UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

United States Courts
Southern District of Texas
FILED
JUN 2 4 2002
Michael N. Milby, Clerk

In re ENRON CORPORATION SECURITIES LITIGATION	
This Document Relates To: MARK NEWBY, *et al.*, individually and on behalf of all others similarly situated, Plaintiffs, vs. ENRON CORP., *et al.* Defendants.	Civil Action No. H-01-3624 **(Consolidated)**
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.	

REPLY MEMORANDUM IN SUPPORT OF MOTION
TO DISMISS OF LEHMAN BROTHERS HOLDINGS INC.

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INTRODUCTION

Arguing that this case involves an unprecedented "worldwide" fraudulent scheme of unparalleled scope, plaintiffs ask this Court to adopt a vast and indefinite theory of Section 10(b) liability. Under plaintiffs' all-encompassing theory of liability based on nothing more than the labeling of their claims against Lehman as "participation in a fraudulent scheme," Lehman is supposedly fully responsible for all of the alleged misrepresentations of Enron and other defendants. That is not because Lehman itself actively engaged in any fraudulent conduct but rather merely because it invested in the LJM2 limited partnership and performed underwriting services in connection with certain Enron securities offerings.

Plaintiffs' theory is ungrounded in the text of Section 10(b) and barred by *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). Plaintiffs' theory also is directly at odds with the requirements of the PSLRA. But plaintiffs would have the Court ignore the law merely because this is the Enron litigation. Claiming a scarcity of legitimate defendants with money, plaintiffs argue that they must be able to target "deep pockets" to achieve "significant recovery." (Pls.' Mem. at 40, 41, 108.) "To put it bluntly," plaintiffs say, if they cannot get away with suing parties who, like Lehman, did business with Enron, Congress will have to go back and correct the "harsh" pleading standards it enacted and "restor[e] aiding and abetting liability." (*Id.* at 41.) Plaintiffs may not like the laws passed by Congress, but they are no less the laws for that.

Plaintiffs complain that the defendants "ignore or grossly mischaracterize" their allegations, but they cite no such mischaracterizations by Lehman. It is plaintiffs who make the allegation that Lehman "participated in the scheme to defraud . . . *by rendering all of the above [banking] services to Enron* . . . ." (Compl. ¶ 108.) And it is plaintiffs who characterize this

conduct as "helping" or "enabling" Enron to commit fraud. (*Id.* ¶¶ 762, 763; Pls.' Mem. at 10, 12, 28, 35, 37, 58, 77, 97, 98, 104.) Those are the words plaintiffs use to describe their "conduct case" against Lehman. Despite plaintiffs' current efforts to label this conduct as "participating in" a scheme, plaintiffs' scheme theory should be seen for what it is — a back door effort to impose aiding and abetting liability in contravention of *Central Bank.*

Not only is plaintiffs' scheme theory contrary to the law, it is unsupported by any factual allegations that would justify any such liability against Lehman. To begin with, plaintiffs fail to show that their scheme allegations against Lehman ever could satisfy the PSLRA. Plaintiffs fail to allege any "manipulative or deceptive" act by Lehman, which plaintiffs admit even their theory requires. Neither Lehman's limited partnership investment in LJM2 nor its underwriting activities comes close to fitting that description. Nor have plaintiffs pleaded any of the specific facts necessary under the PSLRA to create a "strong inference" that Lehman acted with the required state of mind when investing in LJM2 or performing underwriting activities. In fact, plaintiffs do not even allege any facts sufficient to demonstrate that Lehman had knowledge of the purported fraudulent scheme. Instead, plaintiffs continue to rely on wholly conclusory allegations of knowledge, and irrational and legally insufficient allegations of motive and opportunity.

Plaintiffs urge the Court to disregard such "technical pleading arguments" based on the PSLRA because "everyone knows, except apparently the defendants, this case is not" a frivolous one. (Pls.' Mem. at 1.) This "case" is indeed frivolous as it relates to Lehman, and plaintiffs' rhetoric provides no basis for disregarding the PSLRA, which requires the dismissal of any complaint that does not meet its statutory pleading requirements.

