United States Courts
Southern District of Texas
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Michael N. Milby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	§	Civil Action No. H-01-3624 **(Consolidated)**
This Document Relates To:	§	CLASS ACTION
MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated,	§	
Plaintiffs,	§	
vs.	§	
ENRON CORP., et al.,	§	
Defendants.	§	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated,	§	
Plaintiffs,	§	
vs.	§	
KENNETH L. LAY, et al.,	§	
Defendants.	§	

MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO MOTION TO DISMISS BY LEHMAN

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I. INTRODUCTION AND FACTUAL OVERVIEW[1]

In the face of a 500-page complaint alleging the largest and worst securities fraud in the history of the United States[2] in excruciating detail, every single defendant – Enron's insiders, Enron's outside directors, Enron's accountants, Enron's lawyers and Enron's bankers have moved to dismiss. Some claim it is too detailed. Some claim it is not detailed enough. Everyone denies responsibility and not one defendant has seen fit to answer. Every defendant seeks to avoid accountability by raising technical pleading arguments based on the Private Securities Litigation Reform Act of 1995 ("95 Act") which was meant to deter the filing of ***frivolous*** suits – which everyone knows, except apparently the defendants, this case is not. While it does appear that the 95 Act was successful, at least in this case, in deterring plaintiffs' securities lawyers from filing cookie-cutter complaints, it does not appear to have had the same salutary impact with respect to deterring defendants from filing meritless motions to dismiss.[3]

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1 Because any changes to the pleading requirements were not intended to prevent aggrieved parties from obtaining redress for their valid claims "courts still apply Rule 12(b)(6) principles to motions to dismiss securities class action cases." *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1166 (W.D. Wash. 1998) (collecting cases); *see also Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1273 n.1 (11th Cir. 1999). Consequently, the court must accept as true all well-pleaded allegations in the complaint and construe them in the light most favorable to plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232 (1974); *Calliott v. HFS, Inc.*, No. 3:97-CV-0924-I, 2000 U.S. Dist. LEXIS 4368, at *8 (N.D. Tex. Mar. 31, 2000); *Zuckerman v. Foxmeyer Health Corp.*, 4 F. Supp. 2d 618, 621 (N.D. Tex. 1998) (Maloney, R.) (stressing that "the complaint is to be liberally construed in favor of the plaintiff"); *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914, 919 (S.D. Tex. 1998); *Lawal v. British Airways, PLC*, 812 F. Supp. 713, 716 (S.D. Tex. 1992). "A motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6) 'is viewed with disfavor and is rarely granted.'" *Calliott*, 2000 U.S. Dist. LEXIS 4368, at *7. Dismissal is appropriate only if it appears that no relief could be granted under any set of facts that could be proven consistent with the allegations. *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994) (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)); *Tuchman v. DSC Communications Corp.*, 818 F. Supp. 971, 974 (N.D. Tex. 1993), *aff'd*, 14 F.3d 1061 (5th Cir. 1994); *Calliott*, 2000 U.S. Dist. LEXIS 4368, at *3.

2 *See* John C. Coffee, "Guarding the Gatekeepers," *New York Times*, 5/13/02 at A19, referring to Enron as a "[m]ajor debacle of historic dimensions."

3 While the banks all proclaim their innocence and insist that they acted properly, without conflict or corruption, and in accordance with normal commercial lending and investment banking activities, these denials ring hollow in light of the recent revelations of corruption on Wall Street. *See* Maria Vickers & Mike France, "Wall Street: How Corrupt is it?," 5/13/02 *Business Week*, attached as Ex. 1 to plaintiffs' appendix.

If it is "irrational" to engage in acts that violate the law, then it appears Wall Street is deranged. However, if it is irrational to violate the law because of the risk of financial loss and punishment that accompanies illegal conduct then presumably no one would ever violate the law and

Lehman Brothers ("Lehman") denigrates the detailed Consolidated Complaint ("CC")[4] as a "puzzle pleading" that violates Fed. R. Civ. P. 8. But, the CC is of the same style and format sustained by this Court in *In re Landry's Seafood Restaurants, Inc. Sec. Litig.*, No. H-99-1948 (S.D. Tex. Feb. 20, 2001) – a decision defendants basically ignore – and in many other reported and unreported decisions. The "puzzle pleading" charge has been repeatedly rejected by courts which respect good faith efforts by victims of securities fraud to provide the kind of detail and individuality required by the 95 Act – especially in complex multi-party cases. As Judge Debevoise stated in sustaining a lengthy complaint against a public company and its officers and directors:

> Defendants challenge the Complaint, claiming that rather than being a "short and plain statement of the claim" in conformity with Fed. R. Civ. P. 8, it is "puzzle pleading" that fails to meet the requirements of Rule 9(b) and the Private Securities Litigation Reform Act (the "Reform Act"). ***The Complaint certainly is not short, but if it is a puzzle, it is meant for a child and can be assembled readily.***

In re Honeywell Int'l Sec. Litig., 182 F. Supp. 2d 414, 416 (D.N.J. 2002).[5] In truth, ¶¶1–74 of the CC provide a relatively succinct summary of the CC, while the balance of the CC provides the detail required by Rule 9(b) and the 95 Act, thus satisfying plaintiffs' dual pleading obligations.

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acceptance of this after the fact rationale would provide all wrong doers from embezzlers to bank robbers to price fixers and sophisticated securities violators with a built-in defense.

Plaintiffs apologize for the length and repetition involved in responding to motions to dismiss filed by each of the nine banks sued as defendants. However, since the banks insisted, as was their right, to move to dismiss separately and because they have chosen to either ignore or grossly mischaracterize the allegations against them in the 500-page Consolidated Complaint – apparently in the hope that the Court will not be able to find and focus on those allegations – plaintiffs had no choice but to respond separately as to each of the banks and set forth in detail the ***actual*** allegations made against the banks in the CC. After all, plaintiffs are entitled to have the adequacy of their CC against the banks determined based on the ***actual allegations*** of the CC, not defendants' mischaracterization of them.

4 All "¶_" references are to plaintiffs' Consolidated Complaint ("CC") filed 4/8/02.

5 Unless otherwise noted, emphasis is added and citations and footnotes are omitted throughout.

Lehman[6] portrays itself as a victim of the Enron debacle – a financial institution that was merely rendering "ordinary" banking services to Enron when it became engulfed in the Enron conflagration. But this is not what is pleaded in the CC and what is pleaded is what controls in the motion to dismiss context. What the CC pleads and what now must be accepted as true is that Lehman is liable under the 1933[7] and 1934[8] Acts because it (i) sold Enron and Enron-related securities to investors via false Registration Statements; (ii) issued false analysts' reports on Enron; (iii) employed acts and manipulative or deceptive devices; and (iv) participated in a scheme to defraud and a course of business that operated as a fraud or deceit on, purchasers of Enron's securities between 10/18/98 and 11/27/01 (the "Class Period").

A. Year-End 97 Crisis

The fraudulent scheme and course of business involving Enron finds its origin in mid 97 when Enron suffered huge losses on British natural gas and MTBE transactions which called into question its trading and financial risk management statistics. Analysts downgraded Enron's stock and lowered their forecasts of Enron's future earnings growth. Enron's stock lost one-third of its value and Enron's executives' performance-based bonuses were slashed. Enron was determined to halt its stock's decline and push it back to higher levels. Enron knew this could only be accomplished by reporting stronger-than-expected financial results, thus enabling it to credibly

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6 Lehman is an integrated financial services institution that provides commercial and investment banking services and advisory services, including acting as underwriter in the sale of corporate securities and providing investment analysis and opinions on public companies. ¶108.

Lehman suggests we sued the wrong party. We think not. The alleged fraudulent scheme involved ***both*** Lehman's investment banking ***and*** commercial operations, *i.e.*, it is not limited to the actions of Lehman's securities subsidiary. Thus, because the liability of Lehman flows from the activities of both its commercial and investment banking operations, naming the parent corporate entity – which, after all, is legally responsible for the operations and conduct of its subsidiaries – seems appropriate.

Lehman claims it did not engage in any activities described in the complaint but rather that banking and advisory services are performed "only by its subsidiaries." *Id.* But "[w]hether a subsidiary is a separate entity is a question of fact." *Burnside v. Sanders Assocs., Inc.,* 507 F. Supp. 165, 166 (N.D. Tex. 1980), *aff'd,* 643 F.2d 389 (5th Cir. 1981). Therefore, this argument is not one for a motion to dismiss.

7 15 U.S.C. §77a, *et seq.*

8 15 U.S.C. §78a, *et seq.*

forecast stronger future earnings growth. Unfortunately, Enron's actual business operations were not capable of generating such results. ¶8.

To make matters worse, in late 12/97, Enron learned that an entity it had established with an outside investor Joint Energy Development Incorporated ("JEDI") and had done transactions with to generate 40% of the profits Enron reported during 97 – had to be restructured, as the outside investor was going to withdraw from JEDI. This created a crisis. Because the outside investor in JEDI had been independent of Enron JEDI had ***not*** been consolidated into Enron's financial statements *i.e.*, Enron did deals with JEDI as an independent party, recognized profits and did not carry JEDI's debt on its books. Thus, unless JEDI could be quickly restructured with a new, independent investor, ***Enron would have to wipe out all of the profitable transactions it had done with JEDI in 97 – put JEDI's $700 million debt on Enron's balance sheet – and lose the ability to generate profits from similar such deals with JEDI's successor going forward.*** ¶9.

However, Enron ***could not find a legitimate buyer for the outside investor's interest*** in JEDI. So Enron quickly formed Chewco which Enron controlled, to buy the outside investor's interest in JEDI. Chewco ***did not have an outside equity investor which was an independent third party. So, Barclays Bank loaned $240 million to Chewco, requiring a secret guarantee from Enron. Barclays also loaned the money to two straw parties (Little River and Big River) to provide for their purported "equity" investment in Chewco. Because Barclays knew that the purported equity investors in Chewco were, in fact, Enron "strawmen," Barclays required Chewco to support the purported "equity loans" Barclays made to the two "strawmen" via a $6.6 million reserve paid to Barclays***! Because there was no independent outside investor in Chewco, Chewco was required to have been consolidated with Enron and ***all of Enron's 97 profits from transactions with JEDI should have been eliminated***! ¶10.

By the non-arm's-length Chewco transaction at year end 97, Enron avoided a disaster by keeping the previously recorded JEDI profits in place, inflating its 97 reported profits and keeping millions of dollars of debt off its books. Chewco was now also positioned to serve as a controlled entity which Enron could use to do non-arm's-length transactions, creating at least $350 million in phony profits for Enron and allowing Enron to conceal millions of dollars of debt. ***Having now***

created its template for falsity, Enron, and its banks would create other secretly controlled partnerships and entities and use them to generate hundreds of millions of dollars of phony profits while concealing billions of dollars of Enron debt. ¶11.

B. The 97-00 Successes – Enron's Stock Soars

As Enron reported ***better-than-expected year-end 97 financial results***, its stock moved higher. During 98 through mid-01, Enron appeared to evolve into an enormously profitable high-growth enterprise, reaching annual revenues of $100 billion by 00, with annual profits of $1.2 billion, presenting a very strong balance sheet that entitled it to an investment ***grade credit rating***. By 01, Enron had become the 7th largest U.S. corporation and was consistently reporting ***higher-than-forecasted earnings each quarter*** and forecasting ***continued strong growth***. ¶12. Enron extolled the success and earning power of its Wholesale Energy trading business ("WEOS"), its Retail Energy Services business ("EES") and its Broadband Content Delivery and Access Trading, *i.e.*, intermediation, business ("EBS"). ¶2.

Throughout 98 and 99, as Enron reported record profits and a strong financial position, Enron and Enron's banks, ***including Lehman***, stated (¶14(a)):

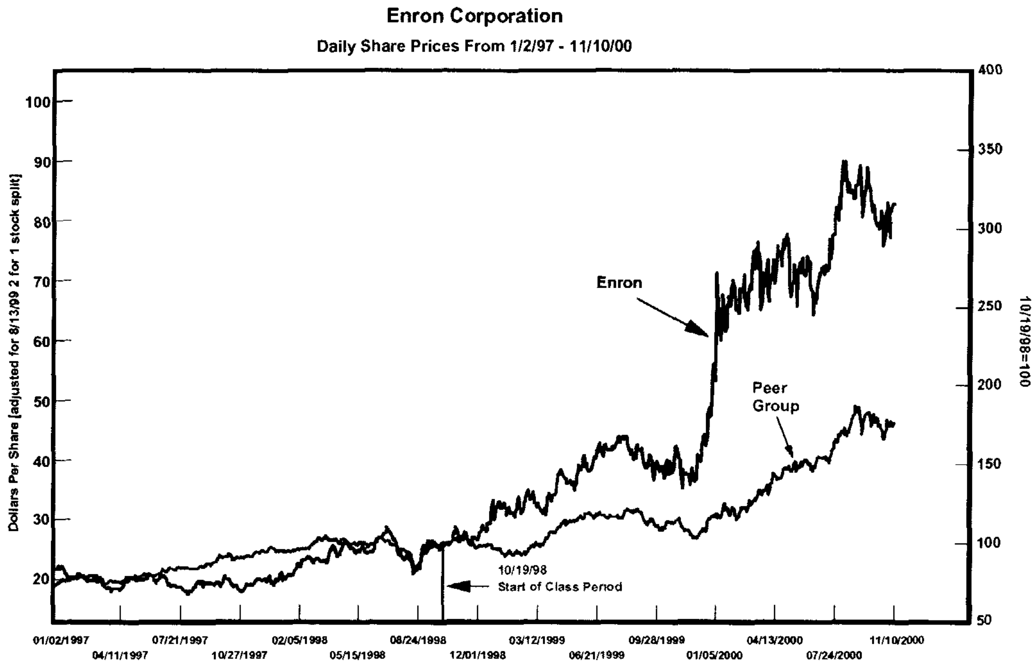
- Enron's strong results were due to the success of all of its business lines.
- Enron had a leading position in each of its businesses. Enron had an extremely strong franchise position.
- Wessex Water would be accretive to Enron's business now and a $20 billion business in five years. Azurix Corp. was becoming a major global water company.
- International projects would drive major earnings growth for Enron. The Dabhol, India power project would contribute to earnings in 99 and beyond.
- WEOS's business remained strong.
- EES was exceeding expectations for contracts and profitability. EES was adding billions in new contracts and would be profitable by 4thQ 00.
- Enron was optimistic about its broadband business. EBS was firing on track.
- Enron's tremendous competitive advantages enabled it to achieve strong EPS growth.
- Enron was very well managed and knew how to manage and mitigate risk. Enron had effectively used off-balance sheet non-recourse financing. Enron had a strong balance sheet. Enron was a master of risk management.
- No other company offered such impressive sustainable growth.

- Enron was hitting on all eight cylinders. Enron's outlook was excellent. Enron was very optimistic.
- Enron was a global powerhouse, with EPS growth to exceed 17%. Enron would maintain strong earnings growth for years.

During 00, as Enron reported record annual profits and a very strong financial position, Enron and its banks, ***including Lehman***, stated (¶14(b)):

- Enron's strong financial results were due to strong results in all operations.
- Enron had very strong momentum. Its trends were sustainable and would accelerate.
- Enron's business was booming. All its operations were gaining momentum.
- Investors were about to see breakout performance of EES and rapid growth and development of EBS.
- EES's new contracts and profitability were accelerating. EES had the potential to double Enron's size in a few years.
- EBS broadband trading was accelerating. The market was larger than expected, and would reach $100 billion in a few years with 3%-4% margins.
- Enron/Blockbuster video-on-demand ("VOD") deal a "killer app." Unparalleled quality of service. Contract worth over $1 billion. VOD to rollout nationally in 01. All components in place. VOD had solid technology and platform.
- Enron's WEOS merchant investments were protected through hedging.
- Enron had monumental earnings potential over the next five years. Enron was well managed and a pioneer in global energy. Enron was never in better shape. Enron was very optimistic about the continued strong outlook for the Company.
- Growth and strong earnings were why investors should buy Enron stock.

As a result of Enron's strong earnings, the positive statements about its business and the forecasts of continuing strong earnings growth, Enron's stock was a very strong performer and its debt securities also traded at high prices. ¶15. Enron's apparent success and forecasts of strong profit growth gave Enron and its bankers ready access to the capital markets by which they raised billions of dollars by selling newly issued Enron securities to public investors, using the proceeds to repay Enron's bank debt. ¶16. Enron's stock soared to its all-time high of $90-3/4 in 8/00 and then continued to trade at or near these levels for months, as shown below (¶15):



However, the apparent success of Enron was an illusion – a false picture created by contrivances and deceptive acts – a fraudulent scheme and course of business that operated as a fraud and deceit on the purchasers of Enron's publicly traded securities. The fraudulent scheme was accomplished by *inter alia*, Enron and several banks, including Lehman, which pocketed millions of dollars a year from Enron – which by 97-98 had become the ***golden goose of Wall Street***. ¶17.

Inside Enron there was a fixation on Enron's stock and doing whatever was required to generate the financial results necessary to push the stock ever higher. Throughout Enron's corporate headquarters in Houston were TV monitors that displayed the price of Enron stock. Inside Enron there was a saying that managers were to be "***ABC***ing," meaning to "***a***lways ***b***e ***c***losing" deals to generate revenues and profits, even if the economics of the deal were suspect – a practice facilitated by a compensation system inside Enron for corporate managers and executives that directly rewarded them financially for ***closing*** transactions and placing a high (*i.e.*, inflated) value on them, regardless of the true economic substance of the deal, so long as the deal generated an apparent profit when "marked to market." ¶50.

Inside Enron, the pressures applied to corporate managers by the top executives to do anything necessary to enable Enron to make its numbers was widespread, as was the knowledge that

Enron's revenues and earnings were being falsified. Former insiders have been quoted as saying "***[y]ou don't object to anything***" and "***[t]he whole culture at the vice-president level and above just became a yes-man culture.***"

> But that culture had a negative side beyond the inbred arrogance. ***Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's*** energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied ***on internal estimates. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts – even though it had no impact on the actual cash that was generated.***

Fortune, 12/24/01 (¶51).

> ***"If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings," says one young Enron control person. "Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"***
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> * * *
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> ***The flaw only grew more pronounced as Enron struggled to meet the wildly optimistic expectations for growth it had set for itself. "You've got someone at the top saying the stock price is the most important thing, which is driven by earnings," says one insider. "Whoever could provide earnings quickly would be promoted."***
>
> ***The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, she says, the harder they would have to push the next year. "It's like being a heroin junkie," she said. "How do you go cold turkey?"***

Business Week, 2/25/02 (¶51). In fact, in mid-8/01, an Enron executive wrote Lay, telling him the Company was "***nothing but an elaborate accounting hoax***," and, in referring to the SPE transactions which Enron's banks – ***including Lehman*** – had funded, that nothing "***will protect Enron if these transactions are ever disclosed in the bright light of day***" – warning that "***[W]e're such a crooked company.***" ¶51.

By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits, while concealing billions of dollars of debt – inflating its shareholder equity by billions of dollars. Enron had turned into the largest Ponzi scheme in history

– constantly raising fresh money by selling its securities or those of related entities – while appearing to achieve successful growth and profits. But, because Enron's reported profits were being generated by phony, non-arm's-length transactions and improper accounting tricks – including the abuse of "mark-to-market" accounting[9] to accelerate the recognition of hundreds of millions of dollars of profits to ***current periods*** from transactions in which Enron was only entitled to receive ***cash over many future years*** – Enron was cash starved. Yet to continue to report ***growing*** profits, Enron was forced to not only continue to engage in such transactions and accounting abuses, ***but to accelerate the number and size of such transactions it engaged in***. This created a vicious cycle, further exacerbating Enron's need to obtain cash from these transactions. To make matters worse, Enron had capitalized controlled entities it was doing phony deals with (including entities which Lehman executives were secretly helping to fund, via the LJM2 partnerships), with shares of Enron stock and ***had agreed to issue millions and millions of additional shares of its stock to these entities if Enron's stock price declined below certain "trigger prices"*** *i.e.*, $83, $81, $79, $68, $60, $57, $52, $48, $34 and $19 per share ***and to become liable for the debt of those entities if Enron lost its investment grade credit rating***. Because of the "triggers" and the way Enron capitalized these entities, it was absolutely vital to Enron, Lehman and the other participants in the fraudulent scheme

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[9] Enron engaged in several accounting tricks and manipulations to falsify its financial results during the Class Period. Chief among these was the abuse of "***mark-to-market accounting***" whereby Enron would compute the purported profit it would ultimately obtain on a multi-year contract, discount that to present value and recognize the entire "mark-to-market" profit in the current period. Enron misused and abused mark-to-market accounting ***throughout its entire business to grossly inflate its reported revenues and profits***. In Enron's WEOS business this was done by assigning unrealistic values to wholesale energy transactions which inflated current period income. In Enron's EES business where Enron had no long-term track record to justify the use of mark-to-market accounting, Enron nevertheless consistently utilized mark-to-market accounting to record huge current period profits on long-term, highly speculative retail energy risk-management contracts which, in fact, Enron had no basis to project a profit on and in fact knew would likely result in losses. Finally, in Enron's EBS business – also a new business where Enron had absolutely no track record which would justify the use of mark-to-market accounting – Enron utilized mark-to-market accounting to generate hundreds of millions of dollars of phony current period profits in several transactions. Also, when reviewing those computations on a quarterly basis as it was required to do, Enron consistently ***increased*** the estimated value of the transaction even though subsequent data revealed ***a reduction of the estimated value of the transaction, a practice known within Enron as "moving the curve."*** ¶36.

and course of business that Enron's stock continue to trade at high levels and that Enron maintain its "investment grade" credit rating, otherwise the scheme would unravel. ¶¶18, 20.[10]

Enron became completely dependent on maintaining its investment grade credit rating and a high stock price so that Enron could continue to have access to the capital markets to borrow billions in commercial paper and to enable it to periodically raise hundreds of millions of dollars of new longer term capital it needed to repay its commercial paper debt and the short-term loans it was receiving from its banks – including Lehman – to sustain its business operations and so the stock issuance "triggers" would not be hit which would force Enron into a death spiral. ¶20.

C. The Partnerships and SPEs

To falsify Enron's reported financial results, Enron and its banks – including Lehman – engaged in a series of purported "partnership" and "related party" transactions with the entities known as SPEs. A public company that conducts business with an SPE may treat that SPE as if it were an independent entity ***only*** if it does not control the SPE. ***And***, at a bare minimum, two other conditions must be met: (i) an owner independent party must make an equity investment of ***at least 3% of the SPE's assets, which must remain at risk throughout the transaction***; and (ii) ***the independent party must exercise control of the SPE***. ¶21.

In 99, Enron created and then entered into numerous business transactions with, two ***LJM partnerships (LJM and LJM2) which Enron secretly controlled. Enron then engaged in numerous non-arm's-length transactions – contrivances and devices to deceive – with the LJM partnerships and associated SPEs, which inflated Enron's reported profits by more than a billion dollars – at the same time enriching Enron's CFO (Fastow) and Enron's banks or bankers –***

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[10] Enron's investment grade credit rating was indispensable. As Enron's CFO stated in a 10/01 conference call, "***We understand that our credit rating is critical to both the capital markets as well as our counterparties.***" Earlier, Fastow stated to *CFO Magazine*, "***My credit rating is strategically critical.***" This investment grade credit rating gave Enron access to the commercial paper market – a market reserved for America's largest and most creditworthy corporations – so that it could borrow billions of dollars to maintain its liquidity and finance its capital-intensive business. This meant that Enron and its banks could easily sell debt securities to investors to raise long-term capital, using the proceeds to reduce short-term commercial paper and other bank debt. Enron's investment grade credit rating was critical to the scheme, as only Enron's insiders and its banks knew, because under the terms of the partnership/SPE deals, ***if Enron's debt was downgraded to below investment grade, the debt of those entities would become recourse to Enron, which could cause the house of cards to topple.*** ¶19.

including Lehman's top executives – who had been secretly allowed to invest in the LJM2 partnership as a reward for their participation in the scheme – by hundreds of millions of dollars. The reason for establishing these partnerships was that they would permit Enron to accomplish transactions it could not otherwise accomplish with an independent entity, by providing Enron with a buyer of assets that Enron wanted to sell. ¶¶23, 29, 646-647.

One of the primary vehicles used to falsify Enron's financial results during 99-01 was LJM2, which was secretly controlled by Enron and used to create numerous SPEs (including the infamous "Raptors") which engaged in numerous non-arm's-length fraudulent transactions to artificially inflate Enron's profits while concealing billions of dollars in its debt in terms so unfair to Enron that the deals would provide huge returns to the LJM2 investors. ¶24. Because the LJM2 partnership was going to be so lucrative to investors in that entity ***and provide exceptional returns to them as the Enron Ponzi scheme continued***, Enron decided that in funding LJM2, it would ***allow certain favored high-level officers of Enron's banks or the banks themselves to get in on LJM2.*** The LJM2 partnership offering memorandum by which Enron brought investors into the partnership – ***which was not a public document*** – contained an invitation to benefit from the self-dealing transactions that LJM2 would engage in. It stressed the "***unusually attractive investment opportunity***" resulting from LJM2's connection to Enron. It emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow, and other Enron insiders. It explained that "***[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities***" and that it "***expects to benefit from having the opportunity to invest [some $150 million] in Enron-generated investment opportunities that would not be available otherwise to outside investors***." It specifically noted that Fastow's "***access to Enron's information pertaining to potential investments will contribute to superior returns.***"[11] ***In addition, investors were told that investors in a similar Fastow controlled partnership (JEDI) that had done deals***

[11] In fact, Fastow's dual role by which he could self-deal on behalf of the LJM2 partnership with Enron's assets was so important ***that investors in LJM2 were assured that they did not have to make any additional capital contributions if Fastow's dual role ended***. ¶24.

with Enron like the ones LJM2 would do had tripled their investment in just two years and that overall returns of 2,500% to LJM2 investors were actually anticipated. ¶25.

Enron and Lehman knew that because LJM2 was going to engage in transactions ***with Enron where Enron insiders would be on both sides of the transactions, the LJM2 partnership would be extremely lucrative – a deal that was virtually guaranteed to provide huge returns to LJM2's investors as the Enron Ponzi scheme went forward.*** In short, the non-public offering memorandum was an invitation to share in the benefits of non-arm's-length self-dealing transactions with Enron – to loot Enron for their benefit. ***The top executives of Lehman were permitted to invest in LJM2, as a reward to them for their ongoing participation in the scheme – a sure thing for them.*** ¶¶24, 25.[12]

It was indispensable to the scheme that LJM2 be funded at year-end 99 to serve as a vehicle to consummate several deals with Enron before year-end 99 to create profits for Enron in the 4thQ 99 so that Enron could meet and exceed its forecasted 99 earnings. However, as had been the case with Chewco at year-end 97, there was tremendous time pressure and Enron (and Merrill Lynch which was to raise the equity money for LJM2) could not complete the formation of LJM2 and raise money from the outside equity investors in LJM2 in time to fully form or fund LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in an extraordinary step, on 12/22/99, Lehman or top officers of Lehman, even though LJM2 had not yet been formed or fully funded, but knowing that LJM2 was going to be an extraordinarily lucrative investment, advanced $1.5 million (via LBJ or LBI Group, Inc.) to "pre-fund" LJM2, *i.e.*, many times more than their allocated shares in LJM2. ¶26. The reason the banks – including Lehman – put up the money to pre-fund LJM2 in 12/99 was that they knew enabling Enron to do the 99 year-end deals with the LJM2 and its SPEs was indispensable to Enron avoiding reporting a very bad 4thQ 99 –

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12 While Enron's publicly filed reports disclosed the existence of the LJM partnerships, these disclosures did not reveal the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not fully disclose the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and to disguise their substance and import. The disclosures also represented that the related-party transactions were reasonable compared to transactions with third parties when, in fact, they were not. ¶67.

which would have caused its stock to plunge and endanger the fraudulent scheme. These vital year-end 99 deals included:

A. ***Collateralized Loan Obligations ("CLOs"). On 12/22/99***, Enron pooled purchaser CLO rights and sold the lowest-rated tranche to Whitewing LLP (an Enron affiliate) and LJM2. Whitewing loaned LJM2 the money to purchase its interest in the CLOs. Enron secretly guaranteed Whitewing's investment and loan to LJM2. This transaction allowed Enron to record the sale of millions of dollars in the 4thQ 99 to an entity that should have been consolidated.

B. ***Nowa Sarzyna (Poland Power Plant). On 12/21/99***, Enron sold LJM2 a 75% interest in the Nowa Sarzyna power plant. Enron had tried to sell this interest by year-end to an independent buyer but could not find an independent buyer in time, so it used LJM2, which paid $30 million. This transaction moved millions of dollars of debt off Enron's balance sheet. This was a sham transaction. The debt financing required Enron to maintain ownership of at least 47.5% of the equity until the project was completed. However, the lender ***granted a waiver*** of this until 3/31/00, at which time Enron and Whitewing reacquired LJM2's equity interest and repaid that loan.

