Q Report falsely stated that Lehman maintained liquidity sufficient to cover "expected cash flows for twelve months. . ." because significant liquidity problems led to Lehman's bankruptcy. SAC ¶ 231. Putting aside that such statements were forward-looking and cannot form the basis of liability, Plaintiffs rely on hindsight to argue that because Lehman went bankrupt in September 2008, it should have known earlier that it would not have sufficient liquidity to cover future needs.

<sup>62</sup> See Portannese v. Donna Karan Int'l, Inc., No. 97-CV-2011 (CBA), 1998 WL 637547, at \*12 (E.D.N.Y. Aug. 14, 1998) ("[P]laintiffs essentially seek to hold [defendant] liable for failing to make projections concerning [future costs]. Sections 11 and 12(a)(2) do not require such forward-looking disclosures") (internal footnote omitted).

## 2. 2007 Quarters

What Plaintiffs say about Lehman's other 2007 Offering Materials is said in cursory fashion. OB 46, 48, 50. With only two exceptions (discussed below), the SAC merely reprints Lehman's financial metrics from each quarterly disclosure during 2007 and asserts that they are false for the same reasons as the 2006 10-K. See SAC ¶¶ 177-98.<sup>63</sup> In the absence of any additional facts pleaded about events during this time frame, Plaintiffs' 2007 offering claims are inadequate for the reasons discussed above. Plaintiffs' approach is doubly insufficient because it ignores the specific context of each set of Offering Materials, and the additional disclosures made by Lehman over the course of the year. See DB 49-56. Because statements can only be actionable if they were false at the time made, timing allegations are essential for Plaintiffs to state a claim.

Lehman's detailed disclosures during this time period included its early adoption of SFAS 157's framework for measuring fair value, under which Lehman clearly indicated the increasing amount of mortgage-related assets that it categorized as Level 2 and Level 3 due to the reduction of liquidity in the capital markets that "resulted in a decrease in the observability of market prices." See, e.g., 2007 3Q Rep. at 61 (Ex. 7); see also 2007 10-K at 41 (Ex. 8). In support of their claim that Lehman's SFAS 157 disclosures were false, Plaintiffs assert only that Lehman was required to classify all mortgage-related assets under Level 2 because the ABX and CMBX were "observable market data." OB 38. But this just misreads SFAS 157: a Level 2 input must be "observable for substantially the full term of the asset or liability" and because of

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<sup>63</sup> The GAAP challenges to the quarterly reports are identical to those addressed to the Annual Reports that Ernst & Young audited. It is also undisputed that Ernst & Young reviewed the presentation of financial information in Lehman's quarterly reports, and, in each case (in 2007 and 2008), issued a letter stating it was "not aware of any material modifications that should be made to the consolidated financial statements" in order for them "to be in conformity with" GAAP. DB 31-32 & n.33. Plaintiffs nevertheless offer no response to the impact of Ernst & Young's opinions and statements on their GAAP claims.

the serious illiquidity in the MBS/CMBS markets during this period, such inputs had to be adjusted in order for them to be useful. See supra at 16. SFAS 157 commands that if an adjustment to “a Level 2 input” is “significant to the fair value measurement in its entirety,” the entire measurement should be a Level 3 measurement. SFAS 157 ¶ A24. Lehman disclosed the number of assets that it measured in each of these categories. Nowhere does the SAC allege that Lehman believed that its Level 3 measurements should have been Level 2 measurements. Nor could it because Plaintiffs disclaim such knowledge by any Defendant. Even if Plaintiffs’ understanding of GAAP were correct, and it is not, the SAC still does not quantify or specify how many assets were erroneously measured using Level 3 inputs instead of Level 2 inputs, and if so, whether the measurements would be different, much less materially so.

The only additional challenges to the 2007 quarterly reports advanced by the SAC also fail to state a claim.

(a) Mortgage-Related Write-downs

Plaintiffs maintain that Lehman materially overvalued its mortgage-related assets and failed to timely and adequately write them down as they became impaired. OB 41-43. But the SAC never alleges when such “timely” write-downs should have occurred and what levels of write-downs would have been “adequate” at the time of any specific Offering. Judgments were required to value such assets as well as the decision when to write them down and by how much. Plaintiffs fail to plead that any of those judgments were not truly held at the time of each disclosure. See DB 28-30, 36. Further, the fact that Lehman later reported write-downs in the third quarter of 2007 does not mean that it should have or could have done so earlier. See supra

at 24-25. Nor is it relevant that some other banks elected to take write-downs on their assets at earlier times and in varying amounts. See supra at 23-24.<sup>64</sup>

(b) Future Impact of Challenge in Subprime Sector

The Opposition does not specifically address each forward-looking statement contained in the 2007 Offering Materials. Instead, Plaintiffs rely primarily on the blanket assertion that such statements are not forward-looking. OB 53. For example, in one of the statements in the 1Q07 10-Q labeled “false and misleading” by the SAC, Lehman acknowledged “challenges” in the U.S. subprime residential mortgage market, but stated “we believe that these challenges will be relatively contained to this asset class.” SAC ¶ 180 (emphasis added). This prediction about future economic conditions is clearly forward-looking, and was specifically identified as such by Lehman. See supra at 11. Therefore, the statement could only be actionable if Plaintiffs alleged that Defendants possessed actual knowledge of its falsity at the time of the disclosure. See 15 U.S.C. § 77z-2(c)(1). Plaintiffs do not make, and repeatedly disclaim, any such allegation.