Plaintiffs' alternative theory of liability, predicated on Lehman's *statements*, fares no better. The only statements of Lehman that plaintiffs identify — those of Lehman's analysts in their reports on Enron — simply are not actionable. Notwithstanding plaintiffs' effort to rewrite the Complaint in their opposition brief, plaintiffs fail either to identify the parts of the analysts' reports that allegedly were false and misleading or the specific facts demonstrating why they were false and misleading when made. Further, plaintiffs offer no response to rulings demonstrating that the statements made by Lehman's analysts are inactionable because they constitute mere statements of optimism or opinion. Finally, the deficiency of plaintiffs' scienter allegations is compounded when it comes to Lehman's analysts' statements. Not only have plaintiffs failed to identify specifically what kind of information Lehman's investment bankers had, when it was conveyed, by whom and to whom, they also have failed to allege any facts demonstrating that any knowledge supposedly possessed by Lehman's investment bankers also was possessed by its analysts notwithstanding the "Chinese Wall" in place at Lehman. Thus, plaintiffs do not come close to satisfying their burden of pleading facts demonstrating that Lehman's analysts knew their statements were false when made.

For these and other reasons discussed below, plaintiffs' Complaint should be dismissed with prejudice as to Lehman.

ARGUMENT

A. Plaintiffs' Conclusory Assertions About Lehman's Alleged "Participation In A Fraudulent Scheme" Do Not State A Claim Against Lehman Under Section 10(b).

1. Plaintiffs' Attempt To Impose Liability On Lehman For Statements Of Others Is Barred By *Central Bank*.

Again, the Supreme Court in *Central Bank* abolished aiding and abetting and other forms of liability not specifically identified in the statute, holding that Section 10(b)

> prohibits only t0he making of a material misstatement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for *acts* that are not *themselves* manipulative or deceptive within the meaning of the statute.

Central Bank, 511 U.S. at 177-78 (emphasis added).[1] After *Central Bank*, liability may be imposed only on a "primary violator" who "[1] employs a manipulative device or [2] makes a material misstatement (or omission) on which a purchaser or seller relies . . ., assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Id.* at 191 (emphasis in original). Because liability under Rule 10b-5 is no broader than under Section 10(b) itself, *id.* at 173, to be actionable, any violation alleged in the "scheme" or "course of business" language of Rule 10b-5 still must meet the definition of using or employing a "manipulative or deceptive device or contrivance," 15 U.S.C. § 78j(b).[2]

The gravamen of plaintiffs' claims in this case is the charge that Enron made numerous false statements about various aspects of its financial condition, all of which caused the price of Enron securities to be artificially and unlawfully inflated. The Complaint itself makes this abundantly clear. At its core are 144 pages of allegedly false or misleading statements about Enron's financial condition, and another 75 pages of "Enron's False Financial Statements" and "Enron's False and Misleading Statements in Its 10-Ks and Registration Statements." (Compl. at 110-254, 266-340.) It is those statements that plaintiffs allege inflated the price of Enron stock. (Compl. at ¶¶ 983, 984; Pls.' Mem. at 5, 6.) By contrast, plaintiffs' fraudulent scheme allegations

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[1] Thus, *Central Bank* abolished secondary liability not only for misrepresentations but for all "manipulative" or "deceptive" acts, regardless of which part of Rule 10b-5 plaintiffs invoke.

[2] As this Court has held, "Section 10(b) bars conduct 'involving manipulation or deception, manipulation being practices . . . that are intended to mislead investors by artificially affecting market activity, and deception being misrepresentation or nondisclosure intended to deceive.'" *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp.

consist of a single boilerplate paragraph on page 255 and scattered repetitious use of scheme jargon.

The Complaint leaves no doubt that the alleged deception and market inflation resulted not from the ordinary business dealings like Lehman's LJM2 limited partner investment and underwriting activities but from Enron's purported improper accounting of its transactions with LJM2 and other related entities, Enron's purported improper accounting for certain of its business units, and Enron's publication of the allegedly false financial results produced by that improper accounting. Plaintiffs repeatedly confirm this in explaining their alleged "scheme":

> Lehman provided both commercial 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.*

(Pls.' Mem. at 28 (bold emphasis omitted, italics added); *see also id.* at 10-11, 14-15, 25; Compl. ¶ 996.) Even this statement is exaggerated and misleading,[3] but it still confirms that the alleged fraud was caused by Enron's accounting and financial misreporting and not by conduct such as the mere capitalization of LJM2 by its limited partners.

Thus, the allegations of the Complaint are directly controlled by *Central Bank*'s core holding on the scope of liability under Section 10(b) for misrepresentations: the statute bars "making" misrepresentations; nothing less is actionable — not aiding, not abetting, not assisting,

(continued...)