C. ***MEGS, LLC. On 12/29/99***, Enron sold LJM2 a 90% equity interest in MEGS, a natural gas system in the Gulf of Mexico. This allowed Enron to avoid consolidating the asset at year-end 99, avoiding millions of dollars of debt on Enron's balance sheet. Enron repurchased LJM2's interest in MEGS in early 00.

D. ***Yosemite. On 12/29/99***, Enron purportedly sold certificates in Yosemite to LJM2, however, in fact, this transaction did not occur until 2/28/00. The transaction was made to appear to occur at year-end 99 to reduce Enron's interest in Yosemite from 50% to 10% so Enron would not have to disclose its ownership of these certificates in Enron's 99 financial statements and that, in effect, Enron owned some of its own debt. On 12/29/99, Condor (an affiliate of Whitewing), which was controlled by Enron, loaned the $35 million to LJM2 to buy the certificates. On 12/30/99, LJM2 transferred the certificates to Condor, satisfying the one-day loan. ¶28.

From 6/99 through 6/01, as Lehman's top executives put $10 million into LJM2, Enron entered into numerous other non-arm's-length fraudulent transactions with the LJM partnerships. Enron sold assets to LJM2 that it wanted to get off its books on terms that no independent third party would ever have agreed to. ***The transactions between the LJM partnerships and Enron or its affiliates occurred close to the end of financial reporting periods to artificially boost reported results to meet forecasts Enron and other participants in the scheme had been making.*** For instance, near the end of the 3rd and 4thQ 99, Enron sold interests in seven assets to LJM1 and LJM2. The transactions permitted Enron to conceal its true debt levels by removing the assets from Enron's ***balance sheet and, at the same time, record large gains. However, (i) as it had agreed in advance it would do, Enron bought back five of the seven assets after the close of the financial reporting period; (ii) the LJM partnerships made large profits on every transaction, even when the asset they had purchased actually declined in market value; and (iii) those transactions generated "earnings" for Enron of $229 million in the second half of 99 out of total earnings for that period of $549 million. In three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against any loss. Thus, the LJM partnerships functioned only as vehicles to accommodate defendants in the falsification and artificial inflation of Enron's reported financial results, while enriching the LJM investors*** who were benefitting from the looting of Enron, ***including the top executives of Lehman***. ¶32.[13]

Thus, these favored investors in LJM2 like the Lehman executives actually ***witnessed*** a series of extraordinary pay outs from the Raptor SPEs which LJM2 controlled over the next two years – securing hundreds of millions of dollars in distributions from the Raptors to LJM2 and ***then to themselves*** – cash generated by the illicit and improper transactions Enron was engaging in – *i.e.*, the manipulative or deceptive devices – with the Raptors to falsify Enron's financial results. Thus, the banks and bankers who were partners in LJM2 - like Lehman executives - ***were not only knowing participants in the Enron scheme to defraud, they were economic beneficiaries of it – and of the looting of Enron. Had the Enron Ponzi scheme continued to operate for the full life***

[13] The returns to the LJM2 investors were huge – up to 2,500% on one deal and 51% overall ***in the first year*** of the partnership. ***Skilling has recently told investigators such gargantuan returns were possible only because LJM2, with Fastow at the wheel, was defrauding Enron in the billions of dollars of deals it was doing with Enron so Enron could create false profits and hide billions of dollars in debt.*** *The New York Times*, "Enron Ex-Chief Said to Voice Suspicion of Fraud," 4/24/02.

of the LJM2 partnership, Enron's banks would have achieved the stupendous returns they were promised – measured in thousands of percent. As it was, they got millions. And these payments from LJM2 were on top of the huge advisory fees, underwriter fees, interest and loan commitment fees Lehman was already getting from Enron and would continue to get if the Enron scheme continued. ¶¶31, 649.

One "hedging" transaction with LJM in 6/99 involved Rhythms NetConnections ("Rhythms") stock owned by Enron, ***to "hedge" Enron's huge gains in Rhythms stock and enable Enron to create a huge profit. Enron transferred its own stock to the SPE in exchange for a note. But if the SPE were required to pay Enron on the "hedge," the Enron stock would be the source of payment. Other "hedging" transactions occurred in 00 and 01 and involved SPEs known as the "Raptor" vehicles. These were also structures, funded principally with Enron's own stock, that were intended to "hedge" against declines in the value of certain of Enron's merchant investments. These transactions were not economic hedges. They actually were manipulative or deceptive devices devised to circumvent accounting rules. The economic reality was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron***. Enron and Enron's banks used these contrivances and devices to deceive to inflate Enron's reported financial results. In 99, Enron recognized income of over $100 million from the Rhythms' "hedging" transaction. ***In the last two quarters of 00, Enron recognized pre-tax earnings of $530 million on several transactions with the Raptor entities*** out of reported pre-tax earnings of $650 million. These ***"earnings" from the Raptors' deceptive contrivances accounted for more than 80% of the total***! ¶33.

Hedging Enron's investments with the value of Enron's stock created an enormous and unusual motive for the participants in the scheme to keep Enron stock trading at inflated levels. This was because if the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This happened in late 00 and early 01. In 12/00, Enron's gain (and the Raptors' corresponding net loss) on these transactions was over $500 million. Enron could recognize these gains – offsetting corresponding losses on the investments in its merchant portfolio – ***only if***

the Raptors had the capacity to make good on their debt to Enron. If they did not, Enron would be required to record a "credit reserve," a loss that would defeat the very purpose of the Raptors, to shield Enron from declines in value of its merchant investments. ¶34.

As year-end 00 approached, two of Enron's LJM2-financed Raptor SPEs were in danger of coming unwound as they lacked sufficient credit capacity to support their obligations. If something were not done to prevent the unwinding of these SPEs, Enron would have to take a multi-million dollar charge against earnings which would expose the prior falsification of Enron's financial results and result in Enron's stock plunging lower and lower, causing more and more of the stock issuance "triggers" to be hit, and a vicious fatal down-cycle would kick in. Therefore, Enron restructured and capitalized the Raptor SPEs at year-end 00 by transferring to them rights ***to receive even more shares*** of Enron stock, creating ever-increasing pressure on Enron and the other participants in the scheme to support Enron's stock price. This artifice enabled Enron to avoid recording a huge credit reserve for the year ending 12/31/00. ¶35.

D. Enron Energy Services ("EES")

Enron and its banks (including Lehman) were telling investors that an area of tremendous growth for Enron was its retail energy services business – EES – where Enron purportedly undertook to manage the energy needs of corporate consumers for multi-year periods in return for fees to be paid over a number of years. Enron and its banks – including Lehman – presented this business as achieving tremendous success by constantly signing new multi-million or even billion dollar contracts which allowed EES to exceed internal forecasts, and that this division had turned profitable in the 4thQ 99 and was achieving substantial gains in its profitability thereafter. ¶37.

The falsification of Enron's financial results was not limited to non-arm's-length fraudulent illicit partnership and SPE transactions. EES was also actually losing hundreds of millions of dollars. This was because in order to induce large enterprises to sign long-term energy management contracts and "jumpstart" this business so it could appear to obtain huge contract volumes, Enron was entering into EES management contracts which it knew would likely result in huge losses. However, by the abuse of mark-to-market accounting, Enron grossly overvalued the ultimate value of these contracts and created greatly inflated current period profits from transactions which generated little, if any, current period cash, and which would likely actually result in long-term cash out plans and losses. As a letter written in 8/01 to Enron's Board by an EES manager stated just after Skilling "resigned"(¶38):

> One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron .... (*i.e.*, ***EES's management's ... hiding losses/SEC violations***).
>
> * * *
>
> ... [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked.
>
> * * *
>
> ... [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion.... [T]hey decided ... to hide the $500MM in losses that EES was experiencing.... ***EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously***.

E. Enron Broadband ("EBS")

Another purported growth area of Enron's business was its broadband services business – EBS – which consisted of constructing an 18,000-mile fiber optic network which Enron was supposedly successfully building out while also engaging in trading access to fiber optic cable capability, *i.e.*, "Broadband Intermediation." Enron and its banks – including Lehman – presented ***both parts*** of Enron's broadband business as poised to achieve and later as actually achieving huge success, reporting that its fiber optic network was being or had been successfully constructed, was state of the art and provided unparalleled quality of service, and that its broadband trading business was succeeding and achieving much higher trading volume and revenues than expected – *i.e.*, "***exponential growth***." ¶39.

A prime example of the purported success of Enron's broadband content business was its video on demand ("VOD") joint venture with Blockbuster Entertainment, announced in 7/00. Enron presented this 20-year agreement as having a ***billion dollar value***, that it was a ***first-of-its-kind product*** whereby consumers would obtain VOD content from Blockbuster in their home as if they were watching the movie on their own VCR (start, stop, rewind) and that this incredible advance in technology was made possible due to the ***high quality of Enron's fiber optic network***. Abusing mark-to-market accounting and using an LJM2 SPE funded, in part, by Lehman executives, Enron recognized an astonishing bogus $110+ million profit on this deal in the 4thQ 99 and 1stQ 00, even though the project was failing in its test markets because Enron did not have the technology to deliver the product as represented – and which could never have gone forward because Blockbuster did not have the legal right to deliver movies in digital format, the only format which could be utilized for VOD. ¶40.

F. New Power

Another example of how Enron and its banks falsified Enron's reported results is the New Power IPO in 10/00, by which Enron improperly created a $370 million profit in the 4thQ 00. Because Enron controlled New Power and owned millions of shares of New Power stock, if Enron could take New Power public and create a trading market in its stock, Enron could recognize a profit on the gain in value on its shares by "hedging" that gain via yet another non-arm's-length transaction via an LJM2 financed SPE – which Lehman executives were investors in. In the 4thQ 00, Enron desperately needed to create profits to perpetuate the Ponzi scheme. Enron did the New Power IPO – 27.6 million shares at $21 per share in 10/00. Then, in a deal secretly structured before the IPO, Enron created a phony profit using an LJM2 SPE called Hawaii 125-0. Enron transferred millions of New Power warrants to Hawaii 125-0 and thus created a huge $370 million "profit" on the purported gain on the New Power warrants. Hawaii 125-0 simultaneously supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, one week later, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. New Power stock immediately fell sharply, as the chart below shows:

This collapse converted Enron's gain on its New Power equity holdings into a huge loss early in 01 – a loss of about $250 million – which was concealed. ¶42.

G. Enron's Access to the Capital Markets

Enron required constant access to huge amounts of capital. For Enron to continue to appear to succeed it had to keep its investment grade credit rating and keep its stock price high. Enron's investment grade credit rating and high stock price could ***only*** be maintained by (i) limiting the amount of debt shown on Enron's balance sheet; (ii) reporting strong current period earnings; ***and*** (iii) forecasting strong future revenue and earnings growth. Yet Enron was able to achieve these ends only by pursuing an increasing number of phony transactions, many of which were accomplished by increasing the number and size of transaction entities which were supposedly independent of Enron but which, in fact, Enron controlled through a series of secret understandings and illicit financing arrangements, including the Lehman financed LJM2 partnership. As a result of reporting strong earnings, the apparent success of its business and its future earnings growth forecasts, Enron had unlimited access to the capital markets, borrowing billions of dollars in the commercial paper markets and by selling billions of dollars of Enron securities to the public. Enron and its bankers – including Lehman – raised at least $10 billion in new debt and equity capital from public investors through numerous offerings of Enron and Enron-related securities, thus raising the capital necessary to allow Enron to repay or pay down its short-term debt and continue to operate. The Enron offerings involving Lehman are shown below (¶48):

ENRON SECURITIES UNDERWRITINGS		
Banks Named As Defendants	**Date of Offering**	**Security Sold**
Lehman Brothers CitiGroup	08/97	$150,000,000 6.5% Notes due 8/1/2002
CS First Boston ***Lehman Brothers*** Merrill Lynch CIBC JP Morgan Bank America	5/98	35 million shares of common stock at $25 per share raising $870 million for Enron
JP Morgan ***Lehman Brothers***	07/98	$250,000,000 6.40% Notes due 7/15/2006 $250,000,000 6.95% Notes due 7/15/2028
CS First Boston ***Lehman Brothers*** Merrill Lynch CitiGroup	02/99	27.6 million shares of common stock at $31.34 raising $870 million for Enron
Lehman Brothers Bank America CIBC	05/19/99	$500,000,000 7.375% Notes due 5/15/2019
Bank America ***Lehman Brothers***	05/00	$500,000,000 Notes due 5/23/2005 and 6/15/2003

H. Late 00/Early 01 Prop-Up

In late 00/early 01, Enron's financial results began to come under scrutiny from a few accounting sleuths and short-sellers, who began to question the quality of Enron's reported financial results. While Enron, its top insiders and its bankers – including Lehman Brothers – assured investors of the correctness of Enron's accounting and the high quality of Enron's reported earnings, the success and strength of its business and its solid prospects for continued strong profit growth, in part because of this increasing controversy, Enron's stock began to decline. As this price decline accelerated, it put pressure on Enron's top executives to do something – anything – to halt the decline in the price of the stock as they knew that if that price decline continued and the stock fell to lower levels, more and more of the Enron stock "triggers" contained in agreements for deals with entities controlled by LJM2 would be triggered, ***which would require Enron to issue over 100 million shares of its common stock to those partnerships, causing a huge reduction in Enron's shareholders' equity***. ¶52.

In late 3/01, inside Enron it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect a shortfall in credit capacity of the Raptor SPEs, which would have been catastrophic and exposed the scheme. Rather than take that loss and face these consequences, Enron, and certain of Enron's banks "restructured" the Raptor vehicles by transferring ***more than $800 million of contracts to receive Enron's own stock to them just before quarter-end, which permitted the participants in the scheme to conceal substantial losses in Enron's merchant investments, keep billions of dollars of debt off Enron's balance sheet and allowed the Enron Ponzi scheme to continue***. ¶53.

During early 01, Enron continued to report record results and it and its bankers – ***including Lehman*** – continued to make very positive statements (¶54):

- Enron's strong results reflected breakout performance in all business units. Enron was a strong unified business.
- WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages.
- EBS intermediation was great. Broadband glut and lowered prices ***would help Enron***.
- VOD was successfully tested and launched. Proven technology created enormous opportunities.
- All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was very optimistic. Enron was confident growth was sustainable for years to come.

I. The Impending Collapse

By the Summer of 01, Enron realized that it would not be able to continue to sustain the illusion of strong profitable growth and that it would have to take large write-offs in the second half of 01 that, in turn, could result in a downgrade of Enron's critical investment grade credit rating –

an event that they knew would mean that debt on the books of the SPEs Enron did business with (and partnerships controlled by them), which debt Enron had assured investors was "***non-recourse***" to Enron would, in fact, become Enron's obligation. ¶55.

On 8/14/01, Enron announced that Skilling – who had become Enron's CEO just months earlier – was resigning, for "***personal reasons***." While this resignation fanned the controversy over the true nature of Enron's finances and the condition of Enron's business, Enron and its banks – including Lehman – lied to investors, telling them that Skilling's resignation was only for personal reasons and did not raise "***any accounting or business issues of any kind***" and that Enron's financial condition "***had never been stronger***" and its "***future had never been brighter***." They said there was "***nothing to disclose***," Enron's "***numbers look good***," there were "***no problems***" or "***accounting issues***." According to them, the Enron "***machine was in top shape and continues to roll on – Enron's the best of the best***." ¶57.

J. The End

By 8/01, inside Enron management employees were complaining to Enron's Board that the fraud at Enron was so widespread it was out of control. In 8/01, two employees complained to the Board (¶59):

A. One employee wrote:

> Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.
>
> * * *
>
> We have recognized over $550 million of fair value gains on stock via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.
>
> ***I am incredibly nervous that we will implode in a wave of accounting scandals.... [T]he business world will consider the past successes as nothing but an elaborate accounting hoax....***
>
> ***[W]e booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse***

or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

* * *

I realize that we have had a lot of smart people looking at this .... ***None of that will protect Enron if these transactions are ever disclosed in the bright light of day.....***

* * *

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

* * *

3. ***There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly....***

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. ***He complained mightily to Jeff Skilling*** .... 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets ....

   b. ***Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.***

   c. I have heard one manager level employee ... say "***I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company."... Many similar comments are made when you ask about these deals....***

B. A second employee wrote:

One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrong doings of the various management teams at Enron. However ... I'm sure the board has only scratched the surface of the impending problems that plague Enron at the moment. (*i.e.*, EES's ... hiding losses/SEC violations ... lack of product, etc.).

* * *

[I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked. (JC Penney being a $60MM loss alone, then Safeway, Albertson's, GAP, etc.). Some customers threatened to sue if EES didn't close the deal with a loss (Simon Properties – $8MM loss day one).... Overnight the product offerings evaporated.... Starwood is also mad since EES has not invested the $45MM in equipment under the agreement.... Now you will loose [sic] at least $45MM on the deal.... You should also check on the Safeway contract, Albertson's, IBM and the California contracts that are being negotiated.... It will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion....

This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, "Disclosures about Segments of an Enterprise and related information," EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about....

There are numerous operational problems with all the accounts.

* * *

... Some would say the house of cards are falling....

You are potentially facing Shareholder lawsuits, Employee lawsuits ... Heat from the Analysts and newspapers. The market has lost all confidence, and its obvious why.

You, the board have a big task at hand. You have to decide the moral, or ethical things to do, to right the wrongs of your various management teams.

* * *

... But all of the problems I have mentioned, they are very much common knowledge to hundreds of EES employees, past and present.

On 10/16/01, Enron shocked the markets with revelations of $1.0 billion in charges and a reduction of shareholders' equity by $1.2 billion. Within days, *The Wall Street Journal* began an exposé of the LJM SPEs, the SEC announced an investigation of Enron, and Fastow "resigned." In 11/01 Enron was ***forced to admit that Chewco had never satisfied the SPE accounting rules and – because JEDI's non-consolidation depended on Chewco's status – neither did JEDI, and Enron consolidated Chewco and JEDI retroactive to 97. This retroactive consolidation resulted in a massive reduction in Enron's reported net income and massive increase in its reported debt***. Enron then revealed that it was restating its 97, 98, 99 and 00 financial results to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity as detailed below (¶61):

ENRON ACCOUNTING RESTATEMENTS				
	1997	1998	1999	2000
Recurring Net Income Amount of Overstatement	$ 96,000,000	$113,000,000	$250,000,000	$ 132,000,000
Debt Amount of Understatement	$711,000,000	$561,000,000	$685,000,000	$ 628,000,000
Shareholders' Equity Amount of Overstatement	$313,000,000	$448,000,000	$833,000,000	$1,208,000,000

These partnerships – Chewco, LJM1 and LJM2 – ***were used by Enron and its banks to enter into transactions that Enron could not, or would not, do with unrelated commercial entities***. The significant transactions were designed ***to create phony profits or to improperly offset losses***. These transactions allowed Enron to conceal from the market ***very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged – that is, that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was simply an entity in which only Enron had a substantial economic stake. The Raptors transactions alone resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ 01 that were almost $1 billion higher than should have been reported***! ¶62.[14]

By 11/28/01 Enron's publicly traded debt had been downgraded to "junk" status and on 12/2/01, Enron filed for bankruptcy – ***the largest bankruptcy in history***. Enron's publicly traded securities have suffered massive price declines, inflicting billions of dollars of losses on purchasers of those securities. ¶66.

As *Newsweek* has written:

> In the late 1990s, by my count, Enron lost about $2 billion on telecom capacity, $2 billion in water investments, $2 billion in a Brazilian utility and $1 billion on a controversial electricity plant in India. Enron's debt was soaring. If these harsh truths became obvious to outsiders, Enron's stock price would get clobbered – and a rising stock price was the company's be-all and end-all. Worse, what few people

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[14] As huge as the 11/01 restatements of Enron's 97-00 financial statements were, they just scratched the surface of the true extent of the prior falsification of Enron's financial statements, failing to eliminate additional hundreds of millions of dollars of phony profits as Enron. ¶63.

knew was that Enron had engaged in billions of dollars of off-balance-sheet deals that would come back to haunt the company if its stock price fell.

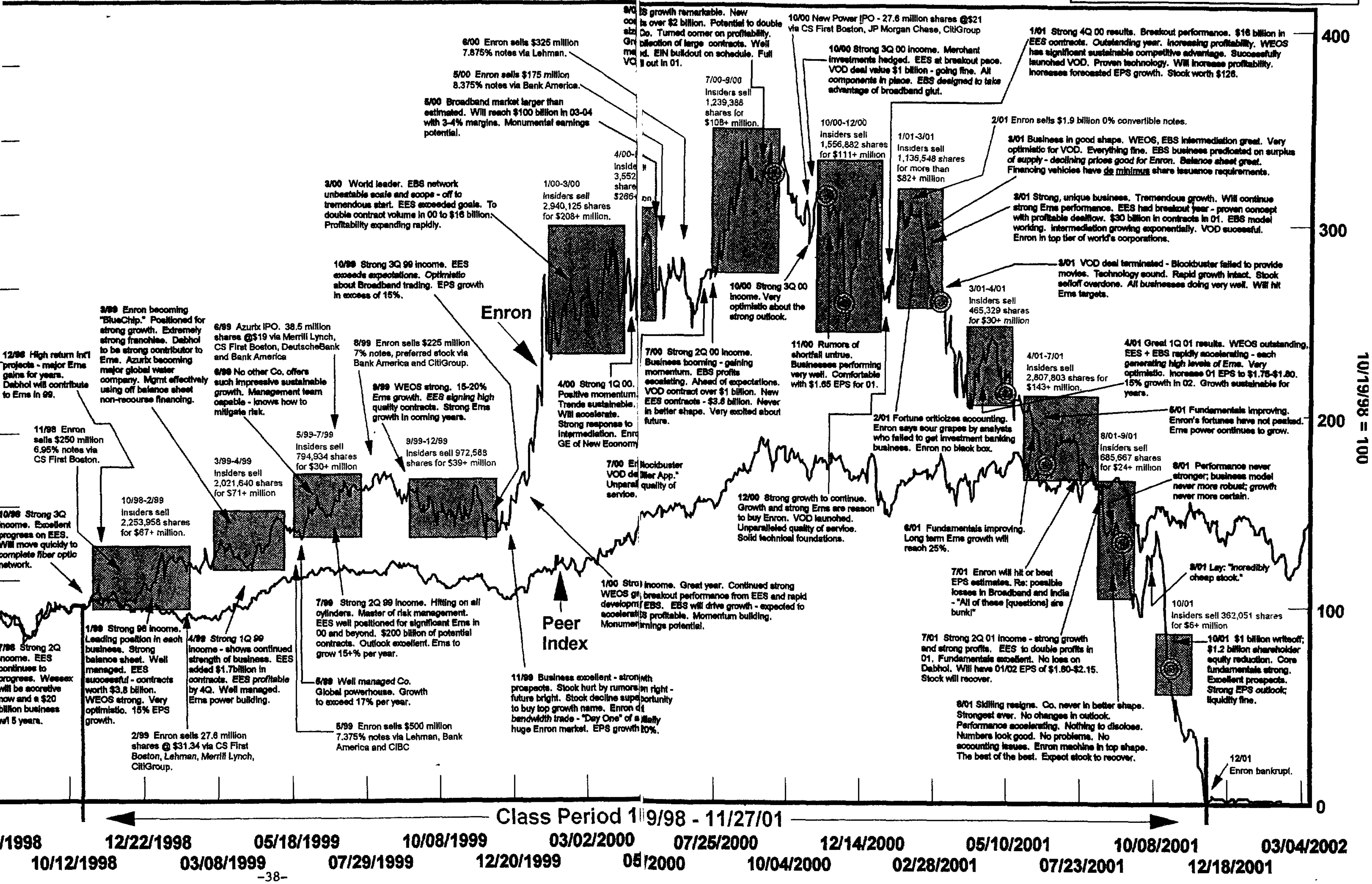
Newsweek, 1/21/02 (¶69).

> ***The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years.*** Those fictional figures, showing nicely rising profits, enable Enron to become the nation's seventh largest company, with $100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, and we have to make accountants mortally afraid of certifying them. Anything else is window dressing.

Newsweek, 1/28/02 (¶69). The rise and demise of Enron is represented graphically below:

...al Shares Sold By Defendants: 20,788,957 shares
...fendants' Insider Trading Proceeds: $1,190,479,472

Er|on Timeline
7|1/98 - 3/7/02



II. SUMMARY OF LEHMAN'S INVOLVEMENT AND LIABILITY

Lehman had an extensive relationship with Enron. Lehman provided ***both*** commercial banking and investment banking services to Enron, funded Enron's secretly controlled LJM2 partnership and its illicit transactions with its SPEs, which enabled Enron to falsify its financial statements and misrepresent its financial condition. Also, top executives of Lehman were permitted to personally invest $10 million in Enron's lucrative LJM2 partnership (through LBJ or LBI Group) as a reward to them for orchestrating Lehman's participation in this fraud. Lehman also sold over $3.4 billion in Enron securities to the public. At the same time, Lehman's ***securities analysts were issuing extremely positive – but false and misleading – reports on Enron, extolling Enron's business success, the strength of its financial condition and its prospects for strong earnings and revenue growth***. ¶¶762-772.

Lehman acted as an underwriter in selling $500 million in 7.375% Enron notes due 2019 and $500 million of Enron 7.875%/8.375% notes due 03/05 in 5/99 and 5/00, respectively – pursuant to a false Registration Statements. *See infra* at 96-97. This exposes Lehman to §11 liability under the 1933 Act – ***non-fraud liability*** – under which it is *prima facie* liable and can avoid liability only by bearing ***its burden of proof*** that it had, "after reasonable investigation, reasonable ground to believe and did believe ... that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading," *i.e.*, the underwriter's so-called "due diligence" defense.

Lehman also made false and misleading statements in a 2/99 Registration Statement for the sale of 27.6 million shares of Enron stock at $31.34 per share in a statement to the financial media in 18 analysts' reports on Enron it issued during the Class Period, and a statement to the financial media which helped to artificially inflate the trading prices of Enron's securities. ¶¶125, 143, 150, 170, 206, 231, 254, 270, 287, 303, 312, 322, 338, 341, 347, 353, 379, 381, 769. Such false statements are expressly made illegal by the text of Rule 10b-5, issued pursuant to §10(b) of the 1934 Act, which prohibits "***any untrue statement of a material fact***" by "***any person***" in connection with securities transactions.

Lehman's false statements in the Registration Statements for the sales of Enron's 7.375% and 7.875%/8.375% notes, to the financial media in 10/99 and in its 18 analysts' reports during the Class Period were also part of a wider pattern of misconduct by Lehman in which Lehman employed acts, manipulative or deceptive devices and contrivances, and participated in a fraudulent scheme and course of business – disguising and thus concealing billions of dollars of loans to Enron, providing millions to finance Enron's secretly controlled partnerships and illicit transactions with associated SPEs to falsify Enron's reported financial condition and profits, all of which operated to artificially inflate the prices of Enron's publicly traded securities. This conduct is also expressly prohibited by the language of §10(b) and Rule 10b-5.[15] Lehman's sale of Enron and Enron-related securities and its analysts' reports are shown on the following graphic chart:

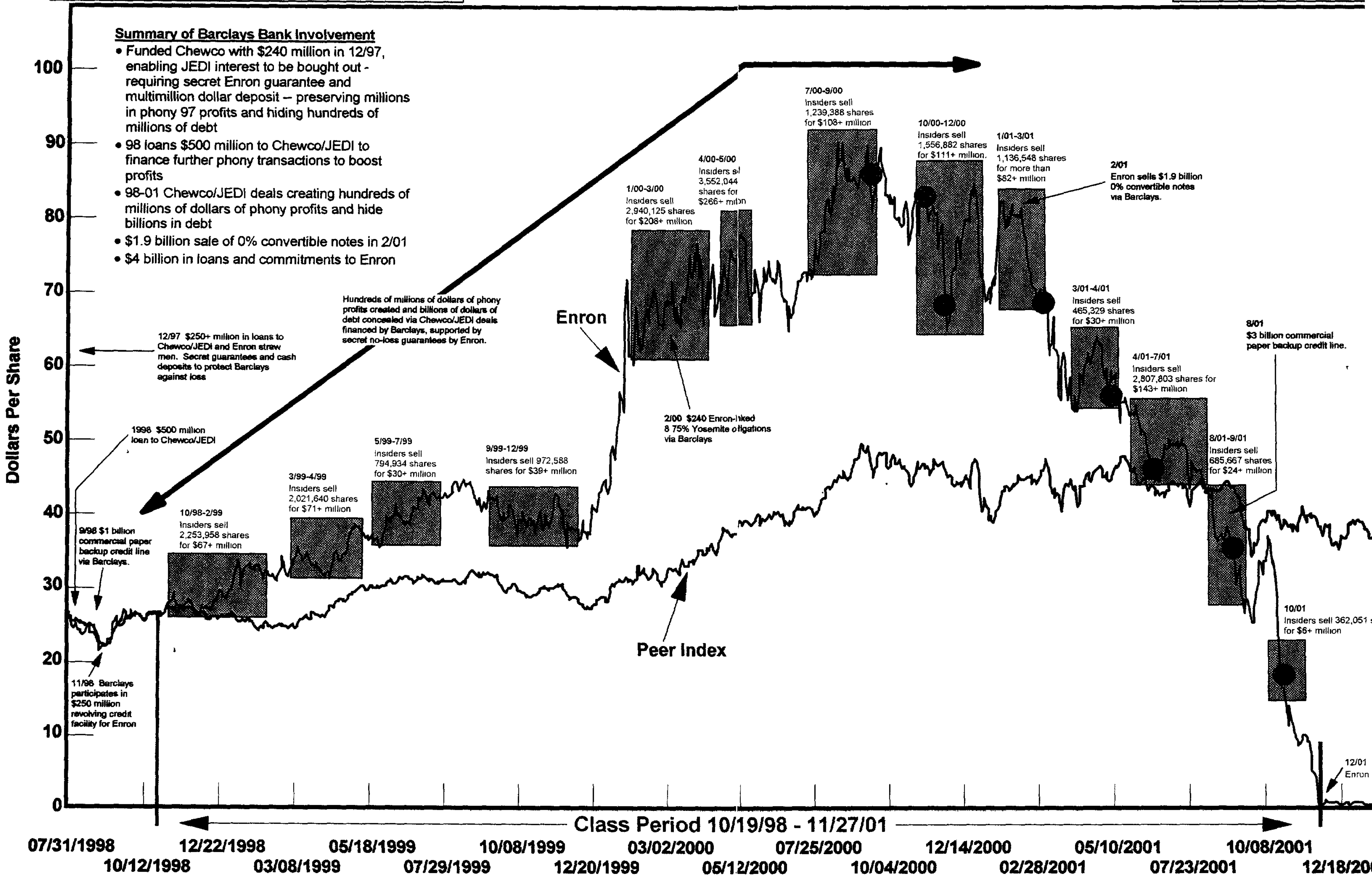
[15] False statements in a Registration Statement can create liability under both 1933 Act §11 and 1934 §10(b) and Rule 10b-5. *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). The remedies provided investors under the 1933 and 1934 Acts are cumulative. *Id.*

Total Shares Sold By Defendants: 20,788,957 shares
Defendants' Insider Trading Proceeds: $1,190,479,472

Enron Timeline -- Barcays Underwritings/Loans/Analyst Reports

7/31/98 - 3/7/02

Bank America Analyst
Enron Stock Issuance



According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud***." In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court referred to the ***dictionary definitions*** of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" *Id.* at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***[a] scheme, plan, or artifice***.'" *Id.* (quoting *Webster's International Dictionary*); *see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Thus scheme liability ***is authorized by the text of §10(b)***. Rule 10b-5 was adopted by the SEC to implement §10(b). In addition to prohibiting false statements, Rule 10b-5 makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***" or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest, Ltd. v. Kimmons*, 228 F.3d 399, 407 (5th Cir. 2000).

