UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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

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

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PRELIMINARY STATEMENT

Plaintiffs argue that the due diligence defense cannot be decided on a motion to dismiss because it "is an intensely factual question." OB at 48.[1] However, Plaintiffs' argument fails because they do not and cannot identify any question at all, let alone an intensely factual one, regarding the Director Defendants' due diligence. Plaintiffs do not dispute that the TAC does not and cannot allege that the Director Defendants knew anything about the Repo 105 issues underlying Plaintiffs' claims. Nor do Plaintiffs, who state affirmatively that the TAC was based on the Examiner's Report (TAC at p. 1), contest that it shows unequivocally the Director Defendants conducted reasonable due diligence and had no knowledge about any Repo 105 issues. In fact, Plaintiffs' own Opposition confirms the Director Defendants' diligence.

Plaintiffs' argument that a motion to dismiss can never be granted based on the due diligence defense is also inconsistent with well-established law. Under the unique circumstances present here, where the Director Defendants' affirmative defense is made plain on the face of the complaint and the documents incorporated therein by reference, it is appropriate to grant a motion to dismiss since Plaintiffs cannot point to any factual allegation remotely suggesting a lack of diligence on the part of the Director Defendants.

ARGUMENT

Plaintiffs do not attempt to rebut the Director Defendants' showing of due diligence. As the TAC and the Examiner's Report make clear, the Director Defendants regularly participated in Board and Board Committee meetings; the Directors Defendants received detailed presentations updating them on the status of Lehman's risk management, liquidity and business operations (including commercial and residential real estate); the Director Defendants met with Lehman's auditors and other professionals and were entitled to rely on them; and the Director

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[1] "Opposition" or "OB" is used herein to refer to Plaintiffs' Memorandum of Law in Opposition to Defendants' Motion To Dismiss the Third Amended Complaint. Unless otherwise noted, capitalized terms used herein shall have the same meanings ascribed to them in the TAC or in Defendants' Memorandum or Director Defendants' Memorandum of Law in Support of Their Motion To Dismiss the Third Amended Complaint ("Director Defendants' Memorandum" or "Dir. Def. Memo").

Defendants took comfort from the continuous presence of government regulators who worked intimately with Lehman throughout the financial crisis. *See* Dir. Def. Memo at 8-13.

Contrary to Plaintiffs' assertion that the due diligence defense can never be considered on a motion to dismiss,[2] it is well established that a court may dismiss claims at the pleading stage when an affirmative defense appears on the face of the complaint. *See Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998) (affirming dismissal on the basis of the affirmative defense of official immunity).[3] Plaintiffs do not mention, much less distinguish, *Pani*. Nor do Plaintiffs address the myriad cases that have granted motions to dismiss based on affirmative defenses in the Section 11 context. *See, e.g., Blackmoss Invs. Inc. v. ACA Capital Holdings, Inc.*, No. 07 Civ. 10528, 2010 WL 148617, at *11 (S.D.N.Y. Jan. 14, 2010); *In Re Britannia Bulk Holdings Inc. Secs. Litig.*, 665 F. Supp. 2d 404, 420 (S.D.N.Y. 2009); *In re Countrywide Fin. Corp. Secs. Litig.*, 588 F. Supp. 2d 1132, 1174-75, 1182 (C.D. Cal. 2008); *In re Openwave Sys. Secs. Litig.*, 528 F. Supp. 2d 236, 246 (S.D.N.Y. 2007).

Rather than address the substance of the Director Defendants' motion, Plaintiffs attempt to establish a new rule of law categorically barring the dismissal of claims, at the 12(b)(6) stage, based on the Section 11 due diligence defense. However, contrary to Plaintiffs' contention that the cases cited by defendants "unequivocally hold that the due diligence defense is a question of fact that should not be decided on a motion to dismiss" (OB at 49 n.41), in *Arkansas Public Employee Retirement System v. GT Solar International, Inc.*, the Court rejected any absolute prohibition against dismissing claims based on the due diligence defense. No. 08-CV-312, 2009

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[2] Plaintiffs conveniently misquote the Director Defendants' Memorandum by claiming that "the Director Defendants admit that the due diligence defense is 'not . . . an appropriate issue for consideration on a motion to dismiss.'" OB at 51. In fact, the Director Defendants candidly acknowledged that the due diligence defense *typically* is not addressed at the motion to dismiss stage – unless it can be established from the face of Plaintiffs' complaint and the documents the Court may consider. Dir. Def. Memo at 5 n.7.