2d 860, 869 n.18 (S.D. Tex. 2001) (Harmon, J.) (citing *Field v. Trump*, 850 F.2d 938, 946-47 (2d Cir. 1988)) (elipses in original).

[3] For example, the Complaint in fact identifies no SPE "transactions" that Lehman funded. Nor are the transactions actually identified in the Complaint intrinsically "illicit" to begin with. It was only Enron's accounting for them that allegedly was wrong. Had those transactions been accounted for and disclosed properly by Enron, even plaintiffs could not argue that there was any fraud.

not helping, and not enabling. *Central Bank*, 511 U.S. at 177.[4] The allegation that Lehman's investment in LJM2 remotely "enabled Enron to falsify its financial statements and misrepresent its financial condition" is a classic aiding and abetting charge barred by *Central Bank*. (Pls.' Mem. at 28.)

Since the aiding and abetting route plainly is closed, in their brief, plaintiffs try to reach the same destination by characterizing their claims against Lehman as ones based on "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." (Pls.' Mem. at 98.) This theory, they contend, is *independent* of their allegations that Lehman itself made misrepresentations, and is based instead on Lehman's "conduct." (*Id.*) But the conduct that plaintiffs claim implicates Lehman in a "scheme" is nothing more than Lehman's investment as a limited partner in LJM2 and its performance of underwriting activities in connection with certain Enron securities offerings. (*Id.* at 76, 103.)[5]

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[4] As set forth in Lehman's original brief, the majority of courts after *Central Bank* have read it to establish a "bright line" test, permitting Section 10(b) liability to be imposed only on a person who actually makes a material misrepresentation, as *Central Bank* itself holds. (Lehman Mem. at 12-13 (citing *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 & n.10 (10th Cir. 1996); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001)).) Even under the "substantial participation" test adopted by the Ninth Circuit (in contravention of *Central Bank*), moreover, plaintiffs allege no substantial participation by Lehman in the statements made by others for which the "scheme" allegedly makes Lehman liable. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1995). Plaintiffs do not contest any of this. Indeed, their brief does not discuss either test. Plaintiffs simply ignore them.

[5] Like the Complaint, plaintiffs' brief makes other conclusory assertions about Lehman as well. Plaintiffs argue, for example, that the Complaint "details numerous specific fraudulent Enron transactions involving Lehman (as participant or financier) . . . ." (Pls.' Mem. at 37.) But their brief and Complaint in fact both fail to identify *any* transaction involving Lehman besides its mere investment in LJM2. Similarly, plaintiffs abandon all restraint in asserting that, *e.g.*, "Enron secretly paid Lehman grossly excessive interest rates on billions of dollars of concealed/disguised loans" (*id.* at 45) — a charge not contained in the Complaint even in conclusory fashion, let alone supported with any specific facts. Indeed, plaintiffs fail to identify a single loan Lehman made to Enron or any Enron-affiliated entity. The brief also repeats the false charge that Lehman "helped structure and finance several of Enron's secretly controlled partnerships and illicit transactions" (*id.* at 43), while failing to identify even one. All the brief's rhetoric aside, the LJM2 investment remains the only Lehman "transaction" alleged in the Complaint, and the Complaint, not plaintiffs' brief, controls. *E.g.*, *Burch v. City of Nacogdoches*, 174 F.3d 615, 617 n.5 (5th Cir. 1999) ("[A]llegations in a response to a motion are not sufficient to amend the complaint.").

Plaintiffs now say that a scheme is a plan or program to commit fraud, or "joint activity," and that liability attaches to anyone who "participates in" the scheme. (*Id.* at 69, 64 n.39, 100.) According to plaintiffs, the scope of liability that attaches is limitless. They argue that "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 the results of the scheme." (*Id.* at 102.) Indeed, they even contend that a defendant need not have any knowledge of others involved in the alleged scheme, or of their acts or statements. (*Id.* at 100.)