In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Court observed that "the second subparagraph of [Rule 10b-5] specifies the making of an untrue statement of a material fact and the omission to state a material fact," *id.* at 152-53, but held that "[t]he first and third subparagraphs ***are not so restricted***." *Id.* at 153. It held that the defendants violated Rule 10b-5 when they participated in "***a 'course of business' or a 'device, scheme or artifice' that operated as a fraud***" – ***even though these defendants had never themselves said anything that was false or misleading***. *Id.*; *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) ("'[We do not] think it sound to dismiss a complaint merely because the ***alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that §10 (b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws***.'") (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). As stated by the Second Circuit: "***Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures.'***"

Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975). "Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws." *Id.*

Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme."*** *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981). *See Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 363 (5th Cir. 1987) (Complaint alleging manipulation of reported financial results by two public companies properly alleged a scheme to defraud or course of business operating as a fraud, the effect of which was to defraud certain purchases of Docutel securities in violation of 10b-5(1) and (3)).

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale.*** Wrongdoing of this scope and on this scale could not have been accomplished solely by the efforts of Enron's executives, no matter how dishonest or determined they may have been. Wrongdoing of this scope and on this scale required the skills and active participation of lawyers, bankers and accountants. It could not have happened otherwise.

The notion that *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), issued a broad edict that lawyers, banks and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability ***does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank who employs a manipulative device[16] or makes a material misstatement (or omission)***

[16] As pointed out earlier, the Court has previously held that §10(b)'s language "any manipulative or deceptive device or contrivance" includes a "scheme to deceive" or "scheme, plan or artifice." *Ernst & Ernst*, 425 U.S. at 199 n.20.

on which a purchaser ... relies[17] may be liable as a primary violator under 10b-5.... In any complex securities fraud, moreover, there are likely to be multiple violators. 511 U.S. at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.***" *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *accord SEC v. First Jersey Sec.*, 101 F.3d 1450, 1471 (2d Cir. 1996).

Central Bank denied recovery to victims of an alleged securities fraud who pleaded ***only one theory of recovery*** against a bank defendant – "secondary" liability they dubbed "aiding and abetting." 511 U.S. at 191. However, neither the words aiding and abetting nor any other language encompassing aiding and abetting appear in §10(b) or Rule 10b-5. The Court said "***[T]he text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation [and] that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as the plaintiffs here do, plead or pursue recovery under the theory that the bank defendant (i) made false and misleading statements in Registration Statements where the bank acted as underwriter in selling securities or other documents the bank issued to the public, *e.g.*, analysts' reports ***or*** (ii) employed acts, manipulative or deceptive devices and contrivances ***or*** (iii) engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "***concede that Central Bank did not commit a manipulative or deceptive act within the meaning of §10(b).***" *Id.* at 191. Plaintiffs here make no such concession. Thus, because the *Central Bank* plaintiffs made fatal concessions and pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost.***

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless the defendants it says made misleading statements because the Court later rejected that argument in *United States v. O'Hagan*, 521 U.S. 642 (1997). The Eighth Circuit had held that, under *Central*

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[17] Because this action's 1934 Act claims are "fraud-on-the-market" claims, reliance is established, *i.e.*, presumed, based on the materiality of false representations to the market, subject to defendants' right to rebut that presumption. *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988); *Summit Props. v. Hoechst Celanese Corp.*, 214 F.3d 556, 561 (5th Cir. 2000), *cert. denied*, 531 U.S. 1132 (2001); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 298 (5th Cir. 1990).

Bank, "§10(b) covers ***only deceptive statements or omissions on which purchasers and sellers ... rely***." *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak because §10(b) prohibits "***any manipulative or deceptive device or contrivance***" in contravention of SEC rules and this reaches "any deceptive device," whether or not the defendant spoke. *Id.* at 653. *Superintendent of Ins.*, 404 U.S. 6, is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10b/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9.

In fact, this court has repeatedly stated:

> ***A defendant need not have made a false or misleading statement to be liable.***

Landry's, slip op. at 9 n.12; *In re Waste Mgmt., Inc. Sec. Litig.*, No. H-99-2183, slip op. at 75 (S.D. Tex. Aug. 16, 2001);[18] *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 869 (S.D. Tex. 2001). Thus, while making false statements is not necessary for §10(b)/Rule 10b-5 liability to attach, here, Lehman actually allegedly made false statements. Thus, the "bright line" test for §10(b) and Rule 10b-5 liability Lehman argues for does not exist! But even if it did Lehman would still be liable due to its own false statements.

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *SEC v. Zandford*, __ U.S. __, No. 01-147, 2002 U.S. LEXIS 4023 (June 3, 2002). In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.

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[18] Because of the length of these opinions, and the fact that this Court has access to them, they have not been attached to this brief.

- ***"[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).*** *Id.* at *13.[19]

- Allegations that defendant "'***engaged in a fraudulent scheme***'" or "'***course of business that operated as a fraud or deceit***'" stated a §10(b) claim. *Id.* at *13, *14-*17.

Central Bank clearly – ***but merely*** – stands for the proposition that no aiding and abetting Ohio/Washington/Georgia/Alabama Group 94 liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain language encompassing "aiding and abetting." The decision in *Central Bank* is actually ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad*** and the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in fraudulent securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.... Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens, 406 U.S. at 151. As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be ***construed broadly to effectuate the statutory policy affording extensive protection to the investing public***. *See Tcherepnin*, 389 U.S. at 336, 88 S. Ct. at 553. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (***indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent and speculative schemes***).

Meason v. Bank of Miami, 652 F.2d 542, 549 (5th Cir. 1981). "***The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.***" *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980).

Here, Lehman did it all. Lehman made false statements in Registration Statements where Lehman acted as underwriter to sell Enron securities in statements to the financial media and in Lehman's analysts reports on Enron. And Lehman employed specified acts, devices and contrivances to deceive – to help falsify Enron's finances which were essential to the ongoing fraudulent scheme and course of business. In short, in order to pocket billions of dollars of fees, commissions, interest

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[19] To the extent *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001), seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

and other charges – profits from its involvement in the fraudulent scheme and course of business – Lehman facilitated, furthered and participated in the fraud. All of these activities directly contravened prohibitions of the 1933 and 1934 Acts. Lehman was not an unwitting victim of the fraud involving Enron – ***it was an active perpetrator of and participant in that fraud. Thus, Lehman's alleged liability is "primary"*** and not "***secondary***."

Not only does the CC assert viable legal theories of recovery against Lehman under the 1933 and 1934 Acts, it also pleads ***in detail*** why the statements made by Lehman were false when made and why Lehman ***knew or recklessly disregarded that those statements were false*** thus satisfying the two-pronged pleading standard, *i.e.*, "falsity" and "scienter" of the 95 Act as applicable to the 1934 Act. 15 U.S.C. §78u-4.

The Registration Statements Lehman used to sell the Enron 7.375% and 8.375% notes in 5/99 and 5/00 and 27.6 million shares of Enron common stock in 2/99 contained Enron's false annual 97 and 98 and interim 99 financial results and other false statements concerning the structures of and Enron's relationship to SPEs and related parties, Enron's financial risk management statistics, as well as the condition of Enron's business operations and the value of its assets. *See infra* at 96-97. The 15 Lehman analysts' reports on Enron issued between 6/99-11/01 also contained false statements about Enron's financial results and financial condition and the success of Enron's EES and EBS businesses. ¶¶170, 206, 231, 254, 270, 287, 303, 312, 322, 338, 341, 347, 353, 379, 381. *See infra* at 78-95. Thus, the allegedly false statements made by Lehman are ***quoted, specified by date, and the reasons the statements were false when made are pleaded***, satisfying the 95 Act's "falsity" pleading requirement.[20]

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20 After LJM2 was formed and Lehman's top executives had secretly been permitted to invest in LJM2 which then funded repeated non-arm's-length fraudulent transactions with Enron to artificially boost its profits and hide its debt, Lehman continued to issue very positive analyst reports on Enron. Each of these reports contained "boilerplate" disclosures like:

> Disclosures: A
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> * * *
>
> Disclosure Legend: A-Lehman Brothers Inc. managed or co-managed within the past three years a public offering of securities for this company.

Lehman's scienter, *i.e.*, its "required state of mind" is also well pleaded.[21] The CC explains how due to the close involvement of Lehman top executives and commercial and investment bankers with Enron, in lending, deal-making and other activities, Lehman knew of the falsity of the statements it was making in Registration Statements and analysts' reports concerning Enron. The CC also details numerous specific fraudulent Enron transactions involving Lehman (as participant or financier) which were intentionally manipulative or deceptive acts or contrivances – falsifying Enron's publicly reported financial results and financial condition and making Enron's business appear to be successful when it was not. These include:

- Helping to "pre-fund" Enron's LJM2 partnership in the last days of 12/99 with $1.5 million advanced by Lehman's top executives (via LBJ or LBI Group, Inc.), which enabled LJM2 to fund four critical non-arm's-length fraudulent year-end 99 deals with Enron to inflate Enron's 99 results – generating false profits and hiding hundreds of millions of dollars of debt. ¶¶26-29, 881-882.

- During 00-01, Lehman top executives ultimately invested $10 million in LJM2 to fund LJM2 as it participated in numerous non-arm's-length fraudulent transactions with Enron to boost its profits during 99-01, while hiding billions of dollars of debt that should have been reported on Enron's balance sheet, while Lehman officials pocketed their share of the lush profits on these LJM deals flowing from the looting of Enron. ¶770.

Finally, in addition to Lehman's knowledge of the fraud and intentional involvement in many of Enron's deceptive and fraudulent transactions, the CC details Lehman's motive and opportunity[22] to engage and participate in the fraudulent scheme and course of business. Lehman was reaping huge amounts of money from the scheme. Lehman or ***top Lehman officials had been rewarded by***

These boilerplate disclosures did not change after Lehman's top executives became investors in LJM2 which funded illicit transactions with Enron to artificially boost Enron's reported profits and/or hide billions of dollars of debt. The failure to disclose the LJM2 investments of Lehman's top executives made their "boilerplate" disclosures false and misleading and ***concealed from the market the very significant and serious conflict of interests between Enron and Lehman which Lehman knew would have cast serious doubts on the objectivity and honesty of those banks' analyst reports and disclosed that Lehman's executives had compromising ties to and serious conflicts of interest regarding Enron***. ¶29. Copies of relevant pages of pre- and post-12/99 Lehman analyst reports are attached as Ex. 3 to plaintiffs' Appendix.

[21] Scienter is only required for the 1934 Act claims. Lehman's 1933 Act liability requires no showing of fraud, intent or knowledge. 15 U.S.C. §77k; *Landry's*, slip op. at 11 n.13, 65.

[22] By selling Enron and Enron-related securities via SEC filed Registration Statements and issuing analysts' reports on Enron and helping structure and finance Enron's illicit partnerships and their related SPE transactions, Lehman had plenty of opportunity to mislead investors and advance the fraud as well.

being allowed to get in on LJM2 and thus reaping huge returns as secret investors in the LJM2 partnership, unusually profitable returns generated by that entity's illicit deals with Enron SPEs – transactions Lehman knew would collapse if Enron's stock fell through the equity issuance trigger prices embedded in those LJM2/SPE deals. Lehman had ***powerful incentives for Lehman to take steps to not only keep Enron solvent, but to maintain its coveted investment grade credit rating*** which provided Enron access to the commercial paper market. Lehman had made and was making hundreds of millions of dollars from the fraudulent scheme involving Enron and Enron's fraudulent course of business and stood to continue to make hundreds of millions more ***if it could be sustained – and to lose a bundle if the scheme was discovered, unraveled or came to an end.*** Lehman had plenty of motive to defraud Enron's investors.

Thus, as to Lehman, the CC pleads 1933 Act §11 non-fraud liability and 1934 Act ***"primary liability" based on legal theories*** of recovery rooted in the express language of §10(b) and Rule 10b-5 and pleads the facts in ***sufficient detail*** to satisfy the "falsity" and "scienter" prongs of the 95 Act's pleading standard applicable to the 1934 Act.

And, in fact, many Courts have upheld complaints against banks in §10(b)/Rule 10b-5 cases where, as here, false statements, manipulative or deceptive devices, contrivances and acts, and participation in a scheme to defraud have been alleged with sufficient particularity. *Cooper*, 137 F.3d at 628 (Scheme liability survived *Central Bank.* Allegations that the investment bank defendants had issued analysts' reports knowing them to be false due to their "***access to inside information***" stated a valid §10(b)/Rule 10b-5 claim); *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144, 150-52 (S.D.N.Y. 2001) (Complaint alleging investment bank made disguised loan to Livent enabling Livent to falsify financial condition, while selling securities to public states valid §10(b)/Rule 10b-5 claims); *Murphy v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1996 U.S. Dist. LEXIS 22207 (D. Or. May 9, 1996) and *Flecker v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5329, at *25 (D. Or. Feb. 12 1997) (Refused to dismiss complaint or grant summary judgment to those banks, stating that their "***roles as analysts, investment bankers and business advisors with extensive contacts with [issuer] defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a***

triable primary liability claims under §10(b)."); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1568 (S.D. Fla. 1993) (Allegations that a securities broker issued false reports on company which made exaggerated predictions while ignoring "red flags" adequately pleaded recklessness); *McNamara v. Bre-X-Minerals Ltd.*, No 5:97-CV-159, 2001 U.S. Dist. LEXIS 4571, at *166 (E.D. Tex. Mar. 30, 2001) (Denied motion to dismiss by J.P. Morgan based on allegations it participated in a scheme to violate §10(b)/Rule 10b-5 by helping to structure fraudulent business transactions, acting as Bre-X's financial advisor, and issuing false analysts' reports, while ignoring "red flags."). *See also SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998) (while there is no aiding and abetting, where complaint properly alleged defendant to be primary violator because he "'***participated in the fraudulent scheme,***'" noting "***lawyers, accountants, and banks who engage in fraudulent or deceptive*** practices at their client's direction [are] a primary violator"); *Scholnick v. Continental Bank*, 752 F. Supp. 1317, 1323 & n.9 (E.D. Mich. 1990) ("bank ... may still be held liable under Rule 10b-5(a) and 10b-5(c) as a participant in the allegedly fraudulent scheme" and "allegations that Continental was directly involved in perpetrating a fraudulent scheme distinguish" case from situation where bank was only engaging in a "'routine commercial financing transaction'"). The CC in this action pleads more wrongful conduct by Lehman vis-à-vis the fraudulent scheme involving Enron and with more specificity than was pleaded in any of the above cases where complaints naming banks as defendants in §10(b)/Rule 10b-5 actions were upheld.

Of course, as with most fraudulent schemes, the scheme to falsify Enron's finances and inflate the prices of its securities – and sustain its fraudulent course of business – ultimately collapsed from the accumulated weight of years of deceit and deception. But the fact that the scheme ultimately collapsed in late 01 is of little legal moment. It had succeeded for years, enriching the perpetrators to the tune of billions of dollars. Securities violators frequently find themselves involved in complicated schemes by which financial reports are manipulated, securities prices are inflated, new securities are sold to the public and yet, despite all their efforts to perpetuate the wrongdoing, the scheme ultimately collapses and their participation is disclosed. But participants in fraudulent schemes – especially Ponzi securities schemes like Enron – expect them to succeed and take action to help them ***continue to succeed, as they gain more profits from the scheme as long as it***

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continues. The fact that such complex schemes may ultimately fail – and the perpetrators may ***then*** suffer some loss – in no way shields them from liability for the damage inflicted on the victims of their unlawful conduct while the scheme was succeeding. In the end it is the public investors in a situation like Enron -- the people and pension funds who invested ***billions of dollars to purchase newly-issued Enron securities to purchase the publicly traded securities of Enron at inflated prices that are left holding the bag. They are the ones who are truly damaged***. And the federal securities laws are supposed to protect them.

The important remedial purposes of investor suits under the anti-fraud provisions of the 1934 Act were ***ratified by Congress when it enacted the 95 Act***:

> The overriding purpose of our Nations securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.
>
> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that ***corporate officers, auditors, directors, lawyers and others properly perform their jobs***.

H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730. Certainly the 95 Act's pleading requirements must be applied and interpreted with these important principles in mind.

It is an unfortunate reality that the worst securities frauds create the most difficult situations for the victims.[23] The issuer (here Enron) goes bankrupt – and is ***shielded from liability***. Whatever directors' and officers' liability insurance policies exist (here some $350 million) ***are impaired*** – as the carriers can claim that they were defrauded into issuing the policies by the issuer's false financial statements. Here, the situation is further exacerbated by the fact that Andersen, which played a significant role in the fraud, is financially impecunious and able to pay only a fraction of the damages suffered by the victims.

If Enron investors are to achieve any significant recovery here, in what is acknowledged to be the largest and worst financial fraud in U.S. history, it will only be because our nation's securities

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[23] For instance, *Equity Funding*, *U.S. Financial*, *Lincoln Savings*, *Washington Public Power Supply Systems* and *Global Crossing*.

laws permit these victims to hold accountable ***securities professionals like banks and lawyers, who are supposed to safeguard the public in securities transactions, for their misconduct in employing acts and contrivances to deceive and participating in a scheme to defraud and a course of business that operated as a fraud or deceit on those purchasers of Enron's securities***. One man's deep pocket is another's legitimate defendant. If our Nation's securities laws do not provide an opportunity for the thousands of investors in Enron – what appeared to be a hugely successful public company earning a billion dollars of profit a year – to pursue Enron's bankers and lawyers who allegedly engaged and participated in the fraudulent scheme and course of business that will make a mockery of the investor protection purposes of our securities laws. To put it bluntly, if the 95 Act's enhanced pleading standard combined with the Court's decision in *Central Bank* operate to shield the banks named as defendants here from even having to answer the complaint and defend the allegations on the merits, then Congress will have to act by ameliorating that harsh pleading standard and restoring aiding and abetting liability.

III. DETAILED FACTUAL ALLEGATIONS REGARDING LEHMAN

> In reviewing the sufficiency of a complaint in response to a motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6), before any evidence has been submitted, the district court's task is limited. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support its claims. *Id.* The district court should consider all allegations in favor of the plaintiff and accept as true all well-pleaded facts in the complaint. *Lawal v. British Airways, PLC*, 812 F. Supp. 713, 716 (S.D. Tex. 1992). Dismissal is not appropriate "unless it appears beyond a doubt that the plaintiff can prove no set of facts in support of [his] claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

Landry's, slip op. at 4 n.8. The Fifth Circuit recently stated, "we will accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiffs." *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 406 (5th Cir. 2001). The Court must consider the allegations in their entirety. As Judge Buchmeyer stated in *STI Classic Fund v. Bollinger Indus.*, No. 3-96-CV-823-R, 1996 U.S. Dist. LEXIS 21553, at *5 (N.D. Tex. Oct. 25, 1996), it is improper to isolate "the circumstances alleged in Plaintiffs' amended complaint rather than to consider them in their totality."[24]

Lehman argues that the three-year statute of repose for 34 Act claims bars plaintiffs from pursuing damages against them for any time period prior to 4/8/99 ***and*** any consideration of its alleged misconduct prior to 4/8/99 for pleading or other purposes. We agree as to the former point, but not as to the latter. In other words, while the three-year statute of repose bars damage recovery from Lehman on behalf of purchasers who purchased before 4/8/99, it does not affect plaintiffs' ability to plead conduct or present evidence of its misconduct prior to that date. *United States v. Ashdown*, 509 F.2d 793 (5th Cir. 1975), affirmed defendants' mail fraud convictions, holding there was no merit in the argument that it was error to admit evidence of acts committed beyond the statute of limitations period where the evidence helped to establish the scheme -- "the statute of limitations is a defense to prosecution, not a rule of evidence. Therefore, once prosecution is timely instituted, the statute of limitations has no bearing on the admissibility of evidence." *Id.* at 798.[25] Instead, the court found that the evidence defendants questioned "***helps establish the scheme and the guilty intent.***" *Id., accord United States v. Blosser*, 440 F.2d 697, 699 (10th Cir. 1971) (Evidence of mail fraud occurring before the statute of limitations "***bore on the existence of the scheme to defraud, the falsity of representations made, and intent.***").[26]

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[24] Lehman makes the point that the 500-page CC uses the word "help" or "helped" to describe its conduct vis-à-vis Enron on some occasions. Seizing on the word help/helped, Lehman claims that its use conclusively shows that the true core allegation against it here is one of aiding and abetting, which is barred by *Central Bank*. This argument is wrong. First of all, persons who participate in a scheme to defraud or a course of business that operates as a fraud or deceit on purchasers of a public company's securities or employ acts or manipulative or deceptive devices are actually "helping" to defraud investors. In any event, this is not medieval England where meritorious actions are dismissed because pleaders used an ambiguous word or mischaracterized a claim for relief. Fortunately, in the United States today, complaints are to be construed ***in favor of the pleader with all ambiguities resolved and inferences drawn in the pleader's favor***. And the CC clearly does repeatedly allege that Lehman participated in a fraudulent scheme or course of business while employing acts, devices and/or contrivances to deceive. That conduct is actionable under the text of §10(b) and Rule 10b-5 as well as the wealth of decisions cited in this brief.

[25] There is no dispute that as to Lehman, claims were timely filed for the three-year period, beginning 4/8/99.

[26] An early case upholding this principle is *Little v. United States*, 73 F.2d 861 (10th Cir. 1934). There, the court held that "if the mails were used in execution of a fraudulent scheme, it is no defense that the scheme was formed and partially carried out back of the statute of limitations. Proof running

A similar result has been obtained in Title VII cases. *Fitzgerald v. Henderson*, 251 F.3d 345 (2d Cir. 2001), *petition for cert. filed*, (Aug. 29, 2001), held that evidence of defendant's sexual advances and the fact that the plaintiff rebuffed those advances at an earlier time were relevant to show defendant's motivation for the harassment that occurred during the time plaintiff's claim was ripe. "***A statute of limitations does not operate to bar the introduction of evidence that predates the commencement of the limitations period but that is relevant to events during the period.***" *Id.* at 365.[27]

Contrary to Lehman's assertions that the CC fails to distinguish between the banks named as defendants or containing specific allegations as to Lehman, the CC pleads Lehman's involvement and actions in great detail. Lehman had an extensive and extremely close relationship with Enron. Lehman provided ***both*** commercial banking and investment banking services to Enron, helped structure and finance several of Enron's secretly controlled partnerships and illicit transactions with its SPEs and helped Enron falsify its financial statements and misrepresent its financial condition

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back of the statute is admissible provided it is connected up with the scheme existing when the letters were mailed." *Id.* at 868; *accord United States v. Marconi*, 899 F. Supp. 458, 463 (C.D. Cal. 1995) (Defendant misunderstood the nature of the statute of limitations as "acts of fraud prior to that date are still evidence of this continuing fraudulent scheme to defraud .... Trier of fact can consider defendant's pre-statute of limitations action to determine whether defendant had the requisite intent to defraud.); *United States v. Whitt*, 718 F.2d 1494, 1501 (10th Cir. 1983) (Certain testimony regarding events that were not within the statute of limitations was used "to establish a scheme or plan rather than as direct evidence."); *United States v. Haskins*, 737 F.2d 844, 848 (10th Cir. 1984) (Affirmed mail fraud and extortion convictions noting that arguments relating to evidence of transactions not charged in the indictment but used to help support scheme allegations could be properly admitted: "The fact that a number of the overt acts performed in furtherance of the conspiracy were committed beyond the statute of limitations does not preclude the admission in evidence of such acts to show the nature of the scheme and [the commissioner's] intent where the later use of the mails occurred."). Although these cases relate to evidentiary issue, the same reasoning should apply in this case at the motion to dismiss stage. If evidence can be admissible at trial regarding defendants' earlier acts in furtherance of their scheme then so too should allegations regarding actions taken beyond the statute of limitations be considered at the pleading stage.

[27] In *Black Law Enforcement Officers Ass'n v. City of Akron*, 824 F.2d 475 (6th Cir. 1987), the Sixth Circuit found the lower court erred when it granted a motion by the City seeking to limit evidence presented in the case to events that occurred within the one year statute of limitations period. *Id.* at 479. "It is clear that the district court erred in using the statute of limitations to bar the admission of evidence. The function of the statute of limitations is to bar stale claims." *Id.* at 482-83. "'The statute of limitations is a defense ..., not a rule of evidence. Therefore, ... [it] has no bearing on the admissibility of evidence.'" *Id.* at 483. The Sixth Circuit found that plaintiffs were correct in offering evidence of events extending beyond the statute of limitations ***as admissible to show motive, intent or continuing scheme***. *Id.* (citing *United States v. Garvin*, 565 F.2d 519, 523 (8th Cir. 1977)).

by hiding over $2.4 billion in debt that should have been on Enron's balance sheet. At the same time, Lehman's ***securities analysts were issuing extremely positive – but false and misleading – reports on Enron, extolling Enron's business success, the strength of its financial condition and its prospects for strong earnings and revenue growth***.[28] In return for Lehman's participation in the

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[28] As the CC explains, the banks named as defendants all evolved into their present form after the repeal of the Glass-Steagall Act in 99. That law prohibited banks from acting in dual capacities and was enacted to remedy abuses that occurred in the 20s when banks sold securities of, and made loans to, their corporate customers. With the repeal of Glass-Steagall, the banks sued here, including Lehman, quickly morphed back into financial services institutions offering commercial ***and*** investment banking services to corporate customers. The abuses of the 20s quickly returned as well. ¶¶643-644. According to *Business Week* on 3/25/02 (¶643):

> After the stock market crashed in 1929, Congress hauled in Wall Street bosses to explain how bankers helped companies inflate earnings for a decade through complex structures. Congress scrutinized bank practices for years, then passed the Glass-Steagall Act, splitting commercial banks from brokerages. That checked the Street's temptation to monkey with clients' finances while flogging their stock.
>
> Now Congress needs answers from Wall Street's chiefs again. Congress repealed Glass-Steagall in 1999, under pressure from bankers ***who swore they would manage such conflicts of interests. They would erect so-called Chinese Walls that forbade sharing information between those selling a company's stock and those arranging its financing***.
>
> ***But the Chinese walls are porous. Bankers ignore them when it's convenient: They take analysts on road shows of investment-banking clients – their way of making it clear they don't want downgrades of those companies***. The walls also provide cover for bankers, who let analysts push a client's stock even when they know the company is in trouble. That's why analysts recommended Enron to the end, though the bankers behind its complex financing knew it was on the skids.