3. 2007 Year End

Ernst & Young issued an unqualified opinion that Lehman’s financial statements included in the 2007 10-K “present[ed] fairly, in all material respects, the consolidated financial position of Lehman . . . in conformity with U.S. [GAAP].” 2007 10-K at 84 (Ex. 8). Plaintiffs again do not allege that this opinion was, or that any Defendant believed it to be, negligent, or explain why Defendants were not entitled to rely on this expertised opinion as a matter of law. See supra at 14-15.

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<sup>64</sup> Plaintiffs also assert that Lehman made an increasing number of margin calls on its correspondent loan originators, and that those loan originators were going out of business is “proof” that Lehman’s write-downs in the Third Quarter were “untimely.” OB 42. However, the SAC alleges that American Home Mortgage, one of the correspondent loan originators, went bankrupt in August 2007, and that Lehman cut off Option One Mortgage Corporation’s credit line in July 2007. SAC ¶ 145. Both of these events are alleged to have occurred in the third quarter of 2007, which ended on August 31, 2007. Thus, if anything, the SAC’s allegations only support the timing of Lehman’s write-downs in that quarter.

In addition, Plaintiffs also ignore the specific disclosures in the 2007 10-K, which (in response to then extant facts and market conditions) included extensive discussion about Lehman's mortgage exposure and the further deterioration in the real estate market. DB 56-57.<sup>65</sup> Although many of these disclosures directly address Plaintiffs' hindsight criticisms about Lehman's earlier filings, the SAC nonetheless asserts without analysis that the 2007 10-K was misleading for the same reasons as the previous disclosures or because it failed to provide even further granularity. See SAC ¶ 200; OB 30. Plaintiffs point to no facts or controlling authority, however, to support their assertion that Lehman's 2007 year-end write-downs and other disclosures were "inadequate" at that time.<sup>66</sup>

#### 4. 2008 Quarters

The SAC also fails to show that anything in the 2008 Offering Materials was false or misleading. First, the 2008 1Q Report made substantial disclosures, including an additional \$4.7

<sup>65</sup> See 2007 10-K at 49 (Ex. 8) (disclosing gross and net write downs on residential and commercial mortgage-related positions, and collateralized debt obligations); 104 (breaking down inventory of mortgage and asset-backed securities by residential and commercial, and then even further into whole loans and securities for each category); 105 (breaking down residential subprime exposure into whole loans and retained interests in securitizations); 113 (describing role in CDO transactions, and amount of CDO exposure); 44-46 (Lehman "restructured [its] global residential mortgage origination business . . . due to market conditions" and "clos[ed] BNC Mortgage LLC, our U.S. subprime residential mortgage origination platform"); 15 ("the residential real estate market in the U.S. has experienced a significant downturn due to declining real estate values, substantially reducing mortgage loan originations and securitizations, and precipitating more generalized credit market dislocations and a significant contraction in available liquidity"); id. ("Further declines in real estate values in the U.S. or elsewhere and continuing credit and liquidity concerns could further reduce our level of mortgage loan originations and securitizations and increase our mortgage inventory while adversely affecting its value."); 22 ("[D]uring the recent mortgage and credit market downturn, these types of market movements have at times limited the effectiveness of our hedging strategies and have caused us to incur significant losses."); 35 ("[T]he weakening of the U.S. housing sector became worse than most observers expected and dislocations began to occur beyond the residential mortgage component of credit markets.").

<sup>66</sup> The SAC also challenges a statement from the 2007 10-K about Lehman's liquidity by presenting that statement in isolation and completely out of context. Compare SAC ¶ 231 ("the Company maintain[ed] a liquidity pool . . . that covers expected cash outflows for twelve months in a stressed liquidity environment") with 2007 10-K at 17 (Ex. 8) ("We maintain a liquidity pool available to [Lehman] that is intended to cover all expected cash outflows for one year in a stressed liquidity environment . . . . To the extent that a liquidity event lasts for more than one year, or our expectations concerning the market conditions that exist during a liquidity event, or our access to funds, prove to be inaccurate . . . our ability to repay maturing indebtedness and fund operations could be significantly impaired.") (emphasis added). Plaintiffs' creative paraphrasing, however, does not remove this carefully disclaimed statement from the safe harbor for forward-looking statements or from the protections offered by the bespeaks caution doctrine.

billion in gross write-downs (which included \$3 billion for residential mortgage-related positions and \$1.1 billion for commercial mortgage-related positions), and specific disclosures about market conditions, Lehman's declining revenues, its write-downs of its mortgage-related assets and the continued risk associated with those assets. OB 57-58. Plaintiffs' only challenge to them is to repeat that the disclosed write-down was inadequate. *Id.* at 43. Devoid of any specifics about what disclosed metrics were false and by how much,<sup>67</sup> this argument lacks merit.