Plaintiffs thus have advanced an unprecedented new theory of liability with no discernible rules at all.[6] They say that it is like a conspiracy, except that no agreement is required — *a conspiracy without the conspiracy*. (*Id.*)[7] Thus, according to plaintiffs, the random, uncoordinated actions of people unknown to one another would constitute a "unitary" scheme (*id.* at 101), so long as a plaintiff later alleged that they all somehow unconsciously "enabled" someone else to perpetrate a fraud (*id.* at 28). Even if this were what plaintiffs' Complaint alleged, it is not the law. The Supreme Court expressly warned against the acceptance of such theories of liability that lack clear rules, "in an area that demands certainty

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[6] The breadth of plaintiffs' theory causes it not only to depart from Section 10(b) but also to defy the PSLRA requirement that "the complaint shall, *with respect to each act or omission alleged to violate this chapter*, state with particularity facts giving rise to a strong inference that *the defendant acted* with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). This language confirms that, after enactment of the PSLRA, a claim may be stated under Section 10(b) based only on (1) a person's own actions (2) undertaken with scienter. Plaintiffs' theory contravenes this plain language in both respects. Plaintiffs' theory would impute liability for actions of others about which Lehman had no knowledge. (*E.g.*, Pls.' Mem. at 100 ("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," regardless of the defendant's lack of knowledge of other participants, their roles or actions, and regardless of the time of their participation.).) Plaintiffs' theory cannot coexist with the PSLRA.

[7] Of course, conspiracy liability is barred by *Central Bank*. *See Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 841 (2d Cir. 1988); *In re MTC Elec. Tech. S'holder Litig.*, 898 F. Supp. 974, 981 (E.D.N.Y. 1995); *In re Valence Tech. Sec. Litig.*, No. 95-20459 JW, 1996 WL 37788, at *11 (N.D. Cal. Jan. 23, 1996).

and predictability," because it leads to the "undesirable result of decisions made on an ad hoc basis, offering little predictive value." *Central Bank*, 511 U.S. at 188 (quotations, citation omitted). Plaintiffs' nontextual, ad hoc approach is forbidden by *Central Bank* and would, if accepted, frustrate the Supreme Court's direction to provide certainty and predictability in the law.

Plaintiffs claim to avoid *Central Bank* by recharacterizing their claims against Lehman as ones based on "participating in the scheme to defraud" instead of "aiding and abetting." (*E.g.*, Pls.' Mem. at 33, 63, 98.) But never in their 119-page response do they explain the difference. There is no difference. Replacing one label with another does not change the substance.

Contrary to plaintiffs' claims, "the statutory text controls the definition of conduct covered by § 10(b)." *Id.* at 175. The phrase "participate in," like aiding and abetting, is not contained in Section 10(b) and is far broader, particularly as wielded by plaintiffs, than the text of Section 10(b) can support. The statute makes it unlawful to "use or employ" a manipulative or deceptive device or contrivance. Even Rule 10b-5's gloss requires one to actually "employ" a scheme or "engage" in a fraudulent course of business. Plaintiffs do not allege that Lehman "used" or "employed" the "broad or general" scheme described by plaintiffs because there is no basis for such a claim. Instead they try to bootstrap their claim by alleging that Lehman "participated in" the scheme. But their bootstrap fails. Because such conduct, like aiding and abetting, is not prohibited by the terms of the statute, it does not give rise to liability. *Id. See also In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 871 n.21 (S.D. Tex. 2001) (Harmon, J.) ("[t]his Court agrees with the majority view that there must be alleged facts showing some *involvement in and control over* the content of the analysts' reports by the

defendants to hold them liable for misleading statements made in those reports") (emphasis added).[8]

A similar attempt to avoid *Central Bank* was rejected in *Primavera Familienstiftung v. Askin*, No. 95 Civ 8905 (RWS), 1996 WL 494904 (S.D.N.Y. Aug. 30, 1996). There, the complaint alleged that an independent investment advisor and certain of its officers and various investment banks violated Section 10(b) and Rule 10b-5 by engaging in a fraudulent scheme to induce investors to invest more than $650 million in certain funds. The fraud involved misrepresentations about the "market neutrality" of the funds' portfolios and the funds' hedging. *Id.* at *2. Although the investment banks were not alleged to have made any of the misrepresentations, plaintiff endeavored to hold them liable for those statements based on their alleged involvement in a supposed scheme to defraud, in which they allegedly participated in the following manner:

- Creating, supplying, and financing the purchase of the majority of the securities traded by the funds' manager and investment adviser and "set[ting] the prices of the 'toxic' securities in the Funds' accounts";
- Conducting the funds' trading activities;
- Supplying the newly created securities traded in the funds and financing their purchase by the funds — the funds were essentially the only purchasers of the securities;
- Executing reverse repurchase agreements to leverage the funds' portfolios through secured loans in which the original security was used as collateral for the loan made by the broker to the customer;

[8] In an attempt to divert the Court's attention, plaintiffs set up a straw man by attributing to Lehman the argument that "*Central Bank* eliminated scheme liability" under Rule 10b-5(a) and (c) and then spend a good portion of their brief attacking that argument. (Pls.' Mem. at 62-78.) But Lehman never made that argument. Moreover, whatever form of scheme liability survives *Central Bank* does not include plaintiffs' theory of "participating in" a scheme.