According to the *Miami Herald* on 3/19/02 (¶644):

> ***Banks Tangled in Fall of Enron***
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> * * *
>
> They are the titans of Wall Street, possessing pedigrees that date to the founding of America and wealth greater than many nations.
>
> * * *
>
> Empowered by the massive deregulation of financial services they zealously sought, New York's investment banks created their masterpiece in Enron, providing every conceivable product and service.
>
> ***They lent it money, often without collateral. They sold its securities to an unsuspecting public. They wrote rosy, inaccurate analyst reports***.

scheme, it received huge underwriting and consulting fees, interest payments, commitment fees and other payments from Enron and related entities. Also, Lehman or top executives of Lehman were permitted to personally invest at least $10 million in Enron's lucrative LJM2 partnership as a reward to them for orchestrating Lehman's participation in this fraud, while Enron secretly paid Lehman grossly excessive interest rates on billions of dollars of concealed/disguised loans. ¶¶762-772.

Lehman engaged and participated in the fraudulent scheme and course of business in several ways. Lehman helped raise over $2 billion from the investing public for Enron via the sale of Enron and Enron-related securities during the Class Period, sales accomplished via false Registration Statements. Lehman also helped fund the key LJM2 partnership Enron secretly controlled and its illicit transactions with SPEs, knowing they were vehicles being utilized by Enron to falsify its reported financial results.

Lehman acted as an underwriter of billions of dollars of Enron securities, including (¶765):

DATE	SECURITY
11/93	8 million shares 8% Enron capital preferred shares at $25 per share
8/97	$150 million 6.5% Enron notes
5/98	35 million shares Enron common stock at $25 per share, raising $870 million
7/98	$500 million 6.40% and 6.95% Enron notes
2/99	27.6 million shares Enron common stock at $31.34 per share, raising $870 million
5/99	$500 million 7.375% Enron notes
5/00	$500 million 8.35% and 7.875% Enron notes

They were pivotal players in the mysterious offshore partnerships that ultimately brought Enron down.

Wearing so many hats was unthinkable a generation ago, when laws kept the banking, brokerage and insurance industries separate. Deregulation changed all that, particularly in 1999 when the Depression-era Glass-Stegall Act was repealed....

* * *

Enron was such a lucrative customer that virtually every Wall Street firm had a relationship with it.

Lehman was willing to engage and participate in the fraudulent scheme and course of business because its participation created enormous profits for Lehman ***as long as the Enron scheme continued in operation*** – something that Lehman was in a unique position to cause. So long as Enron maintained its investment grade credit rating and continued to report strong current period financial results and credibly forecast strong ongoing revenue and profit growth, ***Enron's access to the capital markets would continue to enable Enron to raise hundreds of millions, if not billions, of dollars of fresh capital from public investors so that the scheme could continue.*** ¶767.

In fact, the proceeds of Enron's securities offerings during the Class Period underwritten by Lehman or other investment banks were utilized to repay Enron's existing commercial paper and bank indebtedness. Thus, throughout the Class Period, Lehman was pocketing millions of dollars in investment banking fees by participating in the Enron scheme to defraud and stood to ***continue*** to collect these huge amounts going forward so long as it helped perpetuate the Enron Ponzi scheme, ***while Lehman's top executives pocketed huge returns on their secret investment in LJM2 – returns created by the very manipulative or deceptive acts and contrived transactions between Enron and LJM2 entities which Lehman was financing – and which were hiding billions of Enron's debt and artificially inflating its profits by hundreds of millions of dollars.*** ¶¶767-771.

In addition, Lehman also engaged and participated in the scheme to defraud by ***making false statements to the market regarding Enron***. First of all, the Registration Statements for Enron's 2/99 27.6 million share, $870 million Enron common stock offering, Enron's 5/99 sale of $500 million in 7.3785% notes and Enron's 5/00 $500 sale of million in 7.875%/8.375% notes, where Lehman was one of the lead underwriters contained false and misleading statements – ***which are statements made by Lehman as an underwriter*** – including false interim and annual financial statements, and false statements concerning the structures of and Enron's relationship to SPEs and related parties, Enron's financial risk management statistics, as well as the condition of Enron's business operations and the value of its assets. ¶768. *See infra* at 96-97.

In addition, throughout the Class Period, Lehman ***issued*** 18 analysts' reports on Enron which contained false and misleading statements concerning Enron's business, finances and financial condition and prospects, including those dated 12/9/98, 4/7/99, 5/7/99, 9/21/99, 1/21/00, 4/13/00, 7/25/00, 10/18/00, 2/1/01, 3/12/01, 3/31/01, 4/18/01, 7/26/01, 8/14/01, 8/15/01, 8/17/01, 10/23/01 and 10/24/01. ¶¶125, 143, 150, 170, 206, 231, 254, 270, 287, 303, 312, 322, 338, 341, 347, 353, 379, 381, 769. In addition, on 10/1/99 Ted A. Izatt, Lehman Senior Vice President, was quoted in *CFO Magazine* in a false statement ¶175.

These were all statements by Lehman to the securities markets which helped artificially inflate the trading prices of Enron's publicly traded securities. ***Keeping Enron's stock price inflated was also important to Lehman as it knew that if the stock price fell below various "trigger" prices, Enron would be required to issue millions of additional Enron shares, which would reduce Enron's shareholders' equity by hundreds of millions, if not billions, of dollars, endanger its investment grade credit rating, likely cut off its access to the capital markets, and thus endanger the ongoing scheme from which Lehman and its top officials were profiting***. ¶769.

In addition to making its own false statements, Lehman also engaged and participated in and furthered the fraudulent scheme by participating in deceptive devices, contrivances and illicit transactions with Enron which it knew would falsify Enron's financial condition. ¶768.

One of the primary vehicles utilized to falsify Enron's financial condition and results during the Class Period was a large partnership called LJM2, which was secretly controlled by Enron and was used to create numerous SPEs (including the infamous Raptors) with which Enron engaged in contrived transactions to artificially inflate Enron's profits while concealing billions of dollars in debt that should have been on Enron's balance sheet. ¶¶24, 646-647, 770.

It was indispensable that LJM2 be funded before year-end 99 because of the need to fund SPEs to deal with Enron to create huge 4thQ 99 profits for Enron so it could meet its forecasted 99 earnings and move hundreds of millions of dollars of debt off Enron's balance sheet. However, there was tremendous time pressure and Enron and Merrill Lynch could not raise the money from outside investors in LJM2 in time to fully form or fund LJM2 by year-end 99 with sufficient funds to enable it to do the desperately needed transactions with Enron. Lehman knew, because LJM2 was going to be principally utilized to engage in transactions with Enron where Enron insiders (Fastow, Kopper and Glisan) would be on both sides of the transactions, that the LJM2 partnership would be extremely lucrative – virtually guaranteed to provide huge returns to LJM2's investors. So, in an extraordinary step, top Lehman executives, knowing that LJM2 was going to be an extraordinarily lucrative investment [via LBJ or LBI Group Inc.], put up $1.5 million dollars early (on 12/22/99) even though Enron was not formed or fully funded – many times more than their allocated shares – which, when combined with early funds put up by other banks or bankers – provided the monies needed to pre-fund LJM2. This pre-funding money from Enron's banks and bankers on 12/22/99, provided sufficient monies to enable Enron to engage in the Whitewing, CLO, Nowa Sarzyna Power Plant, MEGS natural gas and Yosemite certificates deals between 12/22-29/99. These were SPE deals funded by LJM2 – transactions that generated millions in phony profits for Enron, just before year-end 99, and moved hundreds of millions of dollars of debt off Enron's balance sheet. ¶647. These deals were nothing more than contrivances, which were then "undone" in the 1stQ 00 with huge returns to LJM2's pre-funders, including the Lehman executives. ¶¶466-475.

The LJM2 partnership, with the funding Lehman's executives provided, was able to form and finance several SPEs – ***including the Raptors*** – with which Enron engaged in manipulative or deceptive devices and transactions to inflate its reported profits, while improperly moving billions in debt off Enron's balance sheet and into the SPEs during 00-01. ¶¶461-464, 476-488, 770.

To the extent that Enron's bankers – including Lehman top executives – were permitted to invest in LJM2, ***this was a reward to them for their ongoing participation in the scheme – and from the looting of Enron***. ¶¶646, 762.[29] ***In this regard, as a reward for its participation, Lehman***

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[29] After LJM2 was fully funded in early 00 as other investors' money flowed into LJM2, the banks' "over-funding" in 12/99 was adjusted for in the subsequent capital contributions to LJM2. ¶647. This is shown below:

LJM2 PARTNERSHIP FUNDING

Partnership Investor	Bank	Total LJM2 Funding Commitment	% of Fund	Pre-Funding 12/22/1999	2d/3d Close Draw	4th Close Draw	Net Investment @ 6/30/00
Chemical Investments, Inc , J P Morgan Partnership Investments Corp , Sixty Wall Street Fund, LP	JP Morgan	$ 25,000,000	6 3928%	3,750,000	$ (1,688,475)	$ (894,485)	$ 1,167,040
CIBC Capital Corporation	CIBC	$ 15,000,000	3 83568%	2,250,000	$ (1,013,085)	$ (536,679)	$ 700,236
Citicorp; Travelers, Primerica	CitiGroup	$ 15,000,000	3 83568%	1,500,000	$ (675,390)	$ (106,470)	$ 718,140

executives were permitted to ultimately invest $10 million in LJM2 to facilitate the funding of that critical vehicle. According to *The New York Times*:

> ***Enron Ex-Chief Said to Voice Suspicion of Fraud***
>
> Jeffrey K. Skilling, the former chief executive of Enron, has told investigators that the top-flight financial returns that investors made from a partnership that did business with the company could have been achieved only if the corporation was defrauded, according to documents and people involved in the case.... He indicated to the S.E.C. and to investigators for a special committee of the Enron board that such returns – which were as high as 2,500 percent in one transaction – could not have been achieved through arms-length transactions, according to these people and investigative notes.
>
> When shown records that laid out the details of the financial returns during his testimony several months ago before the S.E.C., Mr. Skilling was said to have grown agitated as he described his opinion of the information.... Mr. Skilling made his statements to investigators after reviewing LJM2 records .... In the LJM2 presentation, investors were told that the partnership had generated rates of return on its investments in the Raptor ranging from just more than 150 percent to 2,500 percent.

The New York Times, 4/24/02.

Thus, these favored investors in LJM2, like the top executives at Lehman, actually ***witnessed*** and ***benefitted from*** a series of extraordinary payouts from the Raptor SPEs which LJM2 controlled over the next two years – securing hundreds of millions of dollars in distributions from the Raptors to LJM2 and ***then to themselves*** – cash generated by the illicit and contrived transactions Enron was engaging in with the Raptors to falsify its financial results. Thus, the banks and bankers who were partners in LJM2 – like the top Lehman executives – ***were not only knowing participants in the***

BT Investment Partnership, Inc	Deutsche Bank	$ 10,000,000	2 55712%	1,500,000	$ (675,390)	$ (357,786)	$ 466,824
DLJ Fund Investment Partners III, L P	CS First Boston	$ 5,000,000	1 27856%	750,000	$ (337,695)	$ (178,893)	$ 233,412
LBJ Group Inc	Lehman	$ 10,000,000	2 55712%	1,500,000	$ (675,390)	$ (357,786)	$ 466,824
MLJDX Positions, Inc., Louis Chiovacci, ML/LJM2 Co-Investment, LP	Merrill Lynch	$ 22,645,000	5 79059%	750,000	$ (337,695)	$ 707,820	$ 1,120,125
Papyrus I Funding Trust	Bank America	$ 45,000,000	11 50703%			$ 2,261,844	$ 2,261,844

Enron scheme to defraud, they were direct economic beneficiaries of it – and of the looting of Enron. ¶¶31, 649.[30]

After LJM2 was formed and Lehman's top executives had secretly been permitted to get in on LJM2 (ultimately to the tune of over $10 million), and LJM2 was funding repeated non-arm's-length transactions with Enron to create phony profits and hide debt, Lehman continued to issue very positive analyst reports on Enron. Each of these reports contained "boilerplate" disclosures like:

> Disclosures: A
>
> * * *
>
> Disclosure Legend: A-Lehman Brothers Inc. managed or co-managed within the past three years a public offering of securities for this company.

These boilerplate disclosures were the same as they were before 12/99 – i.e., they did not change after Lehman's top executives secretly became investors in LJM2 and LJM2 was funding repeated non-arm's-length fraudulent transactions with Enron to create phony profits and hide debt. The failure to disclose the LJM2 involvement of Lehman's top executives made these "boilerplate" disclosures false and misleading and concealed from the market the very significant and serious conflict of interests which Enron and Lehman knew would have cast serious doubts on the objectivity and honesty of Lehman's analyst reports on Enron and disclosed that Lehman or its executives had compromising ties to and serious conflicts of interest regarding Enron.

IV. LEHMAN IS LIABLE UNDER §11 OF THE 1933 ACT TO PURCHASERS OF ENRON'S 7.375% AND 7.875% NOTES FOR SELLING THOSE SECURITIES IN 5/99 AND 5/00, RESPECTIVELY, PURSUANT TO FALSE AND MISLEADING REGISTRATION STATEMENTS

Wall Street underwriters play an extremely important – indeed indispensable role – in protecting investors in public companies and ensuring that public companies and those associated with public companies comply with their obligations of full, fair and complete disclosure when selling securities to the public.

> By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards. Investors properly rely on this ***added protection which has a direct bearing on their***

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[30] ***These payments from LJM2 were on top of the huge advisory fees***, underwriter fees, interest and loan commitment fees Lehman was already getting from Enron. ¶649.

> ***appraisal of the reliability of the representations in the prospectus.*** The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public.

In re Richmond Corp., 41 S.E.C. 398, 406 (1963). In *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir. 1973), the Second Circuit stated:

> Self-regulation is the mainspring of the federal securities laws. ***No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter.*** He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. Since he often has a financial stake in the issue, he has a special motive thoroughly to investigate the issuer's strengths and weaknesses. ***Prospective investors look to the underwriter – a fact well known to all concerned and especially to the underwriter – to pass on the soundness of the security and the correctness of the registration statement and prospectus.***

In *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968), the court emphasized the importance of independent verification by underwriters:

> The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. ***In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.***

Finally, in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 582 (E.D.N.Y. 1971), the court stated that underwriters

> are expected to exercise ***a high degree of care in investigation and independent verification of the company's representations.*** Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate.

The banks named as defendants in this action grossly violated these duties in their dealings with Enron. This court has recognized that §11 is a non-fraud remedy.

> A plaintiff is not required to demonstrate scienter under §11, and a defendant will be liable for innocent or negligent material misrepresentations. *Id.* Nevertheless, where §11 and §12(a)(2) claims sound in fraud, the plaintiff is required

> to plead the circumstances constituting the alleged fraud with particularity under Rule 9(b). *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1405 & n.3 (9th Cir. 1996), *cert. denied sub nom. Anderson v. Clow*, 520 U.S. 1103 (1997). The Fifth Circuit recently issued an opinion that limits the holding of *Melder* and makes clear that where a complaint does not allege that the defendants are liable for fraudulent or intentional conduct, especially where it disavows and disclaims any allegations of fraud in its strict liability 1993 Securities Act claims, its claims do not "sound in fraud" and they cannot be dismissed for failure to satisfy Rule 9(b). *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, ___ F.3d ___, No. 99-50958, 2001 WL 21259, *2-3 (5th Cir. Jan. 9, 2001).

Landry's, slip op. at 11 n.13.[31]

Lehman acted as underwriter for the sale of Enron securities via the Registration Statements, as specified below:

Securities	Date of Offering/ Registration Statement
7.375% notes due 5/19	5/99
7.875% notes due 03 and 05	5/00

This exposes Lehman to §11 liability under the 1933 Act – ***non-fraud liability*** – under which it is *prima facie* liable and can avoid liability only by bearing ***its burden of proof*** that it had, after reasonable investigation, reasonable ground to believe and did believe ... that the statements therein were true and that there was no omission to state a material fact required to be stated thereon or necessary to make the statements therein not misleading," *i.e.*, the underwriter's so-called "due diligence" defense. §77k(a)(5), (b)(3).

The 5/99 and 5/00 Registration Statements contained false statements or material omissions.[32]

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[31] The CC contains such a disclaimer. ¶1005.

[32] Due to arguments raised by Bank of America, plaintiffs are no longer pursuing §11 claims on the 8.375% notes.

Date of Offering	Date of Registration Statement	Description of Security	Under-writer(s)	Annual Financial Statements/10Ks Incorporated by Reference	Quarterly Financial Statements Included or Incorporated by Reference
5/19/99	2/05/99	$500 million 7.375% notes	Lehman Brothers Bank America CIBC	Registration Statement incorporated the 97 and 98 10-Ks.	10Qs for 3/31/98; 6/30/98 and 9/30/98
5/00 & 6/00	2/05/99	$325 million in 7.875% notes	Lehman Brothers	Registration Statements incorporated 98 and 99 10-Ks.	10Q for 3/31/00

Each of these Registration Statements were false and misleading due to the incorporation of Enron 10-Ks and 10Qs that contained Enron's ***admittedly false financial statements for 97-98-99 and 1Q 00, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars***, as detailed in ¶¶418-611. The restatement of previously issued financial statements is an admission that they were materially false when issued and Enron's 97, 98, 99 and 00 financial results have all been restated by huge amounts. While the Registration Statements included audited annual financial statements, significantly, they also incorporated or included all documents filed pursuant to §13(a) of the 1934 Act prior to the respective offerings, ***including Enron's 10-Qs which contained Enron's admittedly unaudited false and misleading unaudited quarter financial results***. ¶615.[33] Of course, since the interim financial statements were unaudited they were not expertised and Lehman Brothers is responsible for the accuracy of those interim unaudited financial statements.

Thus, under 1933 Act §11, Lehman Brothers, as an underwriter in these offerings, is *prima facie* liable to the purchasers of these securities subject to Lehman Brothers proving that in the

[33] While Lehman Brothers may be able at trial to establish a defense to liability for these expertised, *i.e.*, certified financial statements, in light of the CCs allegations that it knew those annual certified financial statements were false it may not do so now at the 12b-6 stage. *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23.

exercise of due care or diligence, they did not know and could not have known of the falsity of the Registration Statements forecasting these false financial results. Given the duration of falsity (over three years) and the size of the falsity (literally billions of dollars), Lehman Brothers, which foisted these worthless securities on the public, faces quite a burden in this regard.

Each of the Registration Statements which incorporated Enron's 99 10-K made false statements about Enron's EBS business, including the EIN. Enron's 99 10-K stated that "the Enron Intelligence Network (EIN) ... ***currently connects to most major U.S. cities*** ...," and "***the EIN allows Enron to provide high quality delivery services for content providers." This was false because EBS had no "intelligent" network then – and never did***. The EIN – which Enron defined as its network of fiber-optic lines connected by pooling points, at which bandwidth could be metered and directed, and the internally developed Broadband Operating System ("BOS") – was ***never*** completed. Although Enron had access to miles and miles of fiber-optic cable, only a tiny fraction of the lines were lit and connected at pooling points in the U.S. By spring 99, EIN development had "deteriorated into chaos," as stated by a co-author of Enron's broadband business plan, and by 10/99 EBS was "in crisis mode." Simply stated, Enron's representation that EIN "***currently connects to most major U.S. cities***" was a lie. ¶¶631-635.

More importantly, Enron's BOS, which was to regulate the flow of bandwidth through Enron's fiber network – was a complete fiction. Enron publicly extolled a software application called InterAgent, which it inherited through its Modulus acquisition as the cornerstone of its unique BOS – the purported intelligence behind the EIN. In reality, InterAgent was only a small piece of what was essential to develop the successful operating system that Enron represented it had. InterAgent was a communications software application – commonly called middleware – that enabled other applications to communicate with BOS. In fact, constructing an operating system around InterAgent was akin to building a car around a muffler – while a necessary component of the finished product, a muffler was a nonsensical component around which to build the product.

In the end, ***InterAgent served no function in the BOS or the EIN*** for two reasons. ***First***, for InterAgent to work required an operating system into which it could connect. Enron's BOS was to be that operating system, ***but BOS never developed beyond the concept stage***. ***Second***, all Enron ever had resembling the BOS and the EIN were miles and miles of fiber – a little lit, but predominantly dark – some Sun Microsystems and Windows Media Player servers, and the InterAgent software. But Enron was unable to assemble this into a broadband system and make it work. ¶634.

The Registration Statements that incorporated Enron's 99 10-K and 00 10-Q filings contain false statements about EES. Enron's 1stQ 00 10-Q stated that EES had revenues of $314 million and income of $6 million. These numbers were materially false and misleading because the revenue and income for 1Q 00 were falsified and overstated due to overvaluation of the EES contracts and Enron's abuse of mark-to-market accounting as detailed at ¶¶418-611. ¶640. Enron's 99 10-K stated that EES was a "nationwide provider of energy outsourcing products and services to business customers," including energy management services directly to commercial and industrial customers to reduce total energy costs, and reported EES total revenue of $1.8 billion. These numbers were false due to the accounting falsification and manipulations, as described in ¶¶418-611.

In *Landry's*, this court upheld a §11 claim against the defendant investment banks, stating:

> The Court also finds that Plaintiffs have also adequately pled their claims against the Landry Defendants under §11 of the Securities Act. They have identified specific purportedly untrue statements in Landry's Prospectus and alleged that Defendants, who were directors of the issuer and some of whom signed the document, negligently breached their duty to make a reasonable investigation or possess reasonable grounds for believing that the representations were true and not materially misleading. The complaint expressly disavows reliance on or incorporation of the allegations elsewhere in the complaint alleging fraud, thus falling within the holding of *Melder*, 27 F.3d at 1100 n.6. *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, ___ F.3d ___, No. 99-50958, 2001 WL 21259, *2-3 (5th Cir. Jan. 9, 2001).
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> * * *
>
> As for the Underwriter Defendants' motion to dismiss, Section 11 imposes essentially absolute liability for false statements or omissions in a prospectus. No scienter need be alleged Nor do the requirements of Rule 9(b) need to be met. *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, ___ F.3d ___, No. 99-50958, 2001 WL 21259, *2-3 (5th Cir. Jan. 9, 2001). Plaintiffs have met their pleading burden.

Landry's, slip op. at 64-65. The same is true here as to Lehman.

Thus, regardless of the impact of the enhanced pleading standard on plaintiffs' §10b/Rule 10b-5 fraud claims by the 95 Act or the reach of 1934 Act §10(b)/Rule 10b-5 liability, Lehman Brothers is in this case based on its 1933 Act §11 non-fraud liability.

V. LEHMAN CAN BE LIABLE UNDER 1934 ACT §10(b) AND RULE 10b-5 (i) FOR MAKING FALSE STATEMENTS, OR (ii) FOR PARTICIPATING IN A FRAUDULENT SCHEME OR COURSE OF BUSINESS THAT OPERATED AS A FRAUD OR DECEIT ON PURCHASERS OF ENRON'S SECURITIES, OR (iii) FOR EMPLOYING ACTS OR MANIPULATIVE DEVICES TO DECEIVE

Plaintiffs here have also pleaded and are pursuing theories of recovery against Lehman that are well-grounded in the express language of the 1934 Act. Section 10(b) of the 1934 Act states:

> Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly ...
>
> * * *
>
> (b) [t]o use or employ, in connection with the purchase or sale of any security ... ***any manipulative or deceptive device or contrivance*** in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[34]

15. U.S.C. §78j(b).

Rule 10b-5 promulgated by the SEC flows directly from the language of §10(b) itself and provides:

> Rule 240.10b-5 Employment of manipulation and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

[34] Note that §10(b) itself does not expressly prohibit untrue statements of material facts or material omissions. This prohibition, like the prohibition against fraudulent schemes and fraudulent courses of business, is expressed in Rule 10b-5.

Not only does Rule 10b-5 forbid the making of "any untrue statement of a material fact," it also provides for scheme liability. Scheme liability is authorized by the text of §10(b). According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud.***" In *Ernst & Ernst*, the Court referred to the dictionary definitions of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" 425 U.S. at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***a scheme, plan, or artifice.***'" *Id.* (quoting *Webster's International Dictionary*); *see also Aaron*, 446 U.S. at 696 n.13. Clearly, "scheme" is encompassed in the broad language of §10(b).

Thus Rule 10b-5 – adopted by the SEC to implement §10(b) – makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***," "***to make any untrue statement[s]***," or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest*, 228 F.3d at 407.

Prior to the Supreme Court's endorsement of the presumption of reliance based on the fraud-on-the-market theory for both misrepresentations and omissions in *Basic,* 485 U.S. 224, the Fifth Circuit had held that the theory applied ***only*** to omission cases and not misrepresentation cases. Thus, in some instances, securities plaintiffs sought recovery under subsection (1) and (3) of Rule 10b-5 alleging ***fraudulent scheme and course of business liability***. The Fifth Circuit expressly recognized the validity of these theories of recovery.

For instance, in *Finkel*, 817 F.2d 356, plaintiffs sued under §10(b) and Rule 10b-5, claiming that the stock of Docutel was inflated due to false financial reports. According to plaintiff, Olivetti (which owned 46% of Docutel and controlled it) forced Docutel to buy Olivetti's excess inventories at inflated prices so Olivetti could hide losses it was suffering. Docutel concealed this financial manipulation for some time but, when its auditors discovered the financial manipulation and forced a large inventory writedown, huge losses were disclosed and Docutel stock fell. The district court dismissed the complaint against Olivetti and Docutel because plaintiff failed to allege reliance on any of the false statements in Docutel's SEC filings, that were alleged in the complaint.

> But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). ***We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel.***
>
> * * *
>
> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the marketplace; ***if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3)***. Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).

Id. at 363-64; *accord Heller v. Am. Indus. Props. Reit*, No. SA-97-CA-1315-EP, 1998 U.S. Dist. LEXIS 23286, at *14 (W.D. Tex. Sept. 28, 1998) ("The first and third subsections, on the other hand, ***create a duty not to engage in a fraudulent scheme or course of conduct*** ....").

Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme***." *Shores*, 647 F.2d at 468.

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale*** and required the skills and active participation of lawyers, bankers and accountants to help design, implement, conceal and falsely account for the manipulative or deceptive devices, contrivances and acts, and artifices they and Enron were using to falsify Enron's reported profits and financial condition and to continue its fraudulent course of business.

The notion that *Central Bank,* 511 U.S. 164, issued a broad edict that lawyers, bankers and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability

does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser ... relies may be liable as a primary violator under 10b-5.... In any complex securities fraud, moreover, there are likely to be multiple violators." *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.***" *Cooper*, 137 F.3d at 624; *accord First Jersey*, 101 F.3d at 1471; *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 969-70 (C.D. Cal. 1994).

In *Central Bank*, 511 U.S. 164, a public building authority issued bonds to finance public improvements. Central Bank served as indenture trustee. The bonds were secured by liens covering property. The bond covenants required that the liened land be worth at least 160% of the principal amount of the bonds. Central Bank got a letter expressing fear that property values were declining and that perhaps the 160% value test was no longer met. The bank did nothing. Soon afterwards, the public building authority defaulted on the bonds ($2.1 million dollars worth of bonds). The bonds were not publicly traded. Central Bank, which had no commercial lending relationship with the municipal entity involved and which was not an investment bank, issued no analysts' reports about the issuer of the municipal bonds and thus made no statement and took no affirmative act that could have affected the trading price of the municipal bonds in issue. Clearly, this is a significantly different fact pattern from the Enron situation.

The *Central Bank* majority noted that their reasoning was "confirmed" by the fact that if they accepted the plaintiffs' aiding and abetting argument it would impose §10(b) liability when "at least one element critical for recovery" was absent, *i.e.*, reliance. *Id.* at 180 (citing *Basic*, 485 U.S. at 243 (the Supreme Court's "***fraud-on-the-market***" decision) for the proposition that a plaintiff must show reliance to recover under 10b-5). "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements ***or actions***." *Id.* The Court found that allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Id.* However, in this case, the alleged scheme and fraudulent course of business ***inflated*** the prices of Enron's ***publicly traded*** securities. ¶¶74, 418-424, 762-772. Thus, the reliance element is not "***absent***" and the Supreme Court's prior decision in *Basic* is not circumvented – it is satisfied.

Central Bank thus denied recovery to victims of an alleged securities fraud who pleaded only one theory of recovery against the defendant bank – secondary liability dubbed "aiding and abetting." 511 U.S. at 191. However, the words aiding and abetting do not appear in §10(b) or Rule 10b-5. The Court said "***[T]he text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation ... that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as the plaintiffs do here, plead or pursue recovery under the theory that the bank defendant made false and misleading statements in Registration Statements or other documents issued to the public, *e.g.*, analysts' reports ***or*** employed acts and manipulative or deceptive devices or engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "concede that Central Bank did not commit a manipulative or deceptive ***act*** within the meaning of §10(b)." *Id.* at 191. Thus, because the *Central Bank* plaintiffs pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost.***

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless it made misleading statements because the Court rejected that argument in *O'Hagan*, 521 U.S. 642. The Eighth Circuit had held that, under *Central Bank*, "§10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely." *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak. *Id.* Because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules, this reaches "any deceptive device," whether or not the defendant spoke. *O'Hagan*, 521 U.S. at 653. *Superintendent of Ins.*, 404 U.S. 6, is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** court upheld a §10b/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9.