[3] *See also Day v. Moscow*, 955 F.2d 807, 811 (2d Cir. 1992) (affirming dismissal on the basis of res judicata); *Green v. Maraio*, 722 F.2d 1013, 1018-19 (2d Cir. 1983) (affirming dismissal on the basis of qualified immunity); *Grosz v. Museum of Modern Art*, 09 Civ. 3706, 2010 WL 88003, at *26 (S.D.N.Y. Jan. 6, 2010) (dismissing on the basis of statute of limitations).

WL 3255225, at *7 (D.N.H. Oct. 7, 2009). There, the Court plainly stated that the due diligence defense "cannot support [a] motion to dismiss *unless* 'it is (1) definitively ascertainable from the complaint and other sources of information that are reviewable at [the motion to dismiss] stage, and (2) [the] facts establish the affirmative defense with certitude." *Id.* at *6 (quoting *Citibank Global Mkts., Inc., v. Rodriquez Santana*, 573 F.3d 17, 23 (1st Cir. 2009)) (emphasis added).[4]

To be sure, in *Arkansas Public Employee Retirement System* and other cited cases, courts have denied motions to dismiss after careful consideration. But in those cases, the defense had not been established by the pleadings; rather, plaintiffs had identified factual allegations indicating a lack of due diligence. *See* 2009 WL 3255225, at *7 (denying the defendants' due diligence defense because the complaint contained allegations and information sufficient "to prevent a successful due diligence or reasonable investigation defense on the basis of the complaint and other materials cognizable on a motion to dismiss"); *In re Dynegy, Inc. Secs. Litig.*, 339 F. Supp. 2d 804, 871-72 (S.D. Tex. 2004) (denying the director defendants' due diligence defense where neither plaintiff alleged nor defendants argued facts showing that the directors conducted a reasonable investigation).[5]

Here, in contrast, Plaintiffs identify no such facts. Thus, this case is easily distinguishable from the cases in which the due diligence defense has been considered and rejected after having been raised on a dispositive motion. *See, e.g., In re Worldcom, Inc. Secs. Litig.*, No. 02-Civ-3288, 2005 WL 638268, at *12 (S.D.N.Y. Mar. 21, 2005) (denying motion for summary judgment based on due diligence defense where director defendant failed to show "that he conducted *any* sort of investigation, much less a reasonable investigation in light of all relevant circumstances," which raised questions as to whether it was incumbent upon defendant to do more than he did). As discussed in the Director Defendants' moving brief, the TAC and

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[4] *Cf. In re Countrywide*, 588 F. Supp. 2d at 1175 (granting motion to dismiss on reliance grounds).

[5] *Cf. In re Enron Corp. Secs. Litig.*, 258 F. Supp. 2d 576, 639-40 (S.D. Tex. 2003) (denying directors' motion to dismiss based on the reliance defense and stating that the directors were likely aware of allegations of improper conduct against Arthur Anderson and other reports of high-risk activity).

Examiner's Report show the Director Defendants conducted a reasonable investigation and reasonably relied on experts and others. *See* Dir. Def. Memo at 8-13. Moreover, despite Plaintiffs' protestations that the due diligence defense is a highly factual inquiry that cannot be determined on a motion to dismiss (OB at 48-49), Plaintiffs have failed to identify any facts that would call the Director Defendants' due diligence into question.

The TAC does not raise any doubt that the Director Defendants conducted sufficient due diligence; to the contrary, the TAC alleges the Director Defendants were not informed about Repo 105, one of the key issues raised by Plaintiffs. *See* TAC at ¶ 231. The Examiner's Report does not raise any doubt about the Director Defendants' conduct; in fact, the Examiner's Report establishes the Director Defendants' due diligence defense. *See* Dir. Def. Memo at 8-13 (citing to specific portions of the Examiner's Report). Finally, Plaintiffs' Opposition not only fails to identify any allegations or references in the Examiner's Report that remotely suggest a lack of diligence on the part of the Director Defendants, but the Opposition repeats Plaintiffs' allegations and includes extensive citation to the Examiner's Report for the proposition that information regarding Repo 105 was withheld from the Director Defendants despite their having made requests that Plaintiffs allege should have prompted the provision of such information. *See, e.g.*, OB at 68-72, 82-83. Under circumstances analogous to those here, courts have not hesitated to grant dispositive motions. *See Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676, at *4 (N.D. Cal. Oct. 11, 1990) (granting summary judgment on the grounds of the due diligence defense); *In re Avant-Garde Computing Inc. Secs. Litig.*, No. Civ. 85-4149, 1989 WL 103625, at *8-9 (D.N.J. Sept. 5, 1989) (same); *Laven v. Flanagan*, 695 F. Supp. 800, 811-12 (D.N.J. 1988) (same).[6]

[6] Plaintiffs argue decisions involving the due diligence defense in the context of a motion for summary judgment are unpersuasive. That is like arguing that *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), is not persuasive authority on a motion to dismiss under Section 10(b) of the Exchange Act based on materiality because that case was decided on a motion for summary judgment. Of course the Court can consider the summary judgment decisions insofar as they contain relevant discussions of the law governing the due diligence defense. *Cf. Starr v. Georgeson S'holder, Inc.*, 412 F.3d 103, 110 (2d Cir. 2005) (affirming dismissal of complaint because, *inter alia*, in light of *Basic v. Levinson*, the complaint did not meet the materiality requirement).