Second, the SAC challenged Lehman's reporting in its 2008 1Q Report of \$14.6 billion of its residential mortgage as "Alt-A/Prime" assets, without separately quantifying the amount of Alt-A and prime loans, OB 31-32; SAC ¶¶ 119, 209. Lehman had no duty separately to quantify these amounts.<sup>68</sup> DB 58-59. Plaintiffs concede this point and now argue that it is somehow

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<sup>67</sup> Plaintiffs try to fill the void by reference to opinion statements from analysts and other third parties with no firsthand knowledge, such as comments in a March 2008 *Condé Nast Portfolio* article that questioned whether Lehman's write-downs were too small. See OB 49; SAC ¶ 150. But charges in the press, or characterizations by those without first hand knowledge, are inadequate. See *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 308 F. Supp. 2d 249, 260-63 (S.D.N.Y. 2004) (newspaper articles indicating that company was involved in unspecified swap transactions were insufficient to plead securities fraud challenge to specific financial statements that reflected revenue from particular swap transactions); *Survivor Prods. LLC v. Fox Broad. Co.*, No. CV 01-3234 (LGB), 2001 WL 35829267, at \*2 (C.D. Cal. June 12, 2001) (striking references to trade publications and newspaper articles in copyright infringement case where quoted articles did not provide background facts relating to parties, but rather amounted to nothing more than "a post-hoc analysis" of the legal claim). None of these opinions establish, or could establish, that Lehman "possessed the omitted information at the time" it filed its quarterly report. *In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d at 635.

Plaintiffs again contend that their allegation is supported by the other banks' write-downs. OB 43. But how those firms valued their assets is not probative of how much Lehman should have written down its assets. See DB 35-36; supra at 23-24. Plaintiffs' mere assertion that these firms all had "portfolios of residential and/or commercial mortgage and mortgage-related assets that had to be reported at fair value," OB n.65, does not begin to address the gulf of material differences among these portfolios and their valuations, which the SAC would need to bridge to be anything more than speculation. DB 34-35. Finally, Plaintiffs argue that confidential sources CW 7 and CW 23 show the inadequacy of the write-down, OB 47, but none of the CW's allegations provide any facts showing why Lehman's valuations were wrong. DB 27-28; supra at 15.

<sup>68</sup> Plaintiffs argue that the SEC's March 2008 Sample Letter cited in the initial brief for the proposition that Lehman was under no obligation to separately disclose its Alt-A exposure (DB 38-39) is not relevant because it is outside the scope of the Complaint and because it "says nothing about disclosing risk concentrations or known trends." OB 32. The Court may consider SEC materials as persuasive authority on a motion to dismiss, as Plaintiffs do in their Opposition, for example, in citing to SAB 99. See, e.g., OB 52-53. The Sample Letter directly addresses Item 303 of Regulation S-K (in its first sentence) and the requirement to disclose known trends and identifies "disclosure issues" that firms "may wish to consider" in preparation of their filings. Ex. 33 at 1. The Sample Letter confirms that there is no separate requirement to disclose the "nature and type of assets underlying any asset-backed securities, for example, the types of loans (sub-prime, Alt-A, or home equity lines of credit)" although firms "may"

“irrelevant.” OB 32. Instead, Plaintiffs argue that Lehman should have made separate disclosures because not doing so amounted to “limited disclosures,” which omitted “other material facts necessary to render their disclosures not false or misleading[.]” Id. at 32.

The contrary is true here. The SAC does not allege that Lehman actually omitted anything in disclosing the amount of its Alt-A and prime loans together, let alone anything material. Lehman told investors that \$14.6 billion of its residential mortgage inventory was comprised of these two types of assets. Plaintiffs do not deny that this disclosure was accurate, and cannot deny that it both informed investors that Lehman’s holding of Alt-A assets could be as high as the total \$14.6 billion, and that Lehman was not providing a breakdown. To the extent that any investor was concerned about Lehman’s specific Alt-A exposure, it knew that such disclosure was not made and could simply choose not to invest. Cf. Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277, 1291-94 (W.D. Mich. 1986) (because “plaintiff was aware of the above alleged omissions prior to his investment in any of the litigated investment programs” his “knowledge of the omissions is alone fatal to his claim” and noting that plaintiff “was not misled” and was “free to invest elsewhere”), aff’d, 829 F.2d 13 (6th Cir. 1987).