This Court has stated, citing *O'Hagan*, that:

> ***A defendant need not have made a false or misleading statement to be liable.***

Landry's, slip op. at 9 n.12; *Waste Mgmt.*, slip op. at 75; *BMC Software*, 183 F. Supp. 2d at 869. ***Here, however, Lehman allegedly made false or misleading statements in Registration Statements and analysts' reports.***

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *Zandford*, 2002 U.S. LEXIS 4023. In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.
- "***[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).*** *Id.* at *13.[35]
- Allegations that defendant "'***engaged in a fraudulent scheme***'" or "'***course of business that operated as a fraud or deceit***'" stated a §10(b) claim. *Id.* at *13, *14-*17.

Central Bank clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central Bank* is ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad***. Also the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in securities transactions:

> [T]he 1934 Act and its companion legislative enactments (including the 1933 Act) embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.... Congress intended securities legislation enacted

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[35] To the extent *Ziemba*, 256 F.3d at 1205, seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens, 406 U.S. at 151. As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be construed broadly to effectuate the statutory policy affording extensive protection to the investing public. *See Tcherephin*, 389 U.S. at 336. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent ***and speculative schemes***).

Meason, 652 F.2d at 549. "The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively." *Paul F. Newton & Co.*, 630 F.2d at 1118.[36]

Lehman's claim that *Central Bank* eliminated scheme liability is flawed. Notwithstanding *Central Bank*, liability based on participation in a scheme in violation of and schemed to defraud a course of business that operated as a fraud or deceit on securities purchasers on subsections (a) or (c) of Rule 10b-5 continue to be viable theories of liability. Fraudulent scheme or course of business liability is viable because:

- It is encompassed by the ***express language*** of the statute, which prohibits the "direct or indirect" "use or employment" of "any manipulative or deceptive device or contrivance";
- It is encompassed by the ***express language*** of Rule 10b-5;
- It comports with the ***broad antifraud purposes*** of the statute;
- It has ***long been upheld*** by the courts; and

[36] The broad purposes of §10(b)'s prohibition of securities fraud and the Supreme Court's longstanding recognition of such broad purposes also support conspiracy and scheme liability. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."); *Affiliated Ute*, 406 U.S. at 152-53 (Proscriptions of §10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'") (footnote omitted) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *Capital Gains Research*, 375 U.S. at 186 (§10(b) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"); *Superintendent of Ins.*, 404 U.S. at 11 n.7 ("'[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that §10 (b) and Rule 10b-5 prohibit ***all*** fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'") (emphasis in original) (quoting *A. T. Brod & Co.*, 375 F.2d at 397).

- It imposes liability based on a ***primary*** violation of the 1933 Act committed directly by the defendant that goes beyond merely assisting another in committing a violation.

In Central Bank, the plaintiffs did not allege primary liability against the bank, did not allege a scheme to defraud, did not allege a fraudulent practice or course of business and did not invoke subsections (a) or (c) of Rule 10b-5.[37] The plaintiffs alleged only that the bank was "'***secondarily*** liable under § 10(b) for its conduct in ***aiding and abetting the fraud.***'" *Central Bank*, 511 U.S. at 168. The Court, therefore, did not address other liability theories. Yet defendants, including Lehman, offer up numerous rationales as to why *Central Bank* eliminated Rule 10b-5(a) and (c) liability. They are:

1. ***The "Textualist" Rationale.*** The court took a strict textualist approach in concluding that there is no private aiding and abetting liability under §10(b). Just as the statute does not explicitly mention "aiding and abetting," it also does not mention "scheme," "act," "practice," or "course of business."

2 ***The "Manipulation and Misrepresentation Is It" Rationale.*** The court stated that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," *Central Bank*, 511 U.S. at 177, which must be interpreted to mean that liability can only be premised upon conduct falling within subsection (b) of Rule 10b-5.

3. ***The "No More Secondary Liability" Rationale.*** The court's opinion holds that only primary violators may be held liable. Because scheme liability is a secondary liability theory similar to aiding and abetting, it is precluded.

None of these rationales for precluding fraudulent scheme and/or course of business liability is supportable because scheme and course of business liability is a ***textually-based, primary liability theory*** and there is no hard and fast rule that a defendant must make a false statement to face §10(b) liability – while in this case Lehman did, in fact, allegedly make several false and misleading statements.

None of the rationales as to how *Central Bank* eliminated Rule 10b-5(a) and (c) liability hold water.

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[37] The *Central Bank* decision did not distinguish among the different subsections of Rule 10b-5.

- ***The Flaws of the "Textualist" Rationale***

A major flaw of the textualist rationale is that scheme liability is ***firmly based*** on the language of both the statute and the rule. The statute itself contains only the general "***manipulative or deceptive devices or contrivances***" language, leaving it to the SEC to more specifically proscribe fraudulent conduct. The SEC's rule-making authority would be superfluous if the rules it adopted had to use precisely the same words as in the statute. To be sure, "the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," *Central Bank*, 511 U.S. at 173, and "'the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit,'" *id.* at 174 (quoting *Chiarella v. United States*, 445 U.S. 222, 234 (1980)). But it is patently reasonable for the SEC to have determined that the "employment" of a "scheme to defraud" and the "engagement" in a fraudulent "act, practice, or course of business" constitute the "use or employ[ment]" of a "manipulative or deceptive device or contrivance."[38]

In *Ernst & Ernst*, the Court implicitly found that a "scheme to defraud" falls within the meaning of the "manipulative or deceptive device or contrivance" language of §10(b). 425 U.S. at 199 n.20. The Court relied in part on the 1934 dictionary definitions of "device" and "contrivance." *See id.*; *see also Aaron*, 446 U.S. at 696 n.13 (relying on same definitions to find scienter requirement under §17(a)(1) of 1933 Act). Both of those definitions included a "scheme." *See Ernst & Ernst*, 425 U.S. at 199 n.20.[39]

The Court itself showed that *Central Bank* should not be interpreted as ushering in a new era of strict textualist construction of the federal securities laws. In upholding the misappropriation theory of insider trading in *O'Hagan*, 521 U.S. 642, the Court upheld a non-textual form of securities

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38 No subsection of Rule 10b-5 has ever been successfully challenged in any court as being outside the scope of §10(b) in the 60-year existence of the Rule.

39 The statutory prohibition against "directly or indirectly" violating §10(b) must cover a scheme to commit manipulative or deceptive acts. It is unlikely that Congress would have prohibited the direct commitment of a fraudulent act and yet approved the commission of the same fraudulent act through joint activity – *i.e.*, a scheme. The "directly or indirectly" language in §10(b) was not enough for the Supreme Court to save aiding and abetting liability in *Central Bank*. But that was because aiding and abetting liability covered a broader range of conduct than the direct commission of a manipulative or deceptive act. Scheme conduct, however, involves joint action to commit a manipulative or deceptive act that should itself be considered, directly or indirectly, a manipulative or deceptive act by each of the schemers.

fraud and, in doing so, again exposed the long familiar broad expressions of the remedial purposes of the statute.[40]

- ***The Flaws of the "Manipulation and Misrepresentation Is It" Rationale***

The Court in *Central Bank* said that §10(b) "prohibits only the making of a material misstatement (or omission) ***or the commission of a manipulative act***." 511 U.S. at 177. It also indicated §10(b) liability existed where there was reliance or a defendant's "statements or actions." *Id.* at 180; *see also id.* at 191 ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative or deceptive device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming ***all*** of the requirements for primary liability under Rule 10b-5 are met.") (emphasis in original).

There is absolutely nothing in the language of the statute, the legislative history, or the rule that warrants restricting liability solely to misrepresentations or omissions or certain technical forms of manipulation. The express language of §10(b) clearly allows for liability by a person who does not actually make a statement or omit to say something he is under a duty to disclose. The statutory language "directly or indirectly ... [t]o employ" in §10(b) is much broader than simply "directly to make." Similarly, the statutory language "any manipulative or deceptive device or contrivance" is much broader than simply "a misrepresentation or omission." Therefore, if the starting point in interpreting a statute is the language itself, *see Central Bank*, 511 U.S. at 173, there is no reason why liability under §10(b) must be limited to directly making misstatements or omissions or manipulating securities prices through certain specific technical or mechanical means.[41]

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40 The Court also noted that the misappropriation theory is designed to protect the integrity of the securities markets against abuses and that the 1934 Act was enacted in part to insure the maintenance of fair and honest markets and thereby promote investor confidence. *O'Hagan*, 521 U.S. at 652, 657-59. For example, the Court stated that "[t]he theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." *Id.* at 658. The Court detailed how investors would be hesitant to invest in an unfair market. *See id.*

41 As the Supreme Court has stated, "***[n]o doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices***." *Santa Fe*, 430 U.S. at 477.

In addition, the SEC, in adopting subsections (a) and (c) of Rule 10b-5, implicitly recognized this. ***Unless this Court would strike down a rule that has been upheld for 60 years, the language "employ any device, scheme, or artifice to defraud" and "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit" in subsections (a) and (c) of Rule 10b-5 is much broader than simply "make a misrepresentation or omission."***[42]

If the court in *Central Bank* meant to strike down subsections (a) and (c) of Rule 10b-5, the court certainly would have explicitly said so. To the contrary, the courts have long recognized that the scope of liability under subsections (a) and (c) of Rule 10b-5 is broader than that under subsection (b) and that those who engage in a fraudulent scheme may be liable in the absence of misrepresentations or omissions. *See, e.g., Affiliated Ute Citizens*, 406 U.S. at 152-53 (subsections (a) and (c) are broader than subsection (b) of Rule 10b-5); *First Jersey*, 101 F.3d at 1471-72; *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982); *Shores*, 647 F.2d at 468 (en banc); *Competitive Assocs.*, 516 F.2d at 814-15 ("Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. ***Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws.***"); *Blackie v. Barrack*, 524 F.2d 891, 903 n.19 (9th Cir. 1975) ("Rule 10b-5 liability is not restricted solely to isolated misrepresentations or omissions; ***it may also be predicated on a 'practice, or course of business which operates ... as a fraud*** ....'"); *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971) ("Rule 10b-5 is a remedial measure of far greater breadth than merely prohibiting misrepresentations and nondisclosures concerning stock prices. No attempt is made in 10b-5 to specify what forms of deception are prohibited; rather, ***all fraudulent schemes in connection with the purchase and sale of securities are prohibited.***") (emphasis added and in original).

- ***The Flaws of the "No More Secondary Liability" Rationale***

The principal flaws of this rationale are that *Central Bank* did not strike down every form of "secondary" liability and that, in any event, violations through fraudulent schemes, acts, practices,

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[42] Even from a common sense standpoint, schemes, acts, practices, and courses of conduct can readily be manipulative or deceptive, irrespective of any statements or omissions.

or courses of business constitute primary violations of § 10(b). In *Central Bank*, the Court did not make fine distinctions between conduct that constitutes a "primary" as opposed to that which constitutes a "secondary" violation of the statute. Nor did it hold that only "primary" violations are cognizable. It held that aiding and abetting could not constitute a violation because, as interpreted by the courts, aiders and abettors did not commit violations ***but only assisted them***, and the statute holds liable only those who commit violations.

Fraudulent acts, practices and scheme liability and course of business are ***primary*** liability theories in the sense that the defendant is directly liable for committing a violation of the statute. ***The fraudulent scheme, act, practice, or course of business is a direct violation of §10(b) and Rule 10b-5.*** With respect to fraudulent acts, practices and a participation in the scheme to defraud or fraudulent course of business is itself the manipulative or deceptive act, even without the making of misrepresentations or omission. There is nothing derivative, vicarious, or secondary about it. ***And Lehman here allegedly made false and misleading statements as well.***

All three subsections of Rule 10b-5 proscribe conduct for which a defendant may be ***primarily*** liable. Therefore, liability for a scheme to defraud or fraudulent act, practice, or course of business does not run afoul of *Central Bank*'s elimination of aiding and abetting liability. Cases both before and after *Central Bank* have recognized that scheme liability is a form of primary liability. *Hill v. Hanover Energy, Inc.*, No. 91-1964 (JHG), 1991 U.S. Dist. LEXIS 18566 (D.D.C. Dec. 16, 1991), is an example of such a pre-*Central Bank* case. In *Hill*, the defendant argued that the §10(b) claim should be dismissed for failure of the plaintiffs to allege any misrepresentations or omissions of material facts. *Id.* at *10-*11. The court rejected that argument, specifically finding that *Santa Fe* does not restrict §10(b) liability to misrepresentations or omissions. *See id.* at *11-*12. Rather, the court found that the alleged conduct of the defendant Hanover Energy, which included fraudulently inducing the plaintiff to give up his rights to acquire certain stock and to post a letter of credit, could fairly be viewed as manipulative or deceptive within the meaning of § 10(b) and an unlawful scheme to defraud within the meaning of subsection (a) or (c) of Rule 10b-5. *See id.*[43]

[43] District court cases after *Central Bank* have continued to recognize scheme liability as a form of primary liability. For example, in *BMC Software*, 183 F. Supp. 2d at 885-86, this court seemed to recognize scheme liability, although it found that the plaintiffs had failed to satisfy the pleading requirements. In *BMC Software*, when discussing the pleading requirements in securities fraud cases and what must be pled to support scheme allegations this Court stated:

> As its first ground for dismissal, Defendants emphasize that the amended complaint fails to allege with any particularity that nine of the eleven individual Defendants made any representations or participated in any way in the alleged scheme to defraud.... ***Plaintiffs must allege what actions each Defendant took in furtherance of the alleged scheme and specifically pled what he learned, when he learned it, and how Plaintiffs know what he learned.***
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> "***Primary liability may be imposed 'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.***'"

Id. at 885-86, 904-05.

District court cases prior to *Central Bank* recognized scheme liability. In *ZZZZ Best*, the district court directly addressed Ernst & Young's liability under subsections (a) and (c) of Rule 10b-5, explicitly recognizing that liability under Section 10(b) and Rule 10b-5 is not restricted to material misstatements and omissions. 864 F. Supp. at 971-72 ("It appears that the scope of deceptive devices or schemes prohibited by subsections (a) and (c) [of Rule 10b-5] is quite extensive."). The plaintiffs alleged that Ernst & Young, hired to review the company's financial statements, was primarily liable because it participated in the creation of publicly released statements, issued a review report, and failed to disclose additional material facts related to the review report. Ernst & Young moved for dismissal on the grounds that it was really being charged with aiding and abetting liability precluded by *Central Bank.* The court denied the motion, concluding that the facts taken as a whole as to Ernst & Young's participation and knowledge could render it liable under a scheme to defraud. *Id.* at 969-72.

In *Adam*, the plaintiffs alleged that Deloitte & Touche was primarily liable under §10(b) for misrepresentations and "participation in a scheme to defraud" through its involvement with the issuer's press releases and financial statements. 884 F. Supp. at 1401. The plaintiffs also alleged that Deloitte knew of the inadequate controls and deviated from conducting its audits in accordance with generally accepted auditing standards. *Id.* at 1399. The court denied the accounting firm's motion to dismiss because it found that its participation in the preparation of the issuer's statements was part of a scheme to defraud, making the firm primarily liable under Rule 10b-5. *Id.* at 1399-1401. In so holding, the court recognized that Rule 10b-5(b) "essentially outlaws the making of a material misrepresentation or omission," but that subsections (a) and (c) of the Rule "also" outlaw fraudulent schemes and courses of conduct. *Id.* at 1400.

In *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458, 467-70 (S.D.N.Y. 1987), Morgan Stanley's liability did not depend on whether it "certified or made other public representations about a corporation's allegedly misleading statements"; rather its "alleged role in knowingly or recklessly preparing the projections could constitute the employment of a 'device, scheme, or artifice to defraud' in violation of 10b-5(1) or an 'act, practice, or course of business which operates or would operate as a fraud or deceit upon any person' in violation of 10b-5(3)."

A scheme is "'[a] plan or program of something to be done.'"[44] A "scheme to defraud" encompasses any "plan designed or concocted for perpetrating a fraud." *Ballentine's Law Dictionary* ("scheme to defraud") 1142 (3d ed. 1969). It has long included any scheme to defraud investors by causing securities to trade at fraudulently inflated prices.[45] When §10(b) was enacted such conduct already was an unlawful "scheme to defraud" under the mail fraud statute, and today it is called a "fraud-on-the-market" that is actionable under §10(b). *See Basic*, 485 U.S. at 241-47; *Lipton v. Documation, Inc.*, 734 F.2d 740, 744-47 (11th Cir. 1984). Every person who intentionally engages in a "scheme" to defraud is thus ***a primary violator*** of Rule 10b-5 and §10(b).

In *Affiliated Ute Citizens*, 406 U.S. 128, the Court observed that "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," 406 U.S.. at 152-53, but held that "[t]he first and third subparagraphs are not so restricted." *Id.* at 153. It held that the defendants violated Rule 10b-5 when they participated in "***a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud" – even though these defendants had never themselves said anything that was false or misleading.*** *Id.* "***Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures.'"*** *Competitive Assocs.*, 516 F.2d at 811. "Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws." *Id.*

Subsections (a) and (c) of Rule 10b-5 thus are aimed at "broader schemes of securities fraud" than are necessarily embodied in a single misleading statement or document, and the "'classic' fraud

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44 *Aaron*, 446 U.S. at 696 n.13 ("Webster's International Dictionary (2d ed. 1934) defines ... 'scheme' as '[a] plan or program of something to be done; an enterprise; a project; as, a business ***scheme*** [,or a] crafty, unethical project ....'") (emphasis in original). To "scheme" is "[t]o form plans or designs; to devise intrigue." *Webster's International Dictionary* 2234 (2d ed. 1934). *The Oxford English Dictionary* 616 (2d ed. 1989) defines "scheme": "A plan, design; a programme one of action .... Hence, [a] plan of action devised in order to attain some end; a purpose together with a system of measures contrived for its accomplishment; a project, enterprise." *Black's Law Dictionary* 1344 (6th ed. 1990) defines "scheme": "A design or plan formed to accomplish some purpose; a system."

45 In *Harris v. United States*, 48 F.2d 771 (9th Cir. 1931), for example, "[t]he fraudulent scheme charged ... was one for the sale of [a mining company's] corporate stock ... by the manipulation of the price of the stock on the [stock exchanges] and the circulation of false reports concerning the mine through the mails." *Id.* at 774. "In fact, the whole scheme centered around the establishment of an alleged stock exchange value which is in fact wholly fictitious." *Id.* at 775.

on the market case [which] ***arises out of transactions on an open and developed market" easily fits within the expansive language of Rule 10b-5(1) and (3).*** *Lipton*, 734 F.2d at 744-45, 747. Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme.*** " *Shores*, 647 F.2d at 468.

In *Cooper*, 137 F.3d 616, plaintiffs sued Merisel, its officers and directors, its accountants, Deloitte and Touche ***and Lehman Brothers and Robinson-Humphrey, investment banks which served as underwriters of Merisel's public offerings and issued analysts' reports on Merisel.*** The complaint alleged that "'[D]efendants falsely presented the Company's current and future business prospects and prolonged the illusion of revenue and earnings growth by making it appear that the Company's revenue and earnings growth was strong and would continue.'" *Id.* at 620.

Defendants argued that "plaintiffs cannot allege a 'scheme' to defraud, because ***those are conspiracy allegations foreclosed by Central Bank.*** " *Id.* at 624. However, the Ninth Circuit rejected this argument, stating that the complaint "alleges a 'scheme' in which Merisel and the other defendants directly participated, tracking the language of ***Rule 10b-5(a), which makes it unlawful for any person 'to employ any device, scheme, or artifice to defraud.*** '" *Id.* Moreover, "Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant ***committed a manipulative or deceptive act in furtherance of the scheme.*** " *Id.* Furthermore,

> "[t]he absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. ***Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) ... may be liable as a primary violator under 10b-5*** .... In any complex securities fraud, moreover, there are likely to be multiple violators ...."

Id. at 624-25.

In *First Jersey*, 101 F.3d 1450, a top First Jersey corporate official who had not made any false statement claimed he should not be held liable under §10(b) of the 1934 Act for an extensive violation of §10(b) and Rule 10b-5 by First Jersey. The Second Circuit stated:

> Brennan contends that even if First Jersey committed fraud, he should not have been held personally liable for any violation ... as a primary violator of the securities laws....
>
> 1. Primary Liability
>
> "Any person or entity ... who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under [federal securities law], assuming all of the requirements for primary liability ... are met." *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994) (emphasis omitted). ***Primary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration."*** *Azrielli v. Cohen Law Offices*, 21 F. 3d 512, 517 (2d Cir. 1994).
>
> ***The evidence presented at trial sufficed to establish that Brennan had knowledge of First Jersey's frauds and participated in the fraudulent scheme.***
>
> * * *
>
> In light of the evidence presented at trial with regard to Brennan's hands-on involvement in the pertinent decisions, we conclude that the trial court did not err in finding that Brennan ***knowingly participated in First Jersey's illegal activity and that he should be held primarily liable for its violations of the securities laws.***

Id. at 1471-72.

And, in fact, many courts have upheld complaints against banks in §10(b)/Rule 10b-5 cases where, as here, false statements, manipulative or deceptive devices, contrivances and acts, and participation in a scheme to defraud have been alleged with sufficient particularity.

In *Cooper*, 137 F.3d at 628, the court held scheme liability had survived *Central Bank* and specifically noted that allegations that the investment banks named as defendants there had knowingly issued false analysts' reports and had "***access to inside information***" set them apart from other analysts who had issued favorable reports on the issuer during the Class Period and stated a valid §10(b)/Rule 10b-5 claim.

> Lehman Brothers also made specific forecasts.... Although the complaint quotes other analysts who made similar positive statements about [the company's] current status and future prospects, this does not mean that the Lehman Brothers and Robinson-Humphrey analysts' statements are somehow automatically reasonable. All the analysts wrote optimistic reports based in part on information from [the

> company]; ***only Robinson-Humphrey and Lehman Brothers are alleged to have known better through their access to inside information.***
>
> Even the analysts' optimistic statements can be actionable if not genuinely and reasonably believed, or if the speaker is aware of undisclosed facts that tend seriously to undermine the statement's accuracy.... The complaint alleges that the analysts were aware of undisclosed facts that showed there was no reasonable basis for their forecasts, which they did not genuinely believe.

Id. at 629. These false analysts' reports were misleading and deceptive acts and part of the fraudulent scheme. When the banks in *Cooper* claimed the so-called "Chinese Wall" shielded them from liability, the Ninth Circuit rejected this assertion:

> [Defendant investment banks] Robinson-Humphrey and Lehman Brothers assert that they followed SEC rules which prevent the sharing of inside information within their companies. 15 U.S.C. §78o(f) requires registered brokers or dealers to create and enforce "written policies and procedures reasonably designed ... to prevent the misuse ... of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer," and authorizes the SEC to create rules for such policies. ***If Robinson-Humphrey and Lehman Brothers have established such policies and followed them in this case, they may raise that as a defense. The existence of such policies does not, however, preclude plaintiffs from asserting in their complaint that inside information was misused.***

Id. at 628-29. The court said that the Chinese Wall might later be used as a defense, but, the court stated, such an assertion (a factual issue) was ***not*** a defense at the motion to dismiss stage.

In *Murphy v. Hollywood Entm't Corp.*, 1996 U.S. Dist. LEXIS 22207, and *Flecker v. Hollywood Entm't Corp.*, 1997 U.S. Dist. LEXIS 5329, the court refused to dismiss a complaint against investment bankers and then later refused to grant summary judgment to those banks, stating that their "***roles as analysts, investment bankers and business advisors with extensive contacts with [issuer] defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under §10(b).***" *Id.* at *25. In initially denying the bank's motion to dismiss, the court recognized that "***any person or entity who directly participates in an alleged violation of § 10(b), even if that person falls within the category of professionals usually deemed 'collateral' participants, may still be liable as a 'primary violator' under § 10(b).***" *Id.* at *20-*21. The court concluded:

> As for the Underwriters' role in the alleged fraud, plaintiffs do not allege the existence of any contemporaneous "smoking gun" type of documents which would demonstrate that the Underwriter defendants knew they were selling a landfill when they sold Hollywood securities. However, plaintiffs do allege that the underwriter defendants had a "***close association***" ***with Hollywood which gave them "constant***

> ***access" to the individual Hollywood defendants and all relevant, non-public information about the company. Plaintiffs further allege that the underwriter defendants were "direct participants" in the alleged wrongdoing by their role in coordinating the offering, drafting disputed offering documents and conducting a due diligence investigation. This is sufficient to bring the complaint within the scope of allegations similar to those sustained by the Ninth Circuit in Software Toolworks....*** Plaintiffs' claims are not limited to accounting fraud and thus, the underwriters' claimed reliance upon certified accounting statements does not bar the maintenance of plaintiffs' claims under 10(b). ***Further, whether the underwriters' reliance upon expertised portions of the financial statements was reasonable as a matter of law is an issue best addressed on summary judgment.***

Murphy, 1996 U.S. Dist. LEXIS 22207, at *21-*23.

In later denying summary judgment, the *Flecker* court noted that the defendants' motive included a "***desire to keep the stock price above $ 25.50 to avoid having to redeem***" certain shares previously issued in a corporate transaction and that the investment banks "***stood to accrue significant fees***." *Flecker*, 1997 U.S. Dist. LEXIS 5329, at *14. The court stated that "primary liability extends to all who make assertions 'in a manner reasonably calculated to influence the investing public'" (*id.* at *23) and then denied summary judgment because:

> [T]he underwriters ... had long standing close connections to Hollywood such that they either knew or should have known that historical revenues were misstated due to changes in the same store sales base, and that revenue projections were ill-founded given the company's earnings track record as influenced by accounting changes which had the effect of adding revenue to Hollywood's balance sheets and prior earnings per share dividends.
>
> * * *
>
> Based on the foregoing, I find that defendants' roles as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under § 10(b).

Id. at *20, *25.

Livent, 174 F. Supp. 2d 144, shows that a valid §10(b)/Rule 10b-5 claim has been alleged here. In *Livent*, purchasers of Livent securities sued Livent's investment bank (CIBC) for violations of 1933 Act §11 and 1934 Act §10(b)/Rule 10b-5. The court held plaintiffs' §11 claims sufficient under a Rule 8 non-fraud pleading standard. The court also sustained the adequacy of the §10(b)/Rule 10b-5 claims – finding the bank's participation in "Livent's fraudulent scheme" was adequately pleaded. The key allegation against CIBC was that CIBC allegedly made a $4.6 million payment to Livent in return for theatrical royalties, which in reality was a secret "bridge" loan, as CIBC had a side agreement from Livent to repurchase the $4.6 advance in six months for $4.6 million, plus interest – the "CIBC Wood Gundy Agreement." This was a fraudulent contrivance because Livent recorded income on the transaction, but did not record the loan. The district court held scienter adequately alleged, stating:

> It does not require an unreasonable inferential leap to conclude, as the Noteholders suggest, that in entering into the bridge loan transaction and secret side agreements with Livent, CIBC, as Livent's investment bankers since 1993, had acquired substantial knowledge of Livent's real financial condition and was aware of Livent's reasons to account for the $ 4.6 million "non-refundable fee" as a revenue-generating investment rather than a repayable loan....
>
> Significantly, according to the complaint, the proceeds from the alleged fraudulent arrangement were reported by Livent as current revenue in its accounts and public registration statements in order [to] [sic] create a false financial basis to reinforce and ensure the success of Livent securities issues intended in part to repay Livent's substantial debt to CIBC.
>
> From these allegations, ***it is fair to infer that in entering into the CIBC Wood Gundy Agreement, CIBC was aware not only that Livent contemplated marketing securities on the basis of public representations of its financial condition that Livent knew to be false, but that CIBC itself subsequently undertook to solicit and sell the very securities whose value incorporated and was affected by the falsehood CIBC itself had conceived with Livent. In this manner, CIBC's participation in Livent's fraudulent scheme went beyond a passive capacity as Livent's investment banker and financial adviser.***
>
> * * *
>
> ***The Noteholders have pled facts suggesting that CIBC became part and parcel of Livent's misleading statements by entering into a loan transaction whose true character and financial implications it agreed not to disclose.*** This financial interest and complicity not only assisted Livent in concealing critical information, it also committed CIBC to similarly withhold the truth from investors with whom it dealt in Livent securities, a commitment that effectively conflicted with any applicable duty CIBC had to disclose material facts in connection with subsequent public sales of such securities affected by the transaction.
>
> ***Rather than generally reflecting the profit motive of any securities dealer, the concrete benefit derived by CIBC from Livent's fraud alleged here was uniquely personal to CIBC in several ways. Only CIBC, as Livent's investment bankers since 1993, is alleged to have had a longstanding, intimate relationship with Livent executives that offered it uncommon opportunity to know of, and play an active role in Livent's, financial affairs. And only CIBC is accused, in furtherance of its own motives, of assisting Livent in structuring and keeping secret the misrepresented CIBC Wood Gundy Agreement. Later, in publicly marketing Livent securities whose value partly depended on the true nature of that agreement, CIBC stood to realize gains particular to it. Beyond the standard fees and commissions associated with any investment bank's sales of securities. CIBC had a higher stake in Livent's public financings. It uniquely benefitted from the***

application of the proceeds of the Notes sales to Livent's considerable debt to CIBC.