- Extending extensive credit to the funds, thereby enabling the manager and investment adviser to leverage the funds' portfolio dangerously and increasing the trading volume for the benefit of the broker defendants;
- Extending credit to encourage the funds' consumption of the risky securities for which there was no other market;
- Imposing margin obligations on the funds and auctioning off the funds' positions through deemed sales in which the investment bank defendants sought midnight bids from each other; and
- Selling CMOs (Collateralized Mortgage Obligations) to the funds, which helped the funds sell interests to investors.

Id. at *2-4, 6. Plaintiffs further alleged that, at the time the defendants engaged in this conduct, they knew that (i) the funds were the largest consumers of the banks' most speculative tranches of mortgage securities; (ii) the funds' stated investment strategy was one of market neutrality and the funds' inventory and trading of toxic securities was contrary to this policy; and (iii) contrary to the investment adviser's representation that the funds had lost 1% of value, they really had lost over 20% of value. *Id.* at *2-4.

The investment bank defendants in *Primavera* moved to dismiss under *Central Bank*, arguing that plaintiffs sought to impose aiding and abetting liability for the misrepresentations of the other defendants. In response, plaintiff argued that the complaint stated a claim against the investment bank defendants for primary, not secondary, violations of Section 10(b) and Rule 10b-5. Specifically, plaintiff in *Primavera*, like plaintiffs here, claimed that the investment bank defendants had violated Rule 10b-5(a) and (c) by "perpetrat[ing] a fraudulent plan, scheme, and common course of business which operated as a fraud on plaintiff and the class." *Id.* at *7. The court dismissed the claims against the investment bank defendants, finding that "regardless of how it is framed," the complaint was "one of misrepresentation," not a scheme to defraud, and

that plaintiff's allegations against the investment bank defendants "at their core, still constitute, at most, aiding and abetting of the [independent investment advisor defendants']" fraud. *Id.*[9]

Other courts have rejected similar attempts to plead around *Central Bank* using scheme jargon.[10] For example, in *In re Kendall Square Research Corp. Securities Litigation*, 868 F. Supp. 26, 28 n.1 (D. Mass. 1994), the Court rejected plaintiffs' scheme theory of liability, holding:

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[9] The court further held that, "to the extent that the Complaint sets forth allegations of conspiracy," it also fails because *Central Bank* "forecloses secondary civil liability based on an alleged conspiracy to violate the securities laws." *Id.*