More than that, contemporaneous with the relevant Offerings, Lehman did separately disclose its Alt-A and prime inventory during its first quarter earnings call with investors. DB 59. Remarkably, the SAC relies on and quotes at length from this very earnings call transcript, SAC ¶¶ 297-304; see also DB 59, yet the Opposition does not acknowledge this disclosure, nor offer an explanation why it was not adequate. Lehman was under no obligation to disclose anything that was already part of the total mix of information available to investors. See In re Merrill Lynch & Co. Research Rep. Sec. Litig., 272 F. Supp. 2d at 249-50.

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consider such disclosures and further confirms that firms must apply their own “judgment” in using “unobservable inputs to determine the fair value” of assets and liabilities. Id. at 1-2.

Third, Plaintiffs complain that Lehman should have disclosed that its Alt-A assets were “akin to subprime and were similarly impaired.” OB 31. The SEC-filed offering materials for Lehman’s MBS (which were available from the SEC just as the Offering Materials were) disclosed the characteristics of the loans originated as well as the circumstances of their underwriting. See id. at 41-43. Any interested investor could have learned how “akin” such loans were by accessing the same publicly available documents that Plaintiffs used to craft the SAC. See supra at 28.<sup>69</sup>

Finally, Lehman made substantial disclosures regarding its subprime exposure during the second quarter of 2008, including reporting a net loss of \$2.8 billion for the quarter and losses on its hedges for the quarter, as well as a \$2.4 billion gross write-down of residential mortgage-related positions and a \$900 million gross write-down of commercial mortgage and real estate related investments. DB 60. Lehman disclosed that its revenues were “significantly impacted” by “challenging market conditions” that continued to affect its valuation of residential and commercial mortgage-related assets and related hedges, and it warned, among other things, that those conditions could further impact its future hedging strategies. Id. Plaintiffs’ only challenge to these disclosures is that Lehman’s statements were “partial” and false or misleading for the same general reasons as Lehman’s previous disclosures. SAC ¶¶ 213-18; see DB 60. Indeed, the Opposition does not even separately address the disclosures in the 2008 2Q Report, let alone how the SAC shows that any are actionable.<sup>70</sup>

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<sup>69</sup> Plaintiffs are also wrong that Defendants fail to address allegations that Lehman’s write-down of its commercial mortgage assets in the first quarter of 2008 was less than the decline in CMBX index. See OB 37; see also id. at 43-46 (arguing that the ABX and CMBX indices show Lehman’s write-downs in 2008 were too small). Lehman was not required to rely more heavily on these indices. DB 34. It considered them, and disclosed that it had done so along with other inputs; nothing more was required. Id.

<sup>70</sup> Plaintiffs’ references to analysts’ reactions to Lehman’s 2Q 2008 write-downs do not show that any second quarter disclosures were false or misleading. See OB 49. On the contrary, as Plaintiffs themselves describe, based on the second quarter 2008 disclosures, analysts purportedly “questioned the adequacy of prior write-downs,” id.,

**C. The Principal Protection Note Offering Materials Were Not Misleading**

**1. The Offering Materials Disclosed that Repayment of Principal Depended on Lehman's Creditworthiness**

The Second Circuit requires that prospectuses be read as a whole. See, e.g., Halperin v. eBanker USA.com, Inc., 295 F.3d 352, 357 (2d Cir. 2002).

Looking at the Offering Materials for the PPN offerings as a whole, the documents clearly conveyed that:

- Lehman was the issuer and Lehman alone was responsible for payment on the PPNs. See, e.g., Pro. Supp. at S-7 (Ex. 19) (“The notes will be solely our obligations, and no other entity will have any obligation, contingent or otherwise, to make any payments in respect of the notes.”);
- The PPNs were unsecured and holders had the same – and no higher – right to payment as other unsecured creditors of Lehman. See, e.g., Prod. Supp. 550-I (Nov. 27, 2007) at cover page, SS-7 (Ex. 20) (“The notes are the senior unsecured obligations of Lehman Brothers Holdings Inc. . . . The notes are our unsecured and unsubordinated obligations and will rank *pari passu* with all of our other unsecured and unsubordinated obligations.”); and
- Payment on the PPNs was “subject to the credit risk of Lehman Brothers Holdings Inc.” PS No. 1 (52522L525) at 6 (Ex. 28); see also id. at 3 (Lehman’s creditworthiness relevant to “the ability of the issuer to meet its obligations”); Pro. Supp. at S-7 (Ex. 19) (“we [Lehman] may be unable to make payments of principal or interest in respect of the notes and you could lose all or a part of your investment”) (emphasis added).

Although they pay lip service to the law requiring that offering materials be read as a whole, Plaintiffs ignore it in practice, and focus solely on the alleged “literal falsity” of isolated statements concerning principal protection. OB 70. Plaintiffs’ response to the disclosures set forth above (and the others like them) is that they may all be disregarded, because (1) they are allegedly “inconsistent” with the “guarantees” contained in the pricing supplements and (2) the

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not those for the second quarter. And for all the reasons discussed above, Plaintiffs fail to allege any misstatement or omission in the disclosures for those earlier quarters.

pricing supplements govern in the case of any inconsistencies. OB 66, 72-73. These arguments fail.