Id. at 151-54.

Similarly, in *Cascade*, 840 F. Supp. 1558, the court found that allegations that a securities broker ignored red flags presented a sufficient showing of recklessness to constitute scienter. According to the complaint, the broker, Raymond James, continued to recommend Cascade's stock, ignoring red flags that had been raised, while its

> "[R]eports and statements with respect to [the company], while purporting to be disinterested and objective professional investment analyses, based on in-depth current research, were in reality substantially false and misleading sales brochures which made exaggerated predictions based on unverified and unsupported information for which Raymond James knew, or should have known, it had no reasonable basis."

Id. at 1578. Based on the broker's alleged disregard of red flags, the court held the complaint sufficiently pleaded scienter. "These allegations, if true, may evince severe recklessness or proof of knowing misconduct." *Id.*

Finally, in *Bre-X-Minerals*, 2001 U.S. Dist. LEXIS 4571, the court denied the motion to dismiss by J.P. Morgan based on allegations it participated in a scheme to violate §10(b) and Rule 10b-5 in connection with the securities fraud involving Bre-X. In *Bre-X Minerals*, plaintiffs alleged involvement of J.P. Morgan in assisting Bre-X in structuring fraudulent business transactions, acting as Bre-X's financial advisor, and issuing false analysts' reports -- ignoring "red flags" that Bre-X's claimed assets were falsified. Thus, J.P. Morgan's motion to dismiss was denied.[46]

The CC in this action pleads more wrongful conduct by Lehman vis-à-vis the fraudulent scheme involving Enron and with more specificity than was pleaded in any of the above cases where complaints naming banks as defendants in §10(b)/Rule 10b-5 actions were upheld.

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46 *See also U.S. Envtl.*, 155 F.3d at 112 (while there is no aiding and abetting, where complaint properly alleged defendant to be primary violator because he "'***participated in the fraudulent scheme***,'" noting "***lawyers, accountants, and banks who engage in fraudulent or deceptive*** practices at their client's direction [are] a primary violator"); *Scholnick*, 752 F. Supp. at 1323 & n.9 ("bank ... may still be held liable under Rule 10b-5(a) and 10b-5(c) as a participant in the allegedly fraudulent scheme" and "allegations that Continental was directly involved in perpetrating a fraudulent scheme distinguish" case from situation where bank was only engaging in a "'routine commercial financing transaction'").

Lehman cannot escape liability by claiming that the illicit SPEs and contrived transactions detailed in the CC do not meet the technical definition of a "manipulative device." It is of no moment that certain cases, purportedly building on *Santa Fe*, 430 U.S. 462, appear to have expressly read into §10(b)'s manipulation language a limited and restrictive congressional intent to simply prohibit such "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself." *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979); *see also Schreiber v. Burlington N., Inc.*, 568 F. Supp. 197 (D. Del. 1983), *aff'd*, 731 F.2d 163 (3d Cir. 1984); *In re Commonwealth Oil/Tesoro Petroleum Sec. Litig.*, 484 F. Supp. 253 (W.D. Tex. 1979). ***First***, whether or not the SPEs and transactions are technically "market manipulation" devices is academic even under these very cases. The SPE transactions have been pleaded as both contrivances and deceptive devices – and each was clearly deceptive for they falsified Enron's financial condition – thereby allowing for Rule 10b-5 scheme liability to attach. *See, e.g., Hundahl*, 465 F. Supp. at 1362 ("Few efforts to play with the price of a traded stock can be successful without running afoul of section 10(b)'s other weapon deception.").[47] ***Second***, *Santa Fe* is not so restrictive as defendants and certain courts would make it seem. Indeed, the Court clearly expressed its approval of reading the manipulation language of §10(b) broadly by stating: "No doubt Congress meant to prohibit ***the full range of ingenious devices*** that might be used to manipulate securities prices." *Santa Fe*, 430 U.S. at 477.[48] ***Third***, *Santa Fe*, *Hundahl*, *Schreiber* and *Commonwealth Oil/Tesoro* are all clearly off-point because each case really involved what was merely a state law breach of fiduciary duty cause of action, stemming from a corporate merger or

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[47] Liability under §10(b) and Rule 10b-5 may be imposed for actions either manipulative or deceptive. *See, e.g., Cooper*, 137 F.3d at 624 (Each defendant is a primary actor liable under §10(b) "as long as each defendant committed a ***manipulative*** or ***deceptive*** act in furtherance of the ***scheme***.").

[48] *See also id.* at 475-76 ("Those cases forcefully reflect the principle that '[§]10(b) must be read flexibly, ***not technically and restrictively***' and that the statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities....").

acquisition, dressed up in ill-fitting federal securities law garb.[49] This case is not a mere mismanagement or breach of fiduciary duty case. Without question, it is properly before the court as a federal securities action alleging fraud and deception. No one could plausibly suggest otherwise.

In finding the complaint in *Landry's* did not adequately plead a §10(b) claim against the defendant investment banks there, this court stated:

> Plaintiffs have generally alleged without any particularity that the Underwriters also conducted a comprehensive due diligence investigation into Landry's operations and future prospects in connection with the secondary offering, for which they helped prepare the Registration Statement and Prospectus. They purportedly had access to confidential corporate information and communicated frequently with Fertitta and West about the business, but Plaintiffs fail to provide any details or identify specifically ***what kind of information, when it was conveyed, by whom and to whom.*** Plaintiffs have failed to identify any specific information communicated by document or conversations to the Underwriter Defendants or uncovered by them in their due diligence investigation. Instead they have made general statements that might give rise to speculation, but not particularized facts giving rise to a strong inference that the Underwriters acted with severe recklessness or knowingly to support allegations of fraud under the Exchange Act.

Landry's, slip op. at 66. Obviously, the allegations against Lehman in this case are much more detailed than those found wanting in *Landry's*. The specifics regarding Lehman's top executives pre-funding of LJM2 in 12/99 to enable Enron to complete four critical non-arm's-length fraudulent transactions to artificially boost Enron's 99 reported profits, their further funding of LJM2 during 00-01 which enabled LJM2 to engage in large numbers of non-arm's-length fraudulent transactions with Enron to artificially boost its reported profits and hide billions of dollars in debt while they shared in the lush returns provided by these self dealing fraudulent deals which were looting Enron, ***and*** Lehman's extensive investment banking relationship with Enron (three securities offerings during the Class Period totaling $2.9 billion) distinguishes the pleading here from the one found wanting

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[49] *See, e.g., Santa Fe*, 430 U.S. at 479-80 ("There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5...."); *Schreiber*, 568 F. Supp. at 205 ("This case is the perfect example of a plaintiff, who may have nonfrivolous claims based on state law for breach of contract, tortious interference with contract, breach of fiduciary duties and perhaps even conspiracy, attempting to characterize those state law claims as violations of the federal securities laws."); *Commonwealth Oil/Tesoro*, 484 F. Supp. at 259 (plaintiffs bringing additional claims for "breach of fiduciary duty" stemming from merger activities); *Hundahl*, 465 F. Supp. at 1362 ("[F]ederalism supports this court's definition of manipulation. The court in Santa Fe stated, its reluctance to imply a federal cause of action for a claim 'traditionally relegated to state law.... '[T]he acts of which plaintiffs complain ... are classic breaches of fiduciary duty.").

in *Landry's*. Here, Lehman took affirmative steps to falsify Enron's financial results and further the fraudulent scheme. Nothing resembling this was alleged in *Landry's*.

VI. LEHMAN MADE FALSE AND MISLEADING STATEMENTS IN REGISTRATION STATEMENTS, STATEMENTS TO THE MEDIA AND ANALYSTS REPORTS

Despite Lehman's characterizations, the CC does not "predominantly allege aiding and abetting by Lehman." Mot. at 13. With respect to its analyst statements, Lehman's first line of defense is not that the statements issued were accurate, or not misleading, but that the complaint amounts to "puzzle pleading." Mot. at 25. This is not the case, as demonstrated herein and which is evident from a close reading of the CC. Lehman's second line of defense is that the reports merely reiterate statements made by Enron itself or express opinions and beliefs held by Enron's analysts. However, none of the cases cited by Lehman hold that investment banks cannot (or should not) be liable for the false statements of their analysts. Indeed, these statements were material and Lehman knew them to be false – thus, Lehman should be held liable.

Lehman made false and misleading statements in three Registration Statements issued during the Class Period. Lehman also made numerous false statements in analysts' reports on Enron and in at least one statement to the financial media. These statements are detailed below.

In late 98, Enron's stock was a modest performer, tracking or under-performing its peer index of the stocks of similar companies. To help push Enron's stock higher, on 12/9/98, Lehman Brothers issued a report on Enron, rating Enron a "***Buy***" and stating:

> We are raising our full ***year 1999 estimate to $[1.15]*** ... mainly as a function of ***continued strong growth in Wholesale ... as well as the expectation that Enron Energy Services will swing to EBIT positive by the fourth quarter***. In addition, we are initiating a year 2000 estimate of $[1.30].

¶125

On 4/7/99, Lehman Brothers issued a report on Enron, rating Enron a "***Buy***," forecasting 00 EPS of $1.30 for Enron and stating:

> ***Pullback In Stock Creates Buying Opportunity***
>
> Enron has pulled back roughly 12% ... ***we conclude that the pullback is an opportune time to buy the stock.***

* * *

As investors continue to see rapid growth in wholesale earnings, increased globalization of commercial products and services and we get confirmation of the crossover to profits at EES we expect multiple expansion.

¶143.

On 5/7/99, Lehman Brothers issued a report on Enron. It increased the rating on Enron to a "***Buy***," increased Enron's forecasted 00 and 01 EPS to $1.325 and $1.525, forecasted a 15% five-year EPS growth rate for Enron, and stated:

> Over the last 2-3 years Enron has deftly positioned itself to exploit the emergence of three high growth, long-duration trends.... The payoff from this positioning is just beginning. ***The 1995-97 slowdown hurt investor confidence in this complicated story. The market has only partially restored the stock's premium valuation and is still withholding full judgment on the profitability of energy services, wholesale products and international development.... The key to multiple expansion from present levels is the perception that we are at the inflection point in all three catalysts.***

¶150.

By 5/99-6/99, Enron's stock had moved much higher and was out-performing its peer index, in part, because of the favorable reports Lehman had issued. However, the statements made in the three analysts' reports issued by Lehman between 12/98-5/99 were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets, and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(c) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve."

(e) The value of contracts entered into by EES was grossly overstated by the misuse and abuse of mark-to-market accounting to create huge current-period values on what were, in fact, highly speculative long-term contracts on which Enron was almost certain to lose money. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) It was impossible for EES to enter into energy contracts that extended beyond three years and accurately account for energy costs or savings because of the variables related to these contracts. Enron misused these variables in long-term contracts to manipulate its assumptions – moving the earnings curve to create larger contract values and record higher revenues abusing mark-to-market accounting.

(g) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's WEOS and EES operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.

(h) As a result of the foregoing, the revenue and EPS forecasts being made by and for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses, which would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶155.

On 9/21/99, Lehman Brothers issued a report on Enron which rated Enron a "***Buy***," forecasted 00 EPS to $1.30 and a 15% five-year EPS growth rate for Enron and stated:

> We are raising our full year 1999 estimate to $[1.15] ... as a function of continued strong growth in Wholesale ... as well as the expectation that Enron Energy Services will swing to EBIT positive by the fourth quarter.
>
> * * *
>
> Over the last month Enron has pulled back roughly 12% ... the pullback is an opportune time to buy the stock.

¶170.

On 10/1/99, *CFO Magazine* ran an article on Enron stating:

> How Enron financed its amazing transformation from pipelines to piping hot.
>
> When Andrew S. Fastow, the 37-year-old CFO of Enron Corp., boasts that "our story is one of a kind," he's not kidding. In just 14 years, Enron has grown from a heavily regulated domestic natural-gas pipeline business to a fully integrated global energy company ... much of that growth has been fueled by unique financing techniques pioneered by Fastow.
>
> "When I came here in 1990, Enron was a company with a $3.5 billion market capitalization," says Fastow. "Today, we're around $35 billion, and that's without issuing a whole lot of equity. ***We've increased shareholder value, grown the balance sheet, maintained a stable outlook from the rating agencies, and achieved a low cost of capital.***"
>
> ... [W]hen energy stock analysts ... seek how to explain how Enron has remade itself so completely, they emphasize the "remarkably innovative financing." Says ***Ted A. Izatt, senior vice president at Lehman Brothers Inc. in New York: "Thanks to Andy Fastow, Enron has been able to develop all these difference businesses, which require huge amounts of capital, without diluting its stock price or deteriorating its credit quality-both of which actually have gone up. He has invented a groundbreaking strategy.***"
>
> "Fastow's expert balancing act, in fact, ***has earned him the 1999 CFO Excellence Award for Capital Structure Management***" ....

¶175.

On 1/21/00, Lehman Brothers issued a report on Enron. It rated Enron a "***Buy,***" ***increased*** Enron's forecasted 00 and 01 EPS to $1.38 and $1.59 and forecast a 15% five-year EPS growth rate for Enron. It also stated:

Annual Analyst Conference In Houston A Grand Slam As Enron Wowed Analysts and Investors, Driving Stock Up Nearly 14 Points. Given Our Early Assessment Of Broadband Services And The Emergence Of Retail Energy Services As A Growth Segment, We Are Raising Our Target Price On Enron Shares To $80.

* * *

Enron ... Expects To Carve Out Leading Positions In Bandwidth Markets ....

Retail Energy Services ... Now EBIT Positive. EBIT Contribution For 2000 Raised 50% to 75MM from 50MM. Expect 200MM Contribution In 2001....

¶206.

By 1/21/00, Enron's stock had soared much higher to over $70 per share due, in part, to the favorable reports and statements of Lehman. The statements made in the two analysts' reports issued by Lehman between 9/99-1/00 and in a *CFO Magazine* article, were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(b) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled, including Chewco/JEDI, for which Enron had guaranteed loans to the SPEs and Barclays had provided a phony equity portion, to avoid improper consolidation.

(c) Enron represented that it successfully managed its balance sheet by effectively hedging its merchant investments and placing billions of dollars of non-recourse debt in related but independent parties. In fact, the hedges were illusory, not real, and were largely dependent on the value of Enron's own stock where Enron still was exposed to the risk of its merchant investments. In fact, that debt was ***not*** non-recourse because if Enron's credit rating was downgraded that debt would become recourse as to Enron. This was an extraordinarily dangerous situation for Enron because, in fact, based upon its true financial condition, which was known to its insiders, Enron did not deserve the investment grade credit rating it was carrying and it was in constant and precarious danger of losing that rating when the true structure of its off-balance-sheet partnerships and SPEs became known and its true financial condition was revealed.

(d) In fact, Enron did not deserve an investment grade credit rating and did not have a solid or substantial financial structure because it was inflating the value of its assets by billions of dollars while concealing billions of dollars of debt that should have been on its balance sheet. As a result, Enron's true financial structure was extremely fragile.

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices Enron knew would likely result in a loss, and spending millions of dollars in the short term to purchase purportedly more energy-efficient equipment, a significant portion of which costs Enron was likely never to recover and certainly never to make a profit on. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) The purported prospects for, and actual success of, Enron's EBS division was grossly overstated. ***First***, Enron's broadband network – the so-called Enron Intelligent Network ("EIN") – was plagued by serious and persistent technical difficulties, which prevented it from providing the type of high-speed and high-quality transmission that was indispensable to any hope of commercial success. ***Second***, Enron was encountering significant difficulties in completing the build-out of its broadband network and, as a result, did not have currently, and would not have at any reasonable time in the foreseeable future, a functioning broadband network.

(h) The prospects for future revenue and profits from Enron's EBS operation ***and*** the purported value of that operation to Enron and to its stock price were completely false based on arbitrary and unrealistic assertions without any basis in fact because Enron knew from ***current*** problems in that business, as well as the current state of EBS business, that such revenue and profit forecasts and valuations were unobtainable.

(i) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims of future growth that were being made.

(j) As a result of the foregoing, the revenue and EPS forecasts being made by and for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses that would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶214.

On 4/13/00, Lehman Brothers issued a report on Enron. It rated Enron a "***Buy***" with a $90 price target. It also forecast 00, 01 and 02 EPS of $1.41, $1.60 and $1.85 for Enron and a 15% EPS growth rate and stated:

> Enron reported ... earnings of $0.40 verus $0.34, handily beating consensus expectations .... ***Broadband services broke even due to some dark fiber sales. More importantly, key metrics were met or surpassed on both bandwidth intermediation and content services.... Overall, it was a very strong quarter. The growth engine hit on all cylinders.***
>
> * * *
>
> ***Results Validate Investment Thesis, Stock Remains Strong Buy***

... [O]perations are hitting on all cylinders.

¶231.

On 7/25/00, Lehman Brothers issued a report on Enron. It rated Enron a "***Buy***" and forecast 00, 01 and 02 EPS of $1.45, $1.65 and $1.95 and a 15% five-year EPS growth rate for Enron. It also stated:

- ***Retail EBIT Up 50% Q2/Q1 As Processing Of Rapidly Escalating Contract Base Drives Revenues. New Contracts On Schedule To Double Last Years Level.***
- ***Broadband Benchmark Metrics Ahead Of Schedule. Dramatic Growth In Trading Counterparties....***
- ***... Better Than Expected Results. We Need To Raise Numbers: Likely 2001 $1.65, 2002 $1.95.***

¶254.

By 9/00, Enron's stock had moved to its all-time higher of $90+ per share.

In 10/00, Enron's stock fell and pierced the first equity issuance trigger prices in the LJM2/SPEs which Lehman's executives were funding. Lehman quickly moved to defend Enron and support the stock. On 10/18/00, Lehman Brothers issued a report on Enron. It rated Enron a "***Buy***," with a $90 price target, and forecast 00 and 01 EPS of $1.44 and $1.65 for Enron, as well as a 15% five-year EPS growth rate:

> Wholesale EBIT Jumps 66% ... Market Share Gains Evident In All Areas.
>
> Retail Energy Services EBIT Increased Sequentially From 2Q By 25% .... Contracts Signed Top $4 Billion, Up 64% From 1999.
>
> ***Broadband Operations Continue To Hit Start Up Targets In Both Content Services And Intermediation Markets.***
>
> ***... Enron Just Beginning To Harvest Crop From Seeds Sown On A Global Basis.***

¶270.

On 2/1/01, Lehman Brothers issued a report on Enron. It rated Enron a "***Strong Buy***," ***increased*** Enron's forecasted 01 and 02 EPS to $1.75 and $2.05 and maintained a 20% five-year EPS growth rate for Enron. It also stated:

- ***Conference Served To Highlight Superior Franchise. Earnings Targets Lifted Given Leading Market Positions, Entry Into High-Growth Markets And Redeployment Of Capital. Raising Our Estimates And Target Price.***

* * *

- ***2001 Earnings Target Materially Ahead Of Historical Guidance Of 15%.***
- ***Growth Targets Lifted*** ....

* * *

- ***EES Outlook Robust .... Bandwidth Intermediation Has Transformed From Conceptual To Concrete Providing New Platform For Future Growth.***

> Analyst Conference Gives Broad Overview Of Business Franchise: At a well received presentation, management presented a detailed overview of each segments business model and future growth potential. ***Growth targets were lifted*** .... [N]ew earnings target for 01 was materially ahead of historical guidance of 15% growth. ***Accordingly, we are raising our earnings estimates to $1.75 in 2001 and $2.05 in 2002.***

¶287.

The statements made in the four analysts' reports issued by Lehman between 4/00-2/01 were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets, and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(c) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve." ***Curve manipulations occurred in every quarter in all of Enron's WEOS operation.***

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices Enron knew would likely result in a loss, and spending millions of dollars in the short term to purchase purportedly more energy-efficient equipment, a significant portion of which costs Enron was likely never to recover and certainly never to make a profit on. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) The purported prospects for, and actual success of, Enron's EBS division was grossly overstated. ***First***, Enron's broadband network – the so-called Enron Intelligent Network or EIN – was plagued by serious and persistent technical difficulties, which prevented it from providing the type of high-speed and high-quality transmission that was indispensable to any hope of commercial success. ***Second***, Enron was encountering significant difficulties in completing the build-out of its broadband network and, as a result, did not have currently, and would not have at any reasonable time in the foreseeable future, a functioning broadband network. The EIN – the core of the Enron Broadband Operating System ("BOS") – was doomed to failure due to numerous intractable problems.

(h) To inflate the purported revenues of its EBS operations, Enron was engaging in transactions involving so-called dark fiber – unlit broadband-transmission capability – recognizing significant revenue on these transactions when, in fact, they were artificial contrivances known as "dark-fiber swaps," which involved no real economic substance, but were simply a swap of Enron's dark-fiber capacity with some counterparty for its dark-fiber capacity.

(i) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.

(j) As a result of the foregoing, the revenue and EPS forecasts being made by and for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses, which would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶300.

After Enron was forced to reveal the termination of the Blockbuster VOD joint venture and information became more widely circulated that Enron was having increasing difficulties obtaining payment for electricity sold from the Dabhol power plant by the provincial government, Enron's stock declined. Enron and its banks knew that the price decline in Enron stock was triggering huge stock issuance obligations of Enron to SPEs ***that had been propped up at year-end 00 via restructurings to avoid the recognition and reporting of hundreds of millions of dollars of losses at that time. Thus, Enron and its banks including Lehman, flooded the markets with extremely positive and reassuring information about the fundamentals of Enron's business to try to support***

the stock, while behind the scenes Enron and its bankers worked feverishly to once again find a way to restructure several of the LJM2-related SPEs to avoid any major Enron stock issuance which would have caused Enron's stock price to collapse and lead to the exposure and unraveling of the scheme. ¶305.

By 3/01, Enron's stock was falling lower and had pierced several of the equity issuance trigger prices in the LJM2/SPEs which Lehman's executives were funding. The scheme was in danger of unraveling and Lehman again moved to defend Enron and support the stock price. On 3/12/01, Lehman Brothers issued a report on Enron. It rated Enron a "***Strong Buy***," continued to forecast 01 and 02 EPS of $1.75 and $2.05 and a 20% five-year EPS growth rate for Enron and stated:

- Termination of agreement with Blockbuster ***more bark than bite as delivery platform technically sound*** .... No change in ... fundamental outlook. Overreaction has created attractive entry point. Reiterate 1 – ***Strong Buy, Target Price $100***.

* * *

- ***Enron has proven the technical viability of the platform*** ....

¶303.

On 4/18/01, Lehman Brothers issued a report on Enron. It rated Enron a "***Strong Buy***," increased Enron's forecasted 01 and 02 EPS to $1.80 and $2.10, and forecasted a 20% five-year EPS growth rate for Enron. It also stated:

- ***Enron guided annual street expectations higher while handily beating Q1 consensus estimates. Raising our 01 and 02 estimates to $1.80 and $2.10 respectively. Continue to recommend shares in ENE*** ....

* * *

- ENE reported results of $0.47 vs. consensus expectations of $0.45. Results were driven by Wholesale operations .... ***Retail and Broadband segment activities are rapidly gaining traction***.

- Management raised earnings guidance for 2001 to a range of $1.75-$1.80 ....

- ... ***[W]e are raising our 2001 and 2002 annual estimates to $1.80 and $2.10 respectively***.

¶322.

On 7/26/01, Lehman Brothers issued a report on Enron. It rated Enron a "***Strong Buy***" and ***increased*** Enron's forecasted 01 and 02 EPS to $1.82 and $2.18 while forecasting a 17% five-year EPS growth rate for Enron. It also stated:

- ***Wholesale Continues To Knock The Cover Off The Ball. Retail Earnings Showing Acceleration As Backlog Expands 89% Yr/Yr And 22% Q/Q.***

* * *

- ... ***In Our View, Stock Has Minimal Risk*** ....

Wholesale Reports Another Strong Quarter: Wholesale EBIT grew 93% versus 2Q 2000. ***Operations continue to hit on all cylinders....***

Retail Snowball Beginning To Roll Downhill: Energy Services EBIT grew 30% for the quarter. The leading indicator for anticipated growth is new contracts. For the quarter EES registered $7.2 billion in new contracts. This represents an 89% increase versus 2Q 2000 and a 22% increase over Q1 2001.... With the second quarter in the bank (2Q by far toughest comparison for the year) EES is right on target to double EBIT in 2001. ***We continue to view this segments potential in the context of the proverbial snowball thats been launched downhill.***

* * *

The Silver Lining In The Broadband Storm Cloud: ***Transactions, volumes delivered and customers continue to expand at a prodigious rate.... Transactions registered similarly spectacular gains up 31% versus Q1 and over 33-fold versus last year.***

¶338.

The statements made in the three analysts' reports issued by Lehman between 3/01-7/01, were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets, and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(c) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve." ***Curve manipulations occurred in every quarter in all of Enron's WEOS operation***.

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that artificially boosted its financial results.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices Enron knew would likely result in a loss, and spending millions of dollars in the short term to purchase purportedly more energy-efficient equipment, a significant portion of which costs Enron knew it was likely never to recover and certainly never to make a profit on. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) The purported prospects for, and actual success of, Enron's EBS division was grossly overstated. ***First***, Enron's broadband network – the so-called Enron Intelligent Network or EIN – was plagued by serious and persistent technical difficulties, which prevented it from providing the type of high-speed and high-quality transmission that was indispensable to any hope of commercial success. ***Second***, Enron was encountering significant difficulties in completing the build-out of its broadband network and, as a result, did not have currently, and would not have at any reasonable time in the foreseeable future, a functioning broadband network.

(h) To inflate the purported revenues of its EBS operations, Enron was engaging in transactions involving so-called dark fiber – unlit broadband-transmission capability – recognizing significant revenue on these transactions when, in fact, they were artificial contrivances known as "dark-fiber swaps," which involved no real economic substance, but were simply a swap of Enron's dark-fiber capacity with some counterparty for its dark-fiber capacity.

(i) Enron exacerbated the manipulative and deceptive financial impact of dark-fiber swaps by accounting for the revenue or payment it received from the counterparty that bought dark fiber from Enron ***as current-period revenue*** while, at the same time, Enron was ***capitalizing*** the amounts it paid to that party to buy dark fiber from it on the other side of the swap. Thus, Enron avoided recognizing the expense of that purchase in the current period and instead, amortized it over many, many years – a deliberate accounting manipulation where revenue and expense were mis-matched to inflate current-period results.

(j) The prospects for future revenue and profits from Enron's EBS operation and the purported value of that operation to Enron and to its stock price was completely arbitrary and without any basis in fact because Enron knew from ***current*** problems in that business, as well as the current state of EBS business, that such revenue and profit forecasts and valuations were arbitrary, unreasonable and unobtainable.

(k) Enron's purported growth in broadband intermediation – trading bandwidth access – was neither as successful as claimed nor was the market developing as quickly or in the manner Enron asserted. Enron grossly overstated ***the number of customers or counterparties*** it was doing bandwidth intermediation with by counting as ongoing customers or trading partners entities that had done only a test or an experimental trade and not engaging in any ongoing bandwidth intermediation. Enron grossly overstated the ***number of trades*** being conducted by its broadband intermediation to create the illusion of ever-increasing levels of activity, which it accomplished by splitting up what was, in fact, a single unified trade into five or 10 or even more separate trades, thus creating the false image of increasing trading activity.

(l) Enron was abusing and misusing mark-to-market accounting with respect to its broadband intermediation activity, utilizing this accounting method – together with false assumptions of ultimate value – to create much higher current-period revenue and bottom-line results than were reasonable and attainable had proper accounting techniques been used.

(m) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.

(n) As a result of the foregoing, the revenue and EPS forecasts being made by and for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses, which would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶339.

By 8/01, Enron's stock had fallen further, piercing more and more equity issuance trigger prices in LJM2/SPEs that Lehman's executives were funding. Also, Enron's CEO Skilling resigned. The danger that the scheme was unraveling had increased. Again, Lehman came forward to try to support the stock price and preserve the scheme. On 8/14/01, Lehman Brothers issued a report on Enron. It rated Enron a "***Strong Buy***" and continued to forecast 01 and 02 EPS of $1.82 and $2.18 for Enron. Lehman also ***raised*** to 20% the five-year EPS growth rate for Enron. It also stated:

- Relative Valuation Has Bottomed Out. ***Mounting Evidence Of Major New Markets Will Act As Catalyst To Expansion In Multiple. At A Minimum We Expect Collection Of The 20% Growth In EPS.***

* * *

> ***... Enron has quietly lifted earnings guidance from 15% to 20% over the last 12 months indicating that the present rate is sustainable for the foreseeable future.... Significant traction has been gained. Presentations at the annual analyst meeting and the assumption of a higher profile in quarterly investor briefings lead us to believe that market penetration in these new areas will rekindle interest in the stock.***

¶341.