[10] *Benedict v. Cooperstock*, 23 F. Supp. 754, 758 (E.D. Mich. 1998) (concluding that "allegations of mere participation in a fraudulent scheme are insufficient to state a claim under § 10(b)"); *In re Oak Tech. Sec. Litig.*, No. 96-20552 SW, 1997 WL 448168, at *15 (N.D. Cal. Aug. 1, 1997) (dismissing claim for scheme to defraud investors based on allegations of conspiracy because *Central Bank* made this type of secondary liability claim not actionable); *In re Valence Tech. Sec. Litig.*, No. 95-20459 JW, 1996 WL 37788, at *11 (N.D. Cal. Jan. 23, 1996) (noting courts holding that "'conspiracy' or 'scheme' allegations are not actionable under section 10(b) after *Central Bank*. Courts have dismissed claims alleged as 'schemes' on the grounds that they were merely non-actionable conspiracy claims that had been recharacterized.") (citations omitted); *Mishkin v. Ageloff*, No. 97 Civ. 2690 (LAP), 1998 U.S. Dist. LEXIS 14890, at *55-57 (S.D.N.Y. Sept. 23, 1998) (plaintiff alleged that defendant initiated, approved, directed, and carried out the entire scheme, court noted that "a plaintiff cannot establish primary liability by alleging knowledge of a fraud and assistance therein, as suggested by *First Jersey*"); *In re HI/FN, Inc., Sec. Litig.*, No. 99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *35 (N.D. Cal. Aug. 9, 2000) (noting that "scheme" allegations are inconsistent with *Central Bank*'s bar of conspiracy pleading and holding that "allegations of a scheme to defraud by individual defendants who are not alleged to have made statements do not support a claim for violation of § 10(b)"); *Lemmer v. Nu-Kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 U.S. Dist. LEXIS 13978, at *25-27 (N.D. Tex. Sept. 6, 2001) (describing *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997), argument that participants in a scheme can be held liable under Section 10(b) as "disingenuous at best," noting that its complaint did not include allegations of specific misleading statements but was only "vague, general, and unsupported by specific details," and refusing to attribute statements to other defendants on grounds that they were issued as part of a scheme); *Pegasus Holdings v. Veterinary Ctrs. of Am., Inc.*, 38 F. Supp. 2d 1158, 1164 (C.D. Cal. 1998) (noting that plaintiffs' alleged scheme theory was fundamentally inconsistent with *Central Bank*'s language that Section 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act, holding that "[a]llegations of stock ownership and attendance at certain meetings is not enough to establish a functional relationship to a fraudulent scheme"); *Scone Invs., L.P. v. Am. Third Mkt. Corp.*, No. 97 Civ. 3802 (SAS), 1998 WL 205338, at *8 (S.D.N.Y. Apr. 28, 1998) (primary liability does not result for mere performance of routine market functions such as extending a mortgage, providing a credit line, and waiving a covenant to increase the credit line); *Stack v. Lobo*, 903 F. Supp. 1361, 1374 (N.D. Cal. 1995) (scheme allegations appear to be "no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision"); *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 762 (N.D. Cal. 1997) (same); *Strassman v. Fresh Choice, Inc.*, No. C-95-20017 RPA, 1995 WL 743728 (N.D. Cal. Dec. 7, 1995) (same, rejecting any secondary liability premised on "schemes to defraud"); *In re Smartalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 527, 547 (S.D. Ohio 2000) ("'Scheme' theories of relief for securities fraud are limited because there is no longer aider or abettor civil liability in the securities area.") (citation omitted); *Zishka v. Am. Pad & Paper Co.*, No. 3:98-CV-0660-M, 2000 WL 1310529, at *5 (N.D. Tex. Sept. 13, 2000) (dismissing claims against most defendants because they "sound to the Court like aiding and abetting claims").

> Plaintiffs further allege that Price Waterhouse's involvement in the "structuring" of many of the Company's improperly recognized transactions also gives rise to Section 10(b) liability. The Court rules otherwise. While participation in the "structuring" of transactions may be evidence of Price Waterhouse's knowledge at the time it provided its audit opinion, the participation in the "structuring" does not constitute the making of a material misstatement; rather, it is the improper reporting of the "structured" transactions by the Company in its quarterly statements that constitutes the alleged Section 10(b) violation. Once again, it is clear that after *Central Bank*, only the making of material misstatements (or omissions) will be actionable under Section 10(b).

The result must be the same here, particularly since Lehman's alleged involvement in the supposed scheme in this case is far less direct and substantial than was the involvement of the investment bank defendants in the scheme alleged in *Primavera*, or the auditor in *Kendall Square*.

Thus, there is no basis in the law for plaintiffs' attempt to avoid *Central Bank*. The cases on which plaintiffs rely do not stand for the open-ended liability theory they ask this Court to adopt. To begin with, many of the cases pre-date *Central Bank*. *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981); *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987); *Scholnick v. Schecter* (cited by plaintiffs as *Scholnick v. Cont'l Bank*), 752 F. Supp. 1317 (E.D. Mich. 1990); *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458 (S.D.N.Y. 1987); *SEC v. Nat'l Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex. 1971). Accordingly, these cases are either no longer good law or at the very least must be seriously questioned given that, prior to the Supreme Court's abolition of aiding and abetting liability in *Central Bank*, courts had little or no incentive to distinguish between primary and secondary liability, so the lines often were blurred. *In re Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1472 n.15 (N.D. Ill. 1996).