First, the pricing supplements did not unconditionally “guarantee” the repayment of investors’ principal. It makes no sense to talk abstractly about a “guarantee” – or a “promise” or an “assurance,” which terms Plaintiffs also use – without reference to the person giving the guarantee, promise, or assurance. Here, Lehman was the promisor; that is, Lehman promised to repay the principal of the PPNs to investors. While Lehman’s bankruptcy filing will likely leave that promise unfulfilled, at least in part, Lehman’s subsequent failure does not make the initial promise “false.”<sup>71</sup> Thus, Plaintiff’s foundational contention – i.e., that Lehman’s promise of principal protection was “literally false” – is simply not true.<sup>72</sup>

Second, several of the clearest and most relevant disclosures about Lehman’s creditworthiness were made in the very same pricing supplements in which the purported “promises” were made. See, e.g., PS No. 1 (52522L525) at 6, 3 (Ex. 28) (an investment in PPNs was “subject to the credit risk” of Lehman, which could affect its “ability . . . to meet its obligations”). Thus, Plaintiffs are wrong in contending that all qualifications on the promise of principal protection are contained in earlier filings that were allegedly superseded by later “inconsistent” filings. Plaintiffs are forced to try to explain away the pricing supplement disclosures by implausibly suggesting that warnings related to Lehman’s creditworthiness actually related to the risk that an “extrinsic index” may fluctuate. OB 76. This is nonsensical; Lehman’s creditworthiness had nothing to do with the extrinsic indices linked to the PPNs, but

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<sup>71</sup> See, e.g., Champion Titanium Horseshoe, Inc. v. Wyman-Gordon Inv. Castings, Inc., 925 F. Supp. 188, 190 (S.D.N.Y. 1996) (“[T]he only ‘fact’ alleged to show that these representations were false when made is the bald assertion that Wyman failed to so perform. This is patently inadequate on its face to establish either falsity or intent; indeed, if it were otherwise, every complaint for breach of contract would *ipso facto* state a claim for fraud.”).

<sup>72</sup> That Lehman’s promise may not have been as valuable as having secured collateral or FDIC insurance does not render the promise false or illusory. Lehman’s promise meant that, subject to its credit risk, even if the linked index of the PPN declined, Lehman would still return the protected portion of the investor’s principal.

rather, as the pricing supplements disclosed, with “the ability of the issuer to meet its obligations.”<sup>73</sup>

Third, Plaintiffs adopt a wildly expansive interpretation of what statements are “inconsistent” – contending essentially that anything that qualifies the purportedly unqualified “promise” of principal protection is inconsistent and, therefore, irrelevant. Rather than being “inconsistent,” however, the statements spread throughout the Offering Materials simply explain the “complete details” of Lehman’s promise (PS No. 1 (52522L525) at 2 (Ex. 28)) – i.e., that Lehman (and Lehman alone) was the obligor on the PPNs, that the PPNs were senior, unsecured debt of Lehman, and that Lehman’s creditworthiness could affect its ability to repay the PPNs. If all went as planned, Lehman would repay investors at least the protected amount of their principal; but the Offering Materials also explained the risk – however unlikely – that all would not go as planned, and the effect of such developments on an investment in PPNs.<sup>74</sup> When read

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<sup>73</sup> Plaintiffs also contend that an investor might have understood Lehman’s credit rating to be relevant only to the “market value” of the PPNs prior to maturity. OB 76. But the only reason Lehman’s creditworthiness might impact the market value of the notes prior to maturity is because the markets are making judgments on the ability of the issuer to make payments of principal and interest when due. That is the very definition of an issuer’s credit rating. See Fitch Research, [http://www.fitchratings.com/creditdesk/public/ratings\\_definitions/index.cfm](http://www.fitchratings.com/creditdesk/public/ratings_definitions/index.cfm) (last visited July 27, 2009) (“Fitch Ratings” credit ratings provide an opinion on the relative ability of an entity to meet financial commitments, such as interest, preferred dividends, repayment of principal, insurance claims or counterparty obligations.”) (emphasis added); Moody’s, <http://v3.moody.com/ratings-process/Issuer-Ratings/002001005> (last visited July 27, 2009) (“Issuer Ratings are opinions of the ability of entities to honor senior unsecured financial obligations and contracts.”); Standard & Poor’s, <http://www2.standardandpoors.com/aboutcreditratings/> (last visited July 27, 2009) (“Standard & Poor’s ratings express the agency’s opinion about the ability and willingness of an issuer . . . to meet its financial obligations in full and on time.”). Plaintiffs provide no explanation at all of why the pricing supplements prominently disclosed Lehman’s credit ratings if Lehman’s ability to pay was irrelevant.