On 8/15/01, Lehman Brothers issued a report on Enron. The report continued to rate Enron a "***Strong Buy***" and continued to forecast 01 and 02 EPS of $1.82 and $2.18 and a 20% five-year EPS growth rate for Enron. It also stated:

- ***We Don't Expect Any Falloff In Operating Performance Or Unusual Charges To Follow Skilling's Resignation.***
- ***We Would Be A Buyer Of The Stock On Any Significant Weakness .... Rating Remains Unchanged. We Continue To Think At Minimum Investors Will Collect The 20% Growth Rate Over The Next 12 Months.***

¶347.

On 8/17/01, Lehman Brothers issued a report on Enron. It continued to rate Enron a "***Strong Buy***," continued to forecast 01 and 02 EPS of $1.82 and $2.18 and continued to forecast a 20% five-year EPS growth rate for Enron. It also stated:

- ***Last night, we met with Ken Lay and other members of senior management. The Enron machine is in top shape and continues to roll along. We don't see any reason to change our estimates or outlook.***

¶353.

The statements made by Lehman surrounding and after Skilling's resignation in its analysts' reports were false and misleading. First of all, Skilling did not resign for "personal reasons," but rather, because he knew that the scheme to defraud he had been actively participating in was falling apart and about to be exposed, which would result in Enron's stock price completely collapsing and Enron losing its investment grade credit rating and likely going bankrupt. The assurances made that Enron had never been in better shape, its numbers looked good, there were no changes in Enron's earnings outlook, that the Company was very strong and the resignation did not signal any accounting problems or adverse disclosures were all lies as, in fact, Enron's business – which had been propped up through a series of manipulative or deceptive devices and contrivances for years – was now on the verge of complete collapse, due to the accumulated weight of the falsification of its financial results. ¶359.

On 10/23/01, Lehman Brothers issued a report on Enron. The report continued to rate Enron a "***Strong Buy***" and continued to forecast 01 and 02 EPS of $1.82 and $2.18, as well as a 20% five-year EPS growth rate for Enron. It also stated: "***Stock will recover on strength of core business franchise.***" ¶379.

On 10/24/01, Lehman Brothers issued a report on Enron. The report continued to rate Enron a "***Strong Buy***," continued to forecast 01 and 02 EPS of $1.82 and $2.18 for Enron and continued to forecast a 20% five-year EPS growth rate for Enron. It also stated:

> • Ample liquidity exists to handle short term credit needs. $1.7 billion remains on commercial paper backup lines and supplemental revolver.
>
> * * *
>
> • We heard nothing to sway us from our conviction that the stock should be bought aggressively ....

¶381.

The statements issued in 10/01 in analysts' reports by Lehman were false and misleading. The true facts were that Enron's ***operating earnings*** for the 3rdQ 01 as reported were artificially inflated, as detailed herein, in part because of the huge dark-fiber swap transaction with Qwest; the write-offs taken by Enron on 10/16/01 did not clean up its balance sheet – in fact, there were ***billions of dollars of additional overvalued assets still on Enron's balance sheet***; and Enron's shareholder equity was still overstated by $1-$2 billion and Enron's previously reported earnings were grotesquely false as detailed herein. The forecasts of strong 01 operating EPS of $1.80 per share and 02 EPS of $2.15 for Enron were also completely false as there was no basis whatsoever for these forecasts as, in fact, Enron's business internally was collapsing and was riddled with huge operating losses which were actually increasing but continuing to be concealed. In fact, Enron's liquidity was extraordinarily endangered. ¶390.

The statements in the Lehman analysts' reports issued after 12/99 were false for other reasons. After LJM2 was formed and Lehman and/or its top executives had secretly been permitted to invest in LJM2 (ultimately to the tune of over $10 million) after pre-funding LJM2 in 12/99, Lehman continued to issue very positive analyst reports on Enron. Each of these reports contained the below "boilerplate" disclosure:

> Disclosures: A
>
> * * *
>
> Disclosure Legend: A-Lehman Brothers Inc. managed or co-managed within the past three years a public offering of securities for this company.

These boilerplate disclosures were the same as they were before 12/99 – i.e., they did not change after Lehman and/or its top executives became investors in LJM2, providing funding for repeated non-arm's-length fraudulent deals, which created bogus profits for Enron and hid its debt while generating lush returns/profits for Lehman executives from the looting of Enron. The failure to disclose the LJM2 investments of Lehman and/or its top executives made its "boilerplate" disclosure false and misleading and concealed from the market the very significant and serious conflict of interests which Enron and Lehman knew would have cast serious doubts on the objectivity and honesty of Lehman's analyst reports on Enron and disclosed that Lehman or its executives had compromising ties to and serious conflicts of interest regarding Enron.

In addition, Lehman made false and misleading statements in the 2/27/99 Registration Statement used to sell 27.6 million shares of Enron stock at $31.34. The 2/99 Registration Statement was false and misleading due to the incorporation of Enron's 97 10-K and 98 10-Qs that contained Enron's ***admittedly false financial statements for 97-98, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars***, as detailed in ¶¶418-611. The 5/99 and 5/00 Registration Statements used by Lehman to sell Enron's 7.375% and 8.375% notes were similarly false for containing Enron's admittedly false 98 and 99 results and in the case of the 5/00 Registration Statement, Enron's 1stQ00 results as set forth in greater detail in the §11 portion of this brief. The restatement of previously issued financial statements is an admission that they were materially false when issued and Enron's 97-00 results have all been restated in huge amounts. While the Registration Statements included audited annual financial statements, significantly, they also incorporated or included all documents filed pursuant to §13(a) of the 1934 Act prior to the respective offerings, ***including Enron's 10-Qs which contained Enron's admittedly unaudited financial false and misleading unaudited quarter financial results.*** ¶615.[50]

VII. LEHMAN ACTED WITH SCIENTER, *I.E.*, WITH "THE REQUIRED STATE OF MIND" AND HAD MOTIVES AND THE OPPORTUNITY TO DEFRAUD ENRON INVESTORS, AS IT MADE FALSE STATEMENTS, EMPLOYED DECEPTIVE ACTS AND MANIPULATIVE DEVICES AND CONTRIVANCES TO DECEIVE AND PARTICIPATED IN A FRAUDULENT SCHEME OR COURSE OF BUSINESS THAT OPERATED AS A FRAUD OR DECEIT ON PURCHASERS OF ENRON SECURITIES

Lehman can claim neither ignorance nor innocence with respect to the Enron debacle.[51] Lehman had an extensive and close relationship with Enron, during which it gained knowledge of the fraudulent scheme and took affirmative steps to further it. Lehman helped raise over $3.4 billion for Enron via five sales of Enron and Enron-related securities, sales often accomplished via false Registration Statements. Lehman's relationships with Enron were so extensive that ***top officials*** of the bank constantly interacted with the very top executives of Enron, *i.e.*, Lay, Skilling, Causey, McMahon or Fastow, on an almost daily basis throughout the Class Period, discussing Enron's business, financial condition, financial needs and plans, partnerships, SPEs and future prospects. Lehman provided extensive investment banking services to Enron, Lehman helped structure and fund one of Enron's secretly controlled partnership – LJM2 and its SPEs – to facilitate illicit and contrived SPE transactions which falsified Enron's financial statements and misrepresented its financial condition. As a result of Lehman's participation in the fraudulent scheme, it received huge underwriting and consulting fees, interest payments, commitment fees and other payments from Enron and related entities. Lehman's top executives were also permitted to invest $10 million in Enron's lucrative LJM2 partnership as a reward to them for Lehman's participation in this fraud,

50 While Lehman Brothers may be able at trial to establish a defense to liability for these expertised, *i.e.*, certified financial statements, in light of the CC's allegations that Lehman Brothers knew those annual certified financial statements were false, they may not do so now at the 12b-6 stage. *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23.

51 Because Lehman sold Enron securities pursuant to false and misleading registration statements, it faces 1933 Act §11 liability as to which no scienter is required. *See* IV *supra*.

allowing them ***to directly profit from the looting of Enron*** that took place via the repeated non-arm's-length fraudulent LJM2/SPE transactions with Enron, transactions which Lehman and its top executives knew could continue only if Enron's stock continued to trade at high prices – above the so-called equity issuance trigger prices in the LJM2/SPE deals. ¶¶618-621, 762-772. Top Lehman executives also "pre-funded" LJM2 on 12/2/299 with $1.5 million, which funded four critical 99 year-end deals to create phony profits for, and hide debt of, Enron. Lehman executives continued to fund LJM2 during 00-01, with more secret equity money, which enabled LJM2 to engage in repeated non-arm's-length deals with Enron to artificially boost its profits by hundreds of million of dollars while hiding billions of debt – deceiving the securities markets. During 00-01, Lehman executives enjoyed the lush profits flowing from the looting of Enron to the LJM2 investors – including Lehman executives. At the same time, Lehman's ***securities analysts were issuing extremely positive – but false and misleading – reports on Enron, extolling Enron's business success, the strength of its financial condition and its prospects for strong revenue and earnings growth, helping to push Enron's stock higher. As alleged in the CC, this is intentional participation in the falsification of Enron's fraudulent statements and thus in the fraud.***

In evaluating the adequacy of the scienter allegations against Lehman, it is important to keep in mind the different liability theories being alleged under §10(b) and Rule 10b-5 against Lehman. While the CC alleges that Lehman made false and misleading statements in registration statements and analyst reports, Lehman's liability is ***not limited*** to those allegedly false and misleading statements. The CC also alleges Lehman's liability for ***its*** conduct in participating in the scheme to defraud or course of business that operated as a fraud and deceit on purchasers of Enron publicly traded securities. This distinction is important because ***if*** the complaint fails to adequately allege the falsity of Lehman's own statements ***or*** Lehman's knowledge or reckless disregard of the falsity of those statements, the CC may still adequately allege that Lehman knowingly or recklessly employed deceptive acts or participated in the fraudulent scheme or course of business ***or vice versa***. These are distinct liability theories – one based on ***statements*** – the other based on ***conduct***, which can result in liability, either in combination or separately.

It is clear that for §10(b) or Rule 10b-5 liability to attach under either theory, ***scienter must be present***, *i.e.*, either intentional or reckless conduct. Thus, with respect to Lehman's alleged deceptive acts and participation in the fraudulent scheme or course of business, scienter would be adequately pleaded if the facts pleaded give rise to a "strong inference" that in committing those acts, Lehman acted with the "required state of mind," *i.e.*, it acted intentionally or recklessly. This would be so even if Lehman had no knowledge that its ***own statements*** in analysts' reports or Registration Statements were false and misleading, for as this Court has recognized, ***it is not necessary that a defendant have made a false statement to be liable under §10(b) or Rule 10b-5***. *Landry's*, slip op. at 9 n.12.

A defendant may be held liable for participating in a scheme to defraud if it has knowledge of the scheme and commits manipulative or deceptive acts in furtherance of it.[52] *See BMC Software,* 183 F. Supp. 2d at 885-86, 905, 915; *Cooper*, 137 F.3d at 624 ("Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme"); *First Jersey*, 101 F.3d at 1471; *Lemmer v. Nu-Kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 U.S. Dist. LEXIS 13978, at *26-*27 (N.D. Tex. Sept. 6, 2001); *Health Mgmt.*, 970 F. Supp. at 209; *Adam*, 884 F. Supp. at 1401; *ZZZZ Best*, 864 F. Supp. at 967-72. Recklessness satisfies the scienter requirement. *See Nathenson*, 267 F.3d 400.

Whether a defendant has engaged in a scheme to defraud (or whether the complaint has sufficiently alleged so) should be determined by viewing the defendant's conduct (or the allegations of the complaint) ***as a whole***. *See Blackie*, 524 F.2d at 903 n.19 (for scheme liability, complaint should not be fragmented into individual, isolated acts but should be considered as a single overall scheme to defraud); *cf. Affiliated Ute Citizens*, 406 U.S. at 151 ("Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and

[52] We stress that the existence of the scheme and the banks' participation in it are highly factually-dependent questions that either should not be resolved on a motion to dismiss or should be resolved in favor of the plaintiffs. *Richardson*, 451 F.2d at 40 (Whether the defendant's conduct amounts to a manipulative or deceptive act "depends upon the facts and circumstances developed at trial.").

restrictively, but flexibly to effectuate its remedial purposes'") (quoting *Capital Gains Research*, 375 U.S. at 186).

It is axiomatic that with respect to scheme liability, a defendant may be liable for participating in a scheme even if it did not interact with all the other participants, was unaware of the identity of each of the other participants, did not know about the specific roles of the other participants in the scheme, did not know about or participate in all of the details of each aspect of the scheme, or joined the scheme at a different time than the other participants. *See United States v. Craig*, 573 F.2d 455, 483-84 (7th Cir. 1977) (scheme to defraud under mail fraud statute); *United States v. Elam*, 678 F.2d 1234, 1246 (5th Cir. 1982) (conspiracy); *United States v. Alvarez*, 625 F.2d 1196, 1198 (5th Cir. 1980) (en banc) (conspiracy).[53]

Scheme to defraud and conspiracy liability theories, while they share some similarities, are separate and distinct liability theories and the elements of the two theories are not identical. *See United States v. Read*, 658 F.2d 1225, 1239 (7th Cir. 1981). Most significantly, a conspiracy requires an ***agreement*** and imposes liability based on the act of joining that agreement as well as on acts taken in furtherance of the conspiracy. *See id.* at 1240. A scheme to defraud, on the other hand, requires neither an agreement nor the joining of a scheme; liability is imposed based on using the mails or securities exchanges to further the fraudulent scheme. *See id.* Therefore, if knowledge of all the other details, activities, and participants in a scheme is not essential for conspiracy liability, which requires an agreement among the participants, then such knowledge certainly is not necessary for scheme liability, which does not require an agreement.

A defendant who participates in a scheme to defraud is liable for the damages caused by all of the acts taken by the participants in the scheme in furtherance of the fraud. *See In re Software*

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53 As the Supreme Court has stated with respect to conspiracy liability: "[T]he law rightly gives room for allowing the conviction of those discovered [to be participants in a conspiracy] upon showing sufficiently the essential nature of the plan and their connections with it, without requiring evidence of knowledge of all its details or of the participation of others. Otherwise ... conspirators would go free by their very ingenuity." *Blumenthal v. United States*, 332 U.S. 539, 557 (1947).

Plaintiffs cite these conspiracy cases not because they allege conspiracy liability here – they do not. However, since scheme liability is expressly provided for by the language of §10b/Rule 10b-5 and the extent of the scheme liability is ***at best as broad*** as conspiracy liability would be, these conspiracy cases are useful in determining the parameters of scheme liability.

Toolworks Sec. Litig., 50 F.3d 615, 627-29 & n.3 (N.D. Cal. 1995) (participants in scheme to defraud can be liable for statements made by others in the scheme); *Adam*, 884 F. Supp. at 1401 (same); *ZZZZ Best*, 864 F. Supp. at 968-72 (same); *SEC v. Nat'l Bankers Life Ins. Co.*, 324 F. Supp. 189, 194-95 (N.D. Tex. 1971), *aff'd*, 448 F.2d 652 (5th Cir. 1971) (same).[54] A scheme to defraud is a unitary violation, such that the plaintiff need not prove transaction causation with respect to any particular misrepresentations or omissions or other components of the scheme. *See Shores*, 647 F.2d at 469, 472 ("The concept of [a] scheme to defraud satisfies the requirement of 'transaction causation.' ... It has as its core objective that the potential victim engage in the transaction for which the scheme was conceived."); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974); *ZZZZ Best*, 864 F. Supp. at 973 (to satisfy reliance requirement for scheme liability, it need only be shown that market relied on overall fraudulent scheme rather than on individual statements or omissions).

Nat'l Bankers Life, 324 F. Supp. 189 – a pre-*Central Bank* case – recognized that participants in a scheme to defraud under Rule 10b-5 may be held liable for all of the acts involved in the scheme. In that case, the SEC brought an action against 28 defendants for participating in a conspiracy to defraud and a scheme to defraud. *See id.* at 193-94. Since this was a pre-*Central Bank*

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[54] Similarly, under the federal mail fraud statute, 18 U.S.C. §1341, participants in a scheme to defraud are liable for the acts of the other participants in the scheme, even if the others committed the key acts. *See, e.g., United States v. Humphrey*, 104 F.3d 65, 70 (5th Cir. 1997); *United States v. Lothian*, 976 F.2d 1257 (9th Cir. 1992); *United States v. Maxwell*, 920 F.2d 1028, 1035 (D.C. Cir. 1990); *United States v. Lanier*, 838 F.2d 281, 284 (8th Cir. 1988); *United States v. Wiehoff*, 748 F.2d 1158, 1161 (7th Cir. 1984); *Craig*, 573 F.2d at 483-84.

This principle also applies to conspiracy liability. *See Read*, 658 F.2d at 1231-40 (conspirator liable for acts of co-conspirators even if statute of limitations has run on its own acts); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967) (conspiracy); *id.* at 267 n.2 (conspirator liable even for acts of co-conspirators occurring after its own last act); *In re Nissan Motor Corp. Antitrust Litig.*, 430 F. Supp. 231, 233 (S.D. Fla. 1977) (conspirator liable even for acts of co-conspirators occurring prior to its joining conspiracy).

The common law also recognized this with respect to contributing tortfeasors or persons acting in concert, such as through a conspiracy or scheme. *See Restatement (Second) of Torts* §875 (1979) ("Each of two or more persons whose tortious conduct is a legal cause of a single and indivisible harm to the injured party is subject to liability to the injured party for the entire harm."); *id.* at §876(a) ("For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him...."); *id.* at §876, Comment a ("Whenever two or more persons commit tortious acts in concert, each becomes subject to liability for the acts of the others, as well as for his own acts.").

case, the SEC did not focus on the difference between conspiracy and scheme liability, treating them essentially as synonymous, and the court did not focus on the difference between primary violators and aiders and abettors, instead assuming that the SEC intended to hold the co-schemers liable as aiders and abettors rather than as primary violators. *See id.* at 195. But although the court considered the scheme liability of the defendants under the rubric of aiding and abetting, it could just as well have considered it under the rubric of primary liability. Nevertheless, the important point is the court's recognition that co-schemers may be liable for all aspects of the scheme:

> In the narrow sense, a defendant could have aided and abetted a particular fraudulent act under 10(b)(5)(2) or 10(b)(5)(3) or use of a particular device under 10(b)(5)(1) and thus be liable for only the results of that specific violation. In the more expansive sense, a defendant could have aided and abetted a ***general scheme*** under 10(b)(5)(1) and ***thus be liable for the results of all aspects of the scheme*** (assuming the scheme was a broad one).

Id.

As noted above, after *Central Bank*, a defendant may be held liable for participating in a scheme to defraud if it has knowledge and commits manipulative or deceptive acts in furtherance of it. Therefore, bringing the principle recognized in *Nat'l Bankers Life* in line with *Central Bank*, if a defendant with knowledge of a broad or general scheme to defraud commits manipulative or deceptive acts in furtherance of broad aspects of the scheme, the defendant may be held liable for all of the results of the scheme. *See generally Central Bank*, 511 U.S. at 191 ("In any complex securities fraud, moreover, there are likely to be multiple violators....").[55]

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[55] In *Lemmer*, 2001 U.S. Dist. LEXIS 13978, the plaintiffs alleged a scheme to defraud and sought to hold certain of the alleged participants liable for the fraudulent acts of the other participants in the scheme. *See id.* at *25. The court held that, ***on the particular facts of the case before it***, such attribution could not be made because the plaintiffs had failed to sufficiently allege either the existence of the scheme or the defendants' manipulative or deceptive acts in furtherance of it. *See id.* at *26-*27. For example, the sole allegations as to the existence of the scheme were "vague, general, and unsupported by specific details that might support a strong inference of such a scheme." *Id.* at *26. In addition, the complaint made ***no*** allegations regarding the manipulative or deceptive acts of nearly all the defendants in furtherance of the scheme. *See id.* The scheme allegations of the *Lemmer* complaint consisted entirely of the following provision:

> Each of the defendants actually knew the allegedly false statements about Nu-kote's business and future prospects were false and misleading when made. Each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of Nu-kote stock, including false and misleading statements and/or concealed material, adverse facts. The fraudulent scheme and course of business: (a) deceived the investing public regarding Nu-kote's

In evaluating the CC's allegations that Lehman employed acts and manipulative or deceptive devices and contrivances, and participated in a fraudulent scheme and course of business, it is important to focus on the ***type*** of actions Lehman has alleged to have committed in furtherance of the alleged fraudulent scheme or course of business.

In this regard, Lehman participated in the pre-funding of LJM2 on 12/22/99 – putting up $1.5 million ***before*** LJM2 was fully formed or funded and putting up much more money than their allocated share of LJM2's equity was or would have been – to finance four phony, non-arm's-length year-end 99 deals with Enron, ***which were then all quickly unwound during 00, with huge returns to these LJM2 pre-funders. This is obviously intentional conduct – it was not and could not have been the result of negligence or inadvertence.***

With respect to Lehman's liability under §10(b) and Rule 10b-5 for its own false and misleading ***statements***, it is necessary for the complaint to plead specific facts raising a "strong inference" that Lehman knew the statements were false or acted in reckless disregard of their truth or falsity. However, in this regard, Lehman's alleged conduct its participating in the fraudulent scheme or course of business remain highly relevant, for those ***acts*** themselves can show Lehman's ***knowledge*** of the falsity – or its reckless disregard for the truth or falsity – of the ***statements*** it was making.

> products and business; (b) deceived the commercial markets regarding Nu-kote's success in integrating the Pelikan acquisition and developing new products; (c) created false financial results during the 4thQ of FY96 and the first three quarters of FY97; and (d) caused plaintiff and other members of the Class to purchase Nu-kote stock at inflated prices.

Id. at *26-*27. On these facts, the *Lemmer* court concluded that "[a]llowing such general, unsupported allegations of a fraudulent scheme, without any details that support a strong inference of such a scheme such as acts of participation by each of the Defendants, would vitiate the particularity requirements of the PSLRA." *Id.* at *27. In so finding, the court distinguished *Cooper*, 137 F.3d 616, in which the complaint was found to contain sufficient allegations of the defendant's participation in a scheme to defraud to support liability on that basis. *See* 2001 U.S. Dist. LEXIS 13978, at *26.

Unlike the complaint in *Lemmer*, and like the complaint in *Cooper*, the CC in this action includes specific, detailed, and substantial allegations concerning both the existence of a scheme to defraud and the banks' participation in it through numerous manipulative and deceptive acts, as set forth above.

Again, Lehman's executives' involvement in LJM2 – where they helped pre-fund LJM2 on 12/22/99 with $1.5 million, to enable LJM2 to engage in non-arm's-length fraudulent transactions with Enron in the last days of 99 to create bogus income and hide debt, shows that Lehman ***knew (or recklessly disregarded)*** that Enron's financial statements were false, its financial condition was being misrepresented and that its purported business success was not due to strong business conditions or the skill of its managers and the success of their risk management and hedging techniques but rather to non-arm's-length fraudulent financial transactions with controlled entities. Lehman knew its executives were investors in LJM2 and that during 00-01 LJM2 was constantly engaging in transactions with Enron where Enron insiders (Fastow, Kopper and Glisan) were on ***both sides*** of the transactions because the LJM2 partnership was extraordinarily lucrative – providing huge and indeed excessive returns to LJM2's investors, including Lehman's executives – returns Skilling now says were only possible if the transactions were non-arm's-length and fraudulent, *i.e.*, due to the looting of Enron. In this regard, Skilling's recent testimony to the SEC that – upon reviewing LJM2 documents that the returns the LJM2 investors got – ***it was immediately apparent to him*** – (a man who claims to lack financial sophistication) – that those returns from the deals LJM2 was getting via SPE deals with Enron were so huge – ***so lavish – that they had to be due to non-arm's-length fraudulent transactions is key***. According to *The New York Times*:

> ***Enron Ex-Chief Said to Voice Suspicion of Fraud***
>
> Jeffrey K. Skilling, the former chief executive of Enron, has told investigators that the top-flight financial returns that investors made from a partnership that did business with the company could have been achieved only if the corporation was defrauded, according to documents and people involved in the case.... He indicated to the S.E.C. and to investigators for a special committee of the Enron board that such returns – which were as high as 2,500 percent in one transaction – could not have been achieved through arms-length transactions, according to these people and investigative notes.
>
> When shown records that laid out the details of the financial returns during his testimony several months ago before the S.E.C., ***Mr. Skilling was said to have grown agitated as he described his opinion of the information. Had he known the magnitude of the profits, Mr. Skilling was said to have told the regulators, he would have immediately summoned Enron executives involved in the dealings and given them 24 hours to justify such outsize results.***

The New York Times, 4/24/02.[56]

What does this testimony say about the knowledge of a financially sophisticated bank like Lehman which was reaping the very fruits of those fraudulent non-arm's-length LJM2 transactions as they and Fastow looted Enron for their own gain!

These favored investors in LJM2, ***like the Lehman executives***, actually ***witnessed*** and ***benefitted from*** a series of extraordinary payouts from the LJM2-controlled SPEs – securing hundreds of millions of dollars in distributions from the SPEs to LJM2 and ***then huge returns/profits to themselves from LJM2 – cash generated by the illicit and contrived transactions Enron was engaging in with the LJM2 SPEs to falsify its financial results***. Thus, Lehman ***was not only a knowing participant in the Enron scheme to defraud, it was a direct economic beneficiary of it and the looting of Enron***. ¶¶31, 649.

Assuming these allegations are true, then how was it possible for Lehman to be making the kind of extremely positive statements about the strong economic performance of Enron's various businesses, the skill and talent of its management team, the strength of its core businesses, as well as forecasting strong continuing earnings growth over the next several years unless Lehman was deliberately lying or had simply closed its eyes in the blind pursuit of mammon.

Livent, 174 F. Supp. 2d 144, shows that scienter has been well alleged here. In *Livent*, purchasers of Livent securities sued Livent's commercial and investment bank (CIBC) for violations of 1933 Act §11 and 1934 Act §10(b)/Rule 10b-5. The court also sustained the adequacy of the §10(b)/Rule 10b-5 claims – finding the bank's participation in "***Livent's fraudulent scheme***" was adequately pleaded. The key allegation was that CIBC made a $4.6 million payment to Livent in return for theatrical royalties, which in reality was a secret "bridge" loan to Livent, as CIBC had a secret side agreement from Livent to "repurchase" the advance in six months for $4.6 million, plus interest – the "CIBC Wood Gundy Agreement." This was a fraudulent contrivance because Livent

[56] If poor Mr. Skilling, who has publicly protested his lack of financial sophistication could immediately figure out ***LJM2 was a vehicle to defraud Enron, then it is a reasonable inference that sophisticated bankers, like Lehman, who were actually reaping these fantastic returns, knew it all along***.

recorded income on the transaction, but did not record the loan. The district court held scienter was adequately alleged, stating:

> It does not require an unreasonable inferential leap to conclude, as the Noteholders suggest, that in entering into the bridge loan transaction and secret side agreements with Livent, CIBC, as Livent's investment bankers since 1993, ***had acquired substantial knowledge of Livent's real financial condition and was aware of Livent's reasons to account for the $ 4.6 million "non-refundable fee" as a revenue-generating investment rather than a repayable loan....***
>
> Significantly, according to the complaint, the proceeds from the alleged fraudulent arrangement were reported by Livent as current revenue in its accounts and public registration statements in order ***[to] [sic] create a false financial basis to reinforce and ensure the success of Livent securities issues intended in part to repay Livent's substantial debt to CIBC.***
>
> From these allegations, ***it is fair to infer that in entering into the CIBC Wood Gundy Agreement, CIBC was aware not only that Livent contemplated marketing securities on the basis of public representations of its financial condition that Livent knew to be false, but that CIBC itself subsequently undertook to solicit and sell the very securities whose value incorporated and was affected by the falsehood CIBC itself had conceived with Livent. In this manner, CIBC's participation in Livent's fraudulent scheme went beyond a passive capacity as Livent's investment banker and financial adviser.***
>
> * * *
>
> ***The Noteholders have pled facts suggesting that CIBC became part and parcel of Livent's misleading statements by entering into a loan transaction whose true character and financial implications it agreed not to disclose.*** This financial interest and complicity not only assisted Livent in concealing critical information, it also committed CIBC to similarly withhold the truth from investors with whom it dealt in Livent securities, a commitment that effectively conflicted with any applicable duty CIBC had to disclose material facts in connection with subsequent public sales of such securities affected by the transaction.
>
> ***Rather than generally reflecting the profit motive of any securities dealer, the concrete benefit derived by CIBC from Livent's fraud alleged here was uniquely personal to CIBC in several ways. Only CIBC, as Livent's investment bankers since 1993, is alleged to have had a longstanding, intimate relationship with Livent executives that offered it uncommon opportunity to know of, and play an active role in Livent's, financial affairs. And only CIBC is accused, in furtherance of its own motives, of assisting Livent in structuring and keeping secret the misrepresented CIBC Wood Gundy Agreement. Later, in publicly marketing Livent securities whose value partly depended on the true nature of that agreement, CIBC stood to realize gains particular to it. Beyond the standard fees and commissions associated with any investment bank's sales of securities. CIBC had a higher stake in Livent's public financings. It uniquely benefitted from the application of the proceeds of the Notes sales to Livent's considerable debt to CIBC.***

Id. at 151-54.