Plaintiffs attempt to avoid the weaknesses of their claims as to the Director Defendants by setting up a series of straw men in the Opposition. Plaintiffs argue that they need not negate affirmative defenses in their complaint (OB at 49); Plaintiffs assert that the Court should draw "all reasonable inferences" in their favor (*id.* at 51); and Plaintiffs confuse and conflate the issues of red flags and scienter in an attempt to convince this Court that the Director Defendants have demanded some inappropriate standard of pleading from Plaintiffs (*id.* at 50-51). However, Plaintiffs' attempts to distract the Court are baseless. The Director Defendants do not assert that Plaintiffs are required to plead facts preemptively to rebut potential affirmative defenses. Nor do the Director Defendants take issue with the fact that the Court should draw all reasonable inferences in Plaintiffs' favor. Moreover, nowhere do the Director Defendants try to introduce a scienter element into the Section 11 analysis.[7] The Director Defendants simply assert the uncontroversial position that where an affirmative defense is evident from the face of the pleadings and documents before the Court, the Court may grant a motion to dismiss on the basis of the affirmative defense.

Finally, Plaintiffs' attempt to bar the Director Defendants' use of the Examiner's Report cannot be taken seriously. When analyzing a motion to dismiss, courts must consider the entirety of a complaint and any documents the plaintiffs explicitly incorporate into the complaint or upon which the plaintiffs heavily rely. *See, e.g., ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007); *Jorge v. Rumsfeld*, 404 F.3d 556, 559 (1st Cir. 2005) (affirming dismissal of complaint on statute of limitations grounds and acknowledging that "the district court appropriately may consider the whole of a document integral to or explicitly relied upon in

[7] The Director Defendants' references to "red flags" in their opening brief were made in the context of reciting the well-established legal principle that the due diligence defense applies where defendants conducted a reasonable investigation, defendants had reasonable grounds to believe and did believe that the statements at issue were true, and there were no "red flags" of suspicious activity to suggest the defendants should have investigated more, lacked a reasonable basis for believing or did not believe that the statements at issue were true. *See* Dir. Def. Memo at 6-7, 13-14.

a complaint").[8] In particular, it is well established that courts may rely on examiners' reports as bases for dismissal. Dir. Def. Memo at 3-5. Given that Plaintiffs make heavy use of the Examiner's Report in both their TAC and their Opposition,[9] they cannot be heard to argue that the Director Defendants should be precluded from using the document in support of their motion to dismiss. Plaintiffs simply cannot have their cake and eat it too. Consideration of the TAC and the Examiner's Report in deciding the Director Defendants' motion is proper here and compels the conclusion that dismissal under the due diligence defense is well warranted.[10]

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[8] Plaintiffs' reliance on *In re Cendant Corp. Litig.* for the proposition that the Court cannot consider a document that is integral to the complaint on a motion to dismiss is misplaced. There, the court refused to rely on a document, created by the company's counsel and filed with the SEC, that had only been "referred to" in the complaint. *In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354, 365 (D.N.J. 1999). Here, the Examiner's Report is an independent document created at the behest of the Bankruptcy Court for the Southern District of New York upon which Plaintiffs admit their TAC is "based." *See* TAC at p. 1.

[9] *See, e.g.*, Dir. Def. Memo at 4 n.6 (comparing the SAC to the TAC); TAC at p. 1 (stating that allegations are "based upon" the Examiner's Report); OB at 62-63 (relying on the Examiner's Report for the assertions that Erin Callan served on Lehman's Executive Committee, which met on a particular date and discussed Repo 105, and for Joe Gregory's recollection of discussing Repo 105 at that meeting); *id.* at 63 n.70, 64 n.71 (relying on the Examiner's Report to support their allegations that certain individuals were aware of Repo 105).

[10] The Director Defendants incorporate by reference the arguments in Defendants' and E&Y's memoranda in support of their motions to dismiss the TAC, including those that show Plaintiffs' claims should be dismissed under Section 11 pursuant to the reliance defense.

CONCLUSION

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

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Respectfully submitted,

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