Similarly, Plaintiffs never grapple with the inherent contradictions that plague their various claims – contending, on the one hand, that the Offering Materials misrepresented Lehman’s financial condition and, on the other hand, that PPN investors were led to believe that Lehman’s financial condition was utterly irrelevant to their investments. Plaintiffs cannot have it both ways.

<sup>74</sup> Even the Lehman Brothers Inc. “brochures” that Plaintiffs refer to (see SAC ¶ 242(g); OB 74 n.98) clearly disclose the risk of investing in PPNs: “Credit risk – Structured investments are notes, typically debt securities, issued by a financial institution. Therefore, investors face credit risk from the issuer.” Kessler Decl. Ex. G at 8, & Ex. H at 7. Thus, even assuming that these April 2008 and June 2008 documents were part of the PPN Offering Materials for subsequent offerings, they contain no misrepresentations concerning the nature of the principal protection promised by Lehman.

as a whole, the PPN Offering Materials were not misleading; they accurately described the terms of the PPNs and the potential risks and rewards.

Plaintiffs also argue that the risk disclosures in the Offering Materials were “buried,” “de-emphasized,” and “scatter[ed].” OB 76, 77. But Plaintiffs provide no analysis to support their *ipse dixit* assertions, and a fair reading of the Offering Materials demonstrates otherwise. In the documents Plaintiffs cite, for instance, disclosure of the risk presented by Lehman’s creditworthiness was one of the “Key Risks” specifically singled out and highlighted in the pricing supplement – a “short” document of only “six to seven page[s]” that, Plaintiffs concede, was delivered to each and every PPN investor. OB 67; PS No. 1 (52522L525) at 6 (Ex. 28).<sup>75</sup> That Lehman’s creditworthiness appeared last in a one-page list of Key Risks hardly means that it was “buried” or “de-emphasized”; it was there, in bold-faced type, for all to see. Surely, Plaintiffs cannot argue that investors are entitled to ignore clear disclosures simply because they are listed last; something had to be last, and Plaintiffs make no suggestion – nor could they – that the ordering of the risks was so unreasonable as to be false and misleading.

As for the risks disclosed in other documents incorporated by reference, the pricing supplements – far from “de-emphasizing” the risks – expressly advised investors of the importance of reviewing those documents and, in particular, the “Risk Factors” sections of those documents.<sup>76</sup> Where the offering document “unambiguously communicates the importance of

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<sup>75</sup> On both the first and second pages of the pricing supplement, investors were expressly advised to review the “Key Risks” section. PS No. 1 (52522L525) at 1, 2 (Ex. 28).

<sup>76</sup> See, e.g., PS No. 1 (52522L525) at 2 (Ex. 28) (“Before you invest, you should read this pricing supplement together with the base prospectus, as supplemented by the MTN prospectus supplement relating to our Series I medium-term notes of which the Notes are a part, and the more detailed information contained in product supplement no. 550-I (which supplements the description of the general terms of the Notes) and underlying supplement no. 100 (which describes the Index, including risk factors specific to it). . . . **You should also review carefully the “Key Risks” on page 6, “Risk Factors” in product supplement no. 550-I, underlying supplement no 100 and the MTN prospectus supplement for risks related to an investment in the Notes.”**).

reading all relevant material contained within the prospectus,” Plaintiffs cannot plausibly contend that such information was “buried.” I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 763 (2d Cir. 1991).<sup>77</sup>

Lastly, Plaintiffs’ complaints about the need to “parse[] the incorporated materials” to read the disclosures – despite the explicit references in the pricing supplements to the relevant risk sections – are entirely belied by their own claims of alleged misrepresentations in Lehman’s Exchange Act filings. Indeed, Plaintiffs assert misrepresentations or omissions in no fewer than thirteen Forms 10-K, 10-Q, and 8-K incorporated by reference in the Offering Materials, and purport to identify falsehoods in various financial statement line items, footnotes, and descriptions of Lehman’s business, exposure, controls, and financial results. The risk disclosures that disprove Plaintiffs’ claims concerning the PPN offerings are no more “scattered” or “buried” than the alleged misrepresentations on which Plaintiffs base their claims. As in Olkey v. Hyperion 1999 Term Trust, Inc., Plaintiffs “offer no serious rationale as to why a reasonable investor who was reading the prospectuses would consider the warnings too generic to be taken seriously and, at the same time, would find the sections discussing the opportunities and

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<sup>77</sup> Plaintiffs’ cases are inapposite. In Hunt v. Alliance N. Am. Gov’t Income Trust, Inc., 159 F.3d 723, 729 (2d Cir. 1998), the court sustained certain of plaintiffs’ claims, finding that disclosures that warn “of a different contingency than that which plaintiffs allege was misrepresented” may result in liability. Here, Plaintiffs’ claims relate to the very contingency warned of – issuer default. Id. In McMahan & Co. v. Warehouse Entm’t, Inc., 900 F.2d 576 (2d Cir. 1990), the court focused on the need to assess disclosures after reviewing them as a whole, rather than by assessing the “literal truth” of particular statements. It is Plaintiffs here who run afoul of this precept, cherry-picking self-serving statements in certain disclosures without reading the representations as a whole for a complete understanding of the risks at issue. And in In re Alstom SA Sec. Litig., 406 F. Supp. 2d 433 (S.D.N.Y. 2005), and In re Flag Telecom Holdings, Ltd. Sec. Litig., No. 02 Civ. 3400 (WCC), 2009 WL 1181293, at \*9 (S.D.N.Y. May 1, 2009), the courts were faced with defendants’ wholesale failure to disclose material information relating to the relevant issue. No such wholesale omission is at issue here.