The conduct of Lehman, as alleged here, far exceeds that of CIBC in *Livent*, which was sufficient for the court there to conclude that CIBC's scienter, as well as its participation in Livent's "fraudulent scheme" was adequately pleaded.

As a result of its involvement with Enron, Lehman obtained detailed information concerning the actual financial condition of Enron throughout the Class Period and knew that the actual condition of Enron's business, its finances and its financial condition was far worse than was being publicly disclosed by Enron, or as described or disclosed in each of Lehman's analyst reports on Enron. Thus, Lehman knew (or was reckless in not knowing):

(a) Enron had set up LJM2 at year-end 99 so that Enron could use SPEs funded by that vehicle to engage in non-arm's-length self-dealing transactions which would enrich the investors in the LJM2 partnership – including Lehman – and, at the same time, permit Enron to generate artificial profits and conceal its true debt level by moving billions of dollars of debt off its balance sheet and onto the balance sheet of LJM2's SPEs;

(b) Enron had entered into a number of transactions with secretly controlled SPEs being funded by LJM2 which Lehman was funding – while administering its affairs – to finance these transactions, which would require Enron to issue millions of shares of Enron common stock. If Enron's common stock fell below trigger prices ranging from \$83-\$19 per share, not only would Enron be required to issue huge amounts of additional stock, also, the debt of the SPEs with which Enron was doing business would not, in fact, be non-recourse to Enron as represented but, in fact, would become and be recourse to Enron if, as and when Enron's credit rating was lowered – something Lehman knew would occur if, as and when Enron's true financial condition became public or became known to the rating agencies.

Lehman also acted as an underwriter in five securities offerings, for Enron raising \$3.4 billion for Enron and related entities.

Of course, motive and opportunity remain relevant considerations in determining if scienter has been adequately alleged. Lehman had very strong economic motives to employ acts and contrivances to deceive and participate in the fraudulent scheme or course of business. Throughout the Class Period, Lehman was pocketing millions of dollars a year in investment banking fees by participating in the Enron scheme ***and huge returns on its executive secret investment in LJM2*** – returns created by the looting of Enron via the very manipulative or deceptive acts and contrived transactions between Enron and LJM2 entities which Lehman was financing to defraud and stood to ***continue*** to collect these huge amounts going forward, so long as it helped perpetuate the Enron Ponzi scheme, ¶767.

Lehman was willing to engage and participate in the fraudulent scheme and course of business because its participation created enormous profits ***for Lehman as long as the Enron scheme continued in operation*** – something that Lehman was in a unique position to cause.

No one had a greater motive than those who were secretly looting Enron, *i.e.*, Fastow and Enron's banks and bankers, to deceive investors as to the true state of Enron's financial condition and business prospects because that deceit was central to preserving Enron's access to public capital markets and keeping Enron's stock price inflated because that inflated stock price was the key to supporting non-arm's-length fraudulent LJM transactions with SPEs that were enriching the banks and bankers. The involvement of Lehman in LJM2 was, bluntly put, a reward – a payoff – for its participation in the fraudulent scheme and one that they would continue to profit ***from as long as the Enron Ponzi scheme could be continued*** – generating huge returns for them as secret private equity investors in LJM2 ***which returns were only possible because the transactions that were being constantly entered into with Enron were non-arm's-length and fraudulent – generating bogus profits for Enron while hiding debt and at the same time generating excessive returns for LJM2 with Fastow, Enron's CFO, operating the levers on both sides of all deals.***

Simply put, Lehman which was involved in LJM2, was engaged in looting Enron for its own personal profit. This gave them a tremendous motive to keep Enron afloat and its stock price inflated so that Enron could consistently go back, with their help, to the capital markets to raise capital to keep the Enron Ponzi scheme going. While the banks may now whine about the losses they claim to have suffered when the Enron Ponzi scheme collapsed, they were secretly rubbing their hands in glee during the years that the scheme succeeded and Enron was being looted while being propped up with public money which was flowing into their dirty hands and then their own deep pockets.

Then add to this mix the huge investment banking fees Lehman was extracting from Enron by helping to keep the Ponzi scheme going, either lending money to Enron to liquify Enron or by raising money from the public to liquify Enron, and then using money raised from public investors to repay itself or other banks. ***These were huge securities offerings*** – $500 million in notes sold in 7/98; $870 million raised from the sale of common stock in 2/99; $500 million raised for Enron via the sale of 7.375% notes in 5/99; $500 million raised for Enron via the sale of 7.875% notes in 5/00; and $1 billion raised from the sale of Osprey notes in 7/01. While the investment banking fees to be gained in an isolated securities offering by an investment bank which does not have an ongoing relationship with the issuer may not, in and of itself, create sufficient weight to show a motive to defraud – surely the size and the continuity of the investment banking fees here, especially when combined with the fees being obtained from the bank's commercial activities in the context of the bank's secret involvement in the LJM2 partnership must be given great weight vis-à-vis motive. After all, a complaint is to be construed in its entirety and the inferences are to be drawn in favor of the plaintiff.

Thus, on top of its executive involvement in LJM2, Lehman had ***constant access*** to Enron's top executives and Enron's financial records, finances, plans, etc. ***in connection with a series of large ongoing major commercial loans and/or lending commitments, as well as several securities offerings between 98 and 01***! Thus, this is ***not*** a situation of alleging scienter against a bank that had only isolated contact with an issuer in the context of doing limited due diligence in connection with a single or even periodic securities offerings. Here, what is alleged, is (i) ***constant access by the bank's investment banking operator which was selling securities of the company to the public and was also constantly issuing analyst reports about the company to the public; and (ii) while the bank's executives were secretly investing in a huge partnership (LJM2) which was doing non-arm's-length fraudulent transactions with Enron which were generating hundreds of millions of dollars of phony profits, while hiding billions of dollars of Enron's actual debt and generating massive returns to the bank, as its secret investment in the LJM2 partnership benefitted from the looting of Enron.***

In interacting with Enron, Lehman functioned as an unified entity. There was no so-called "Chinese Wall" to seal off the Lehman securities analysts from the information which Lehman obtained rendering commercial and investment banking services to Enron. Alternatively, even if some restrictions on the information made available to Lehman's securities analysts existed, those unilateral and self-serving actions are insufficient to prevent imputation of all knowledge and scienter possessed by the Lehman legal entity, as its knowledge and liability in this case is determined by looking at Lehman as an overall legal entity. ¶764.[57]

Knowledge is imputed to a corporation through its employees and agents via *respondeat superior*. To determine the *mens rea* of a corporation, courts not only consider the actual knowledge of each individual employee, but also aggregate each employee's knowledge under a theory referred to as the "Collective Knowledge Doctrine."

The Fifth Circuit has clearly found in favor of applying traditional notions of *respondeat superior* to impute knowledge to a corporate defendant in both civil and criminal proceedings. *Standard Oil Co. v. United States*, 307 F.2d 120, 127 (5th Cir. 1962). Furthermore, "'[w]hether the corporate officer or agent was possessed of actual knowledge of facts is ordinarily (a question) of fact for the jury. Whether the knowledge of, or notice to, an officer of a corporation is to be imputed to the corporation is a question of law for the court.'" *Am. Standard Credit, Inc. v. Nat'l Cement Co.*, 643 F.2d 248, 270 (5th. Cir. 1981).

While *Standard Oil* does not limit the imputation of knowledge to high-level employees,[58] subsequent Fifth Circuit cases do appear to focus much more on the employee's position in the company. *See In re Hellenic Inc.*, 252 F.3d 391, 395 (5th Cir. 2001) ("[W]e have observed that the question of 'privity or knowledge must turn on the facts of the individual case,' stating that a

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57 Any claimed "Chinese Wall" cannot provide a defense at the motion to dismiss stage. *Cooper*, 137 F.3d at 628-29.

58 ***"[N]o contention is made that 'knowledge' can be acquired only through supervisory or executive personnel.*** On the contrary, while status of the actor in the corporate hierarchy might well have decisive significance in determining the question we later discuss concerning the intention to benefit the corporation, the corporation may be criminally bound by the acts of subordinate, even menial, employees.... ***Likewise, no contention is, or can at this late date, be made that mere violation of instructions would shield the corporation from criminal responsibility for actions which its agents have taken for it.***" *Standard Oil*, 307 F.2d at 127 (emphasis added).

corporation 'is charged with the privity or ***knowledge of its employees when they are sufficiently high on the corporate ladder***.' We have further explained that privity or knowledge is 'imputed to the corporation when the employee is an executive officer, manager or superintendent whose scope of authority includes supervision over the phase of the business out of which the loss or injury occurred.'") (footnotes omitted).

The First Circuit has detailed the Collective Knowledge Doctrine and its justifications as such:

> [Defendant] Bank contends that the trial court's instructions regarding knowledge were defective because they eliminated the requirement that it be proven that the Bank violated a known legal duty. It avers that the knowledge instruction invited the jury to convict the Bank for negligently maintaining a poor communications network that prevented the consolidation of the information held by its various employees. ***The Bank argues that it is error to find that a corporation possesses a particular item of knowledge if one part of the corporation has half the information making up the item, and another part of the entity has the other half.***
>
> ***A collective knowledge instruction is entirely appropriate in the context of corporate criminal liability***. *Riss & Company v. United States*, 262 F.2d 245, 250 (8th Cir. 1958); *Inland Freight Lines v. United States*, 191 F.2d 313, 315 (10th Cir. 1951); *Camacho v. Bowling*, 562 F. Supp. 1012, 1025 (N.D. Ill. 1983); *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. 730, 738-39 (W.D. W.Va. 1974); *United States v. Sawyer Transport, Inc.*, 337 F. Supp. 29 (D. Minn. 1971), *aff'd*, 463 F.2d 175 (8th Cir. 1972). The acts of a corporation are, after all, simply the acts of all of its employees operating within the scope of their employment. The law on corporate criminal liability reflects this. *See, e.g., United States v. Cincotta*, 689 F.2d 238, 241, 242 (1st Cir.), *cert. denied*, 459 U.S. 991, 103 S. Ct. 347, 74 L. Ed. 2d 387 (1982); *United States v. Richmond*, 700 F.2d 1183, 1195 n.7 (11th Cir. 1983). ***Similarly, the knowledge obtained by corporate employees acting within the scope of their employment is imputed to the corporation***. *Steere Tank Lines, Inc. v. United States*, 330 F.2d 719, 722 (5th Cir. 1964). Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. ***The aggregate of those components constitutes the corporation's knowledge of a particular operation. It is irrelevant whether employees administering one component of an operation know the specific activities of employees administering another aspect of the operation***:
>
> > ***"[A] corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual who then would have comprehended its full import. Rather the corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly***."
>
> *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. at 738. Since the Bank had the compartmentalized structure common to all large corporations, ***the court's collective knowledge instruction was not only proper but necessary***.

United States v. Bank of New England, N.A., 821 F.2d 844, 855-56 (1st Cir. 1987).

This district court has explicitly endorsed the Collective Knowledge Doctrine. *See Burzynski v. Aetna Life Ins. Co.*, No. H-89-3976, 1992 U.S. Dist. LEXIS 21300, at *13 (S.D. Tex. Apr. 1, 1992) ("[T]he knowledge of Aetna's agents and employees is imputed to the corporation under the doctrine of '***collective knowledge***.'") (citing *Steere Tank Lines, Inc. v. United States,* 330 F.2d 719,722 (5th Cir. 1963)).[59]

Lehman claims that it lost money at the end of the day when the Ponzi scheme collapsed. But this argument actually cuts against them. Like a gambler at the craps table who has a long run of good luck, but keeps doubling-up and ends up with a huge amount of chips at work on the table when he finally rolls a seven, Lehman did very, very well for itself and its top executives as long as the run of good luck continued, *i.e.*, the Enron house of cards stood. But, they paid the price when seven came up. In fact, as the financial exposure of the banks to Enron increased as the scheme progressed – ***it only increased the motive of the banks, like Lehman, to keep Enron looking good and keep its stock price up so that its increasingly fragile financial structure would not collapse and so that Enron would continue to have access, with the help of the banks, to the capital markets to raise monies to pay back Enron's debts to the bank.***

At the end of the day, the scienter allegations against the banks in this complaint are uniquely strong in part because the unique circumstances of this case. The banks named as defendants here chose to vastly expand types of business they did with Enron and types of commercial transactions they engaged in with Enron. In so doing, they entangled themselves in the affairs of the company that was committing the largest and worst securities fraud in the history of the United States. The banks chose to facilitate and participate in that fraud – and to make false and misleading statements because it gave them – the banks and their top executives – the opportunity to reap huge profits. Having top bank executives and banks secretly invest millions of dollars in partnerships that engage in non-arm's-length fraudulent transactions with a public company to loot it, while creating hundreds

59 Additionally, in *Am. Standard Credit*, 643 F.2d at 271 n.16, the Fifth Circuit stated: "'The general rule is well established that a corporation is charged with constructive knowledge, regardless of its actual knowledge, of all material facts of which its officer or agent receives notice or acquires knowledge while acting in the course of his employment within the scope of his authority, even though the officer or agent does not in fact communicate his knowledge to the corporation.'"

of millions of dollars of phony profits and hiding billions of dollars of debt, while the banks were secretly engaging in other bogus transactions with the public company, further artificially boosting its reported earnings and hiding additional billions of dollars of debt and all the while issuing glowing analysts' reports praising the skill and integrity of the company's management, the tremendous successes of its core businesses, the success of its risk management and hedging techniques, and its wonderful future business and earnings prospects, is simply not banking business as usual. Or if it is, this country and our financial markets are in terrible trouble.

VIII. LEHMAN VIOLATED THE TEXAS SECURITIES ACT IN CONNECTION WITH THE SALE OF THE 6.95% NOTES AND 6.40% NOTES

The CC asserts valid claims under art. 581-33 of the Texas Securities Act ("TSA") against the defendants named in plaintiffs' Fourth Claim for Relief, including Lehman, one of the underwriters of the 6.95% Notes and the 6.40% Notes. The misconduct at issue occurred in substantial part in Texas and thus the Washington Board properly seeks relief under TSA art. 581-33.

"Under Texas law the burden is on the party asserting the application of foreign law to first show the existence of a true conflict of laws and then to demonstrate which law should apply based on state contacts to the asserted claims." *Weatherly v. Deloitte & Touche*, 905 S.W.2d 642, 650 (Tex. App. – Houston [14th Dist.] 1995, writ dism'd w.o.j.). Defendants cannot meet the burden, as defendants wrongful conduct, including the false statements used by defendants to sell $500 million of Enron debt, occurred in and/or emanated from Texas. For example, Enron's Form 10-K for 1997 (which was incorporated in the Registration Statement used to sell the Notes) was materially false because it concealed debt which had been hidden in the illicit JEDI/Chewco entity from Enron's balance sheet. *See, e.g.*, ¶¶9-11, 613. The fraudulent formation of JEDI/Chewco was performed by, among others, Vinson & Elkins attorneys in Houston, Enron and Enron employees who were stationed in Houston, and Andersen employees in Andersen's Houston office. As the majority of the misconduct that occurred and gives rise to plaintiffs' Fourth Claim for Relief occurred in and/or emanated from Texas, defendants have not carried their burden.

A. Texas Courts Regularly Apply Texas Law to Misconduct Which Has a Nexus with or Emanates from Texas

The TSA is properly invoked under the factual circumstances presented here. The TSA is a broad remedial statute designed to not only protect Texas residents, but also to "***protect non-Texas residents from fraudulent securities practices emanating from Texas.***" *Baron v. Strassner*, 7 F. Supp. 2d 871, 875 (S.D. Tex 1998) (Judge Werlein). Defendants ignore that Texas courts construe the TSA to afford protection to all individuals affected by misconduct emanating from Texas, including those residing outside Texas. *See, e.g., Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 921 (Tex. Civ. App. – Houston [1st Dist.] 1976, writ ref'd n.r.e.). In *Rio Grande*, the Texas Court of Appeals held: "A state is damaged if its citizens are permitted to engage in fraudulent practices even though those injured are outside its borders." *Id.* Moreover, even though almost all of the alleged misconduct, including the preparation of the false selling documents (the Registration Statement and Prospectus), took place in Texas, the law does not actually require that plaintiffs show that the sale of the securities in question was primarily linked to the State of Texas. "***[T]he Texas Securities Act applies if any act in the selling process of securities covered by the Act occurs in Texas.***" *Id.* at 921-22; *see also Texas Capital Sec., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App. – Houston [1st Dist.] 2001, pet. ref'd) (same).

Lehman argues that defendants' sale of $500 million of Enron debt by Enron, its directors and its investment bankers pursuant to a false and misleading Registration Statement and Prospectus created in and disseminated from Texas lacks any "meaningful nexus" with Texas. *See* Mot. at 30. This assertion strains credulity. Here, the allegedly false Registration Statement and Prospectus used to sell the 6.40% Notes and the 6.95% Notes (which form the basis of the Washington Board's claim for relief) were created by Texas lawyers in Houston. The Prospectus and Registration Statement (relevant excerpts of which are attached as Ex. 11 to plaintiffs' Appendix) state that the validity of the Notes was passed on in Texas by James V. Derrick, Jr. ("Derrick"), Senior Vice President and General Counsel of Enron, and Bracewell and Patterson, L.L.P. Derrick worked out of Enron's office in Houston. Bracewell and Patterson maintains offices in Houston, Austin, Corpus Christi, Dallas/Ft. Worth, San Antonio and Reston, Texas. Indeed, Derrick's opinion letter stated:

> I am a member of the bar of the State of Texas. The opinion set forth above is limited in all respects to the laws of the State of Texas, the General Corporation Law of the State of Oregon, and federal law.

The Registration Statement incorporates Enron's 97 false financial statements (which defendants have now admitted were materially false). These were prepared and audited in Houston, Texas. Also, the false Registration Statement was signed by Texas citizens in Texas and filed with the SEC by an issuer from its headquarters in Houston. *See* Registration Statement at 31-32. And last, but not least, the Prospectus and Registration Statement instructed persons seeking copies of Enron's SEC filings incorporated therein to contact Enron's "principal executive offices" in Houston, Texas. To suggest that the acts and conduct underlying the 98 sale of $500 million of Enron debt lacked any relation to Texas simply ignores reality.

Defendants' arguments not only ignore reality and the text of the offering documents, but also disregard the allegations of the CC. For example, notwithstanding defendants' admission that the Fourth Claim for Relief incorporates by reference each of the preceding paragraphs of the CC, defendants conveniently ignore those allegations. For example, plaintiffs allege that "many of the acts and practices complained of herein occurred in substantial part in this district." ¶77. Defendants ask this Court to find that defendants have met their burden by engaging in a fact-intensive analysis while ignoring that Enron's false 97 financial statements (which were incorporated in the Registration Statement and Prospectus and which defendants have now admitted were materially false) were prepared in material part by Enron executives and audited by Andersen accountants at the Company's Houston headquarters. *See* ¶¶93(b),(d),(g),(h),(n),(p)-(t); ¶897 (Andersen personnel "were present at Enron's Houston headquarters on a year-round basis. Andersen's Houston and Chicago offices were routinely involved in development, consulting and accounting for the fraudulent deals and transactions at issue here[]."); ¶906 ("Andersen's Houston office alone had at least eight partners working on Enron engagements, five of which were assigned to Enron full time, as well as at least 100 additional professionals. Numerous Houston Andersen auditors worked solely on Enron engagements.").

Defendants cite no Texas authority for the proposition that the Texas securities laws should not apply in circumstances such as those presented here – where the false selling documents were prepared in and disseminated from Texas and a major portion of the alleged misconduct occurred in Texas. In an effort to meet the burden of showing that Texas law does not apply, Lehman resorts to attempting to rely on dicta from a Texas appellate court – ***which did, in fact, apply Texas law***. *Enntex Oil & Gas Co. v. State*, 560 S.W.2d 494, 497 (Tex. Civ. App. – Texarkana 1977, writ ref'd n.r.e.). *See* Mot. at 31. However, Judge Werlein of this Court rejected the same attempted application of the *Enntex* dicta that Lehman makes here. *See Baron*, 7 F. Supp. 2d at 875 ("*Enntex* appears consistent with the proposition that the TSA may as well protect non-Texas residents from fraudulent securities practices emanating from Texas.").[60] Thus, Lehman's attempt to rely on strained interpretations of laws other than the TSA simply ignores the facts of this case and the fact that in order to "construe the Texas Securities Act 'to protect investors,'" Texas appellate courts give the TSA "'the widest possible scope.'" *Anheuser-Busch Cos. v. Summit Coffee Co.*, 934 S.W.2d 705, 708 (Tex. App. – Dallas 1996, writ dism'd).

B. The Application of Texas Law to Misconduct Which, in Large Part, Originated in and Emanated from Texas Comports with Constitutional Principles

There is a sufficient nexus between defendants' alleged misconduct and the application of Texas law such that the Commerce Clause of the U.S. Constitution is not abridged. "'[F]or a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of

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60 Defendants also attempt to cite other cases from other jurisdictions, but none are persuasive. For example, defendants rely on *Singer v. Magnavox Co.*, 380 A.2d 969, 981-82 (Del. 1977). See Mot. at 30. However, unlike the present case, the alleged misconduct was not connected with the state whose law was to be applied. *Singer*, 380 A.2d at 981-82. The only connection was simply that Delaware was the location of the merger vote. The *Singer* court stated: "We are not persuaded that because the corporate merger vote was held in Delaware this is a sufficient connection with the alleged fraud to permit plaintiffs to invoke the Act. That is simply too fragile a basis on which to establish subject matter jurisdiction ***over an alleged fraud in Pennsylvania*** or over a contract made in New York." *Id.* at 982. ***In this case the alleged misconduct occurred in and emanated from Texas.***

Lehman also cites *Allen v. Oakbrook Sec. Corp.*, 763 So. 2d 1099, 1100-01 (Fla. Dist. Ct. App. 1999), for the same proposition as *Singer*. Again, defendants overreach. *Allen* relies heavily on *Singer* and, thus, fails for the same reasons. There were no contacts between the fraud and the state in that case. The *Allen* court noted that the sales "occurred entirely in other states." *Id.* at 1100. No doubt Lehman and J.P. Morgan would like to ignore reality. However, defendants can hardly contend in good faith that the sale of $500 million of Enron 6.40% Notes and 6.95% Notes was not linked in any way to Texas.

its law is neither arbitrary nor fundamentally unfair.'" *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 818 (1985). Not only does Texas have significant contacts to the alleged misconduct, no other state has anywhere near the connection to the alleged misconduct, or a greater interest in the outcome of this litigation, than Texas.[61]

Texas' contacts to the wrongdoing committed by defendants in connection with the sale of the 6.40% Notes and 6.95% Notes is substantial. Most notably, the false offering documents used to sell the Notes were, in substantial part, prepared in and disseminated from Texas. Further, all of the defendants sued for violations of the TSA – Enron's officers and directors, along with its lawyers, Andersen, and Lehman and J.P. Morgan – maintained offices in Texas and those offices were utilized in connection with the alleged misconduct. This is sufficient to satisfy the Due Process Clause and the Full Faith and Credit Clause of the U.S. Constitution.

IX. CONCLUSION

In fact, as this Court knows, a key Arthur Andersen partner condemned the LJM2 partnership – in an e-mail once destroyed, but later resurrected. According to *The New York Times*, 5/10/02 "Andersen Lawyer Accuses Prosecutors of Misconduct":

> [I]n one e-mail message written by Mr. Neuhausen [an Arthur Andersen partner] ... he lambasted Enron's plan to allow its chief financial officer to run a partnership that did business with the company, calling it terrible and asking, "***Why would any director sign off on such a scheme***?"

Indeed. And how could any sophisticated bank have gone in on such a "scheme"? The answer to Neuhausen's question is greed and arrogance – qualities that were present in abundance in Enron's insiders, its outside directors, its lawyers, accountants and banks.

On 2/26/02, *Dow Jones News Service* ran a story headlined: "***Next Stop On Enron Express: Wall Street***." It noted the "***long gravy train of stock and bond offerings that Enron sent the Streets' way over the past decade***." It also discussed:

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61 Indeed, applying the cases cited by defendants for the proposition that Texas law does not apply, it seems that defendants would find that no state's law could be applied to defendants' misconduct. It is not hard for one to imagine their arguments: the only connection to Oregon is that it is the state of incorporation of Enron, the only connection to New York is that it is where the underwriters were located, and Washington is just the state where the plaintiff resides.

[T]he now-infamous LJM2 partnership set up by Enron's former chief financial officer, Andrew Fastow. It's been well-documented now ... that high-powered finance firms such as CS First Boston, Merrill Lynch, JP Morgan and Citigroup, were lured into the LJM2 partnership by the promise of potentially rich returns and the chance to get an inside peek into Enron's mysterious deals.

* * *

... ***Wall Street – which got rich touting Enron – is still acting as if it has nothing to answer for in the Enron mess.***

So far, most Wall Street institutions have said little about the Enron debacle, issuing either blanket "no comments," or denying any responsibility for the company's collapse. CS First Boston, which underwrote more than $4.5 billion in Enron stock and bond offerings – roughly 20% of Enron's total underwriting work since 1990 ... has refused to say anything whatsoever. Merrill Lynch, which lined up investors for Fastow's LJM2 partnership and underwrote more than $4 billion in stock and bond offerings for Enron, has been a bit more talkative – ***but only to say it's utterly blameless.***

* * *

Between them, Citigroup and J.P. Morgan served as lead manager on more than $20 billion in syndicated bank loans to Enron over the past decade, with Citigroup also underwriting more than $4 billion in stock and bond offerings for the company ....

... Wall Street has plenty of explaining to do. Jonathan Kord Lagemann, a securities lawyer and former general counsel for a brokerage firm, says the Enron affair exposes the ***"enormous conflict of interest" inherent in these firms' efforts to be three things at one time: underwriter, corporate analyst and stock seller.*** To start, there's the obvious issue of whether pressure from their firms caused 10 of the 14 research analysts who followed Enron to keep recommending the stock to investors, even as the company was racing toward bankruptcy. A related issue is whether the analysts knew or should've known just how dire the situation was at Enron, since many of them work for firms that were invested in the partnerships that played a critical role in Enron's off-balance-sheet transactions.

¶645. The blatant self-dealing by Enron's banks has not gone unnoticed:

Many institutional investors declined to buy into LJM2 because of Fastow's conflict of interest. But some of the world's biggest institutions took a piece. Among them ***were Citigroup, Credit Suisse Group, Deutsche Bank, JP Morgan, and Lehman Brothers.***

What were they thinking? Much of the world's financial community turned out to be willing enablers of Enron. No wonder "Wall Street credibility" is fast becoming an oxymoron. Investors are angry ....

Business Week, 2/11/02 (¶648).

The CC is not a blunderbuss long winded journey to nowhere. It is a thoroughly investigated detailed blueprint of Lehman's culpability which states a claim upon which relief can be granted under accepted legal theories.

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Respectfully submitted,

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
WILLIAM S. LERACH
DARREN J. ROBBINS
HELEN J. HODGES
BYRON S. GEORGIOU
G. PAUL HOWES
JAMES I. JACONETTE
MICHELLE M. CICCARELLI
JAMES R. HAIL
JOHN A. LOWTHER
ALEXANDRA S. BERNAY
MATTHEW P. SIBEN

WILLIAM S. LERACH

401 B Street, Suite 1700
San Diego, CA 92101
Telephone: 619/231-1058

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
STEVEN G. SCHULMAN
SAMUEL H. RUDMAN
One Pennsylvania Plaza
New York, NY 10119-1065
Telephone: 212/594-5300

Lead Counsel for Plaintiffs

SCHWARTZ, JUNELL, CAMPBELL
& OATHOUT, LLP
ROGER B. GREENBERG
State Bar No. 08390000
Federal I.D. No. 3932

ROGER B. GREENBERG

Two Houston Center
909 Fannin, Suite 2000
Houston, TX 77010
Telephone: 713/752-0017

HOEFFNER BILEK & EIDMAN
THOMAS E. BILEK
Federal Bar No. 9338
State Bar No. 02313525
Lyric Office Centre
440 Louisiana Street, Suite 720
Houston, TX 77002
Telephone: 713/227-7720

Attorneys in Charge

BERGER & MONTAGUE, P.C.
SHERRIE R. SAVETT
1622 Locust Street
Philadelphia, PA 19103
Telephone: 215/875-3000

Attorneys for Staro Asset Management

WOLF POPPER LLP
ROBERT C. FINKEL
845 Third Avenue
New York, NY 10022
Telephone: 212/759-4600

SHAPIRO HABER & URMY LLP
THOMAS G. SHAPIRO
75 State Street
Boston, MA 02109
Telephone: 617/439-3939

Attorneys for van de Velde

THE CUNEO LAW GROUP, P.C.
JONATHAN W. CUNEO
MICHAEL G. LENETT
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

Washington Counsel

N:\CASES\Enron\WSL-Opps-MTD\oppLehmanMTD brf