Other of plaintiffs' cases involved classic manipulation or defendants who themselves controlled and orchestrated a scheme often involving failure to disclose deceptive conduct that defendants had a duty to disclose. *See, e.g., In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144, 152 (S.D.N.Y. 2001) (the bank defendant "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"); *SEC v. Zandford*, 122 S. Ct. 1899 (2002) (individual broker who carried out a scheme of illegally selling his clients' securities and stealing the profits); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996) (a securities brokerage firm and its principal personally orchestrated and carried out a scheme of manipulative stock transactions using the firm's branch offices and personnel)[11]; *United States v. O'Hagan*, 521 U.S. 642 (1997) (classic insider trading case); *Murphy v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1996 U.S. Dist. LEXIS 22207, at *23 n.10 (D. Or. May 9, 1996) (plaintiffs cite this case without telling the Court that the opinion stated: "I do agree with the Underwriter defendants that mere participation in a 'scheme' that includes the issuance of false financial statements . . . would fail under *Central Bank.* Plaintiffs must prove what they have alleged in their complaint and responding papers — that is that the underwriters were direct, knowing participants in the drafting of documents which included material misstatements and/or omissions."); *see also* the pre-*Central Bank* cases *Finkel,* 817 F.2d at 358 (corporate issuer was entirely responsible for scheme of forcing its 46% owned subsidiary to buy overpriced inventory and then misreporting the transactions); *Scholnick*, 752 F. Supp. 1317 (bank used its role exceeding that of a normal

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[11] *First Jersey* is also an example of the cases cited by plaintiffs that relied on and quoted language from *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994), for the proposition that 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." 101 F.3d at 1471. That holding was *overruled* by *Central Bank. See Mishkin v.*

lender to arrange scheme and to fraudulently take funds invested by plaintiffs from company's bank account to satisfy outstanding debt as agreed with company); *Bankers Life*, 404 U.S. 6 (defendants fraudulently caused a corporation they controlled and as to which they had fiduciary obligations to sell valuable securities for virtually nothing).

Plaintiffs also rely on cases demonstrating the importance of participating in the making or drafting of the alleged misrepresentations as a predicate to finding a violation of Section 10(b). *See, e.g.*, *Flecker v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5329, at *25 (D. Or. Feb. 12, 1997) (defendants actually participated in document-drafting and decision-making); *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997) (pre-PSLRA case in which "scheme" theory completely superfluous to result because defendant actually made all of the misrepresentations constituting the scheme); *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1995) (accountant's substantial participation in drafting a letter to the SEC was held to be a sufficient basis for liability under *Central Bank*, but summary judgment was *granted* to underwriters who had not directly participated and lacked knowledge of alleged facts underlying the claims); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 969 (C.D. Cal. 1994) (defendants were alleged to have drafted press releases and modified financial data, but "more than simply knowing assistance with the underlying fraudulent scheme is required for Section 10(b) liability"); *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 109 (2d Cir. 1998) (a brokerage employee personally engaged in manipulative acts such as wash sales); *see also* the pre-*Central Bank* case *Union Carbide*, 676 F. Supp. at 468-69 (requiring "direct participation in a misrepresentation," and finding primary liability of Morgan Stanley for preparing misleading financial projections

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Ageloff, No. 97 Civ. 2690 (LAP), 1998 U.S. Dist. LEXIS 14890, at *55 (S.D.N.Y. Sept. 23, 1998); *Roer v. Oxbridge, Inc.*, 198 F. Supp. 2d 212, 227 n.5 (E.D.N.Y. 2001).

used in company's financial statements). These cases have no application here, given that Lehman is not alleged to have played any role in making or drafting any of the alleged misrepresentations of Enron or the other defendants.

Finally, several of the foregoing cases were SEC enforcement actions. *See National Bankers Life Ins. Co.*, 324 F. Supp. 189 (cited by plaintiffs (Pls.' Mem. at 102) for the proposition that liability can be imposed for "aid[ing] and abett[ing] a general scheme," which they claim to square with *Central Bank* merely by changing the phrasing to "participating in a scheme to defraud"); *First Jersey Sec. Inc.*, 101 F.3d 1450; *Zandford*, 122 S.Ct. 1899. The SEC, however, is statutorily authorized to bring enforcement actions against a person who "knowingly provides substantial assistance" in committing securities fraud. 15 U.S.C. § 78t(f). *Central Bank* bars a similar private action.