Finally, although it is cited by Plaintiffs, the holding of Greenapple v. Detroit Edison Co., 618 F.2d 198 (2d Cir. 1980), supports the adequacy of the relevant risk disclosures in the PPN Offering Materials. Indeed, the risk disclosures at issue are not “submerge[ed] in a flood of collateral data” nor are they slighted “through seemingly cavalier treatment.” Id. at 210. According to Greenapple, as long as the disclosures are not “so obscure” or “confusing” they will not constitute a misstatement of material fact under Section 11. Id. As demonstrated both in Defendants’ opening brief and here, the disclosures at issue were unambiguous and prominent, satisfying this standard.

protections enticingly specific.” 98 F.3d 2, 8 (2d Cir. 1996).

**2. The Offering Materials Did Not Need to Disclose the Obvious Fact that if Lehman Were Unable to Pay, Investors Would Not Receive Their Principal**

The crux of Plaintiffs’ argument about risk disclosures is that “[n]one of these statements alerts investors to the fact that their investments will be worthless if Lehman becomes insolvent and cannot pay its debts.” OB 75. Even ignoring that the Offering Materials, read as a whole, convey exactly this message, Defendants had no obligation to disclose what is obvious to even the most unsophisticated investor.

“It is not a violation of any securities law to fail to disclose a result that is obvious even to a person with only an elementary understanding of the stock market.” Zerman v. Ball, 735 F.2d 15, 21 (2d Cir. 1984) (quoting Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1220 (9th Cir. 1980)). Here, the Offering Materials plainly disclosed that Lehman was the issuer of the PPNs; Plaintiffs do not contend otherwise. OB 78 n.104. It should have been obvious to any investor that if the issuer of the notes became insolvent and unable to pay, then, by definition, the investor would not receive repayment of his or her investment. Many courts have rejected claims based on the failure to disclose similarly obvious risks. In Brogren v. Pohl, 933 F. Supp. 793, 801 (D. Minn. 1995), for instance, the defendants disclosed that their company was “suffering from severe liquidity problems” and that, if it did not obtain outside financing, it would be unable “to meet either its short-term or long-term liquidity needs.” In light of these disclosures, the court dismissed plaintiffs’ claim and held that defendants did not have to state the “obvious” fact that the company “would not be able to continue operating if it did not obtain outside financing.”

Id.<sup>78</sup>

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<sup>78</sup> See also Zerman, 735 F.2d at 21 (no obligation to disclose that, in connection with a margin account, investor “might be required to put up more money if the market went down”); Bischoff v. G.K. Scott & Co., 687 F.

Accordingly, the Court should reject Plaintiffs' argument that the Offering Materials were required to disclose that the PPNs were not a completely risk-free investment.

**D. Plaintiffs Incorrectly Assert Defendant Callan's Liability Under Section 11**

As a well-known seasoned issuer, Lehman utilized Form S-3 for the 2006 automatic shelf registration and subsequently updated that shelf registration through Rule 424(b)(2) prospectus supplements. See Supplemental Declaration of Victor L. Hou, Ex. A (listing Lehman Form 424(b)(2) filings made during Callan's tenure as CFO). Rule 430B(f)(2) and 430B(f)(4) were designed to establish a statute of repose for shelf registrations with respect to Section 11 liability and to more appropriately align the timing for liability under Section 11 as to issuers and underwriters. See SEC Release 33-8591, section V(B)(1)(b)(iii)(B). Rule 430B(f)(2), not cited by Plaintiffs, makes clear that where Rule 424(b)(2) supplements are used to update a shelf registration, a new effective date for purposes of Section 11 liability is established only with respect to the issuer and underwriters. 17 C.F.R. § 230.430B(f)(2).<sup>79</sup> Plaintiffs' reliance on Rule 430B(f)(4), which they admit to finding "somewhat confusing," OB 64, is misplaced because that section applies to issuers that do not utilize Rule 424 prospectus supplements to update an automatic shelf registration, but rather update the registration by filing a new prospectus under Section 10(a)(3) of the Securities Act.<sup>80</sup>

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Supp. 746, 751 (E.D.N.Y. 1986) (no obligation to disclose that "there were risks connected with the securities purchases"); Newman v. L.F. Rothschild, Unterberg, Towbin, 651 F. Supp. 160, 164 (S.D.N.Y. 1986) (no obligation to disclose that margin accounts "contain a certain degree of risk" and that "a market decline can precipitate a margin call"); In re Thomson McKinnon Sec., Inc., 141 B.R. 33, 37 (Bankr. S.D.N.Y. 1992) (no obligation to disclose "the risks associated with the options trading and margin purchases").

<sup>79</sup> See also SEC Release 33-8591, section V(B)(1)(b)(iii)(B) ("[W]e believe that for other persons, including directors, signing officers, and experts, the filing of a form of prospectus should not result in a later Section 11 liability date than that which applied prior to our new rules.").

<sup>80</sup> See In re Countrywide Fin. Corp. Sec. Litig., 07-cv-05295-MRP-MAN, 2009 WL 943271, at \*7 (C.D. Cal. Apr. 6, 2009) (holding that Rule 430B did not treat former officer as having re-signed the shelf registration for purposes of Section 11 liability "because the subsequent Rule 424(b)(2) supplements and Rule 433 free-writing

Thus, under Rule 430B, Defendant Callan is not deemed to have signed the 2006 shelf registration statement at the time each of the Rule 424(b)(2) prospectus supplements were filed during her tenure as CFO (December 2007 through June 2008). Having never signed the registration statement, Callan does not fall within the scope of Section 11(a) which expressly defines the classes of defendants incurring Section 11 liability. Such scope of liability is limited by the language of the statute to “every person who signed the registration statement,” 15 U.S.C. § 77k(a), directors and partners, accountants, and underwriters, and is not enlarged by a rule promulgated by the SEC.<sup>81</sup> Callan thus cannot be liable under Section 11 for any of the Offerings. DB 71.

**E. The Section 15 Claim Fails As A Matter Of Law**

Because there is no primary liability under Sections 11 or 12(a)(2) against any controlled person, the derivative claim under Section 15 fails as a matter of law. See, e.g., ECA, Local 134 v. JP Morgan Chase Co., 553 F.3d, 187, 206-07 (2d Cir. 2009) (dismissing Section 15 claim “for want of a primary violation” under Section 11); DB 71-72.

The Section 15 claims against Defendants Gregory and Lowitt fail for the additional reason that the SAC does not adequately plead that they controlled any alleged primary violator. See, e.g., In re Refco, 503 F. Supp. 2d at 637. Neither of these defendants signed the Shelf Registration Statement or 2006 Prospectus, and the SAC does not even assert a primary Section 11 violation against them. For the first time in the Opposition, Plaintiffs contend that Gregory and Lowitt had control over the other officers alleged to have been primary violators: Fuld,

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prospectus did not meet the exceptions that Rule 430B makes for filings required under the '33 Act § 10(a)(3) or a fundamental change under Regulation S-K Item 512(a)(1)(ii).”).

<sup>81</sup> See Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 175, 114 S. Ct. 1439, 1447 (1994); SEC v. Zandford, 535 U.S. 813, 816 n.1, 122 S. Ct. 1899, 1901 n.1 (2002) (“The scope of Rule 10b-5 is coextensive with the coverage of § 10(b)”).

Callan, and O'Meara. But this new argument has no factual basis. The SAC does not allege that Gregory or Lowitt, President/COO and CFO respectively at the time, had control over any primary violator. Indeed, neither could have controlled Fuld, who as Chairman and CEO was senior to both of them, and Lowitt could not have had control over his predecessor CFOs, Callan and O'Meara.<sup>82</sup>

Likewise, there is no legal basis for Plaintiffs' convoluted theory of agency. Plaintiffs assert that because Gregory and Lowitt controlled the Company, they also controlled agents of the Company, the alleged primary violators. OB 80. But Plaintiffs provide no authority for their novel theory. Neither case they cite for this proposition even involves Section 11, 12 or 15 claims. See OB 80 (citing Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 101 (2d Cir. 2001); Tellabs Inc., 513 F.3d at 708-10).<sup>83</sup> Accordingly, for this additional reason, Plaintiffs fail to plead a Section 15 claim against Gregory and Lowitt.

## CONCLUSION

For the foregoing reasons, and those set forth previously, the Securities Act claims should be dismissed with prejudice.

Dated: New York, New York  
July 31, 2009

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<sup>82</sup> Similarly, the SAC does not plead that Callan, who never signed the Shelf Registration Statement or 2006 Prospectus, controlled a primary violator. Callan could not have controlled Fuld, who was senior to her; nor could she have controlled O'Meara, her predecessor CFO.

<sup>83</sup> Plaintiffs' statement that control person liability claims have been allowed to proceed where the primary violator is unavailable is misleading. In In re Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 286 (3d Cir. 2006), the only case Plaintiffs cite for this proposition that finds Section 15 liability, the court noted that the complaint "expressly asserted that [the company] should be primarily liable as a result [of alleged misstatements] under Section 15." Id. at 286; see OB 81 & n.107. The SAC does not include an allegation that Lehman was the primary violator for purposes of Plaintiffs' Section 15 claims.

Respectfully submitted,

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