There is, in short, no case that this defendant can find which endorses the all-encompassing scheme liability advocated by plaintiffs here. Rather, liability has been imposed post-*Central Bank* only on defendants who were principally responsible for carrying out the manipulative and deceptive actions that constituted the scheme. Plaintiffs nowhere allege that Lehman "initiated, approved, directed, and carried out the entire scheme." *Mishkin v. Ageloff*, No. 97 Civ 2690 (LAP), 1998 U.S. Dist. LEXIS 14890, at *56-57 (S.D.N.Y. Sept. 23, 1998); *see also Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628, 640 (S.D.N.Y. 1999) (dismissal of claims for failure to demonstrate that law firm had power to direct corporations through which allegedly manipulative trades were accomplished). Instead, plaintiffs claim that Lehman participated in the scheme because it did business with Enron. That does not create Section 10(b) liability. Whether plaintiffs call it aiding and abetting, assisting, "helping," "enabling," "participating in a fraudulent scheme," or anything else, they are still trying to

impose liability on Lehman for alleged false and misleading statements *made by others*, which *Central Bank* squarely prohibits.[12]

2. Plaintiffs Fail To Allege Any Manipulative Or Deceptive Act By Lehman.

Plaintiffs concede that Lehman could be liable even under their theory only if Lehman itself committed "manipulative or deceptive acts in furtherance of [the scheme]." (Pls.' Mem. 99, 102.) But the acts that plaintiffs allege do not meet that standard.

"'[M]anipulation' is not a magic word whose use in a complaint automatically defeats a motion to dismiss." *Pin v. Texaco, Inc.*, 793 F.2d 1448, 1452 (5th Cir. 1986). Manipulation is "virtually a term of art" that "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (quotation, citation omitted). Neither Lehman's investment in LJM2 nor any lending or underwriting it performed comes close to such market tampering, and plaintiffs all but concede as much.

Plaintiffs' fallback is that "Lehman cannot escape liability by claiming that the illicit SPEs and contrived transactions detailed in the [Complaint] do not meet the technical definition of a 'manipulative device.'" (Pls.' Mem. at 76.) This is so, they say, because they have pleaded these "SPE transactions" as "deceptive" as well manipulative — "they falsified Enron's financial condition." (*Id.*) But deception is limited to intrinsically misleading conduct such as making

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[12] Confronted with the observation that their Complaint repeatedly characterizes every aspect of Lehman's alleged involvement as "helping" Enron commit fraud, plaintiffs first try to pass off their own words as "ambiguous" or inadvertent "mischaracterizations." (Pls.' Mem. at 42 n.24.) In the end, however, plaintiffs have no choice but to admit that they meant what they said: "[P]ersons who *participate in* a scheme to defraud or a course of business that operates as a fraud or deceit ... or employ acts or manipulative or deceptive devices *are actually 'helping'* to defraud investors." (*Id.* (emphasis added).) Indeed, plaintiffs' brief itself continues to describe Lehman's role as "helping," "enabling," "permit[ting]," and "allow[ing]" Enron to carry out a scheme. (*E.g., id.* at 14, 25, 35, 37 n.22, 43, 46, 58, 77, 97, 98, 108, 109.) Liability for helping is, however, barred by *Central Bank*, whether it is helping a scheme or

false or misleading statements or omissions (where there is a duty to disclose), including insider trading and misappropriation. *See, e.g., Zandford*, 122 S. Ct. 1895 (misappropriation by broker); *BMC Software*, 183 F. Supp. 2d at 869 n.18 ("deception [is] misrepresentation or nondisclosure intended to deceive") (quotation, citations omitted).[13] The act of investing in LJM2 obviously did not "falsify" Enron's financial condition and was in no way "deceptive." Nor are there any particularized allegations in the Complaint that Lehman was involved in any way in any other "transactions," and, in any event, it was not any of those other transactions that allegedly inflated Enron's stock price but Enron's alleged accounting and financial reporting that did so.

Plaintiffs' solution is apparently to suggest that business transactions that otherwise are not deceptive become deceptive when conclusory knowledge of a broader scheme is alleged. (Pls.' Mem. at 77 (arguing that the LJM2 investment was deceptive because the scienter "allegations against Lehman in this case are much more detailed than those found wanting in [*In re Landry's Seafood Rest., Inc. Sec. Litig.*, No. H-99-1948, slip op. at 66 (S.D. Tex. Feb. 20, 2001)]").) But that is not so. Whether an act is deceptive depends on the nature of the act itself and not on the defendant's state of mind. *Ellison*, 36 F. Supp. 2d at 637 (holding that whether one is liable as a primary violator or a secondary violator turns on the nature of the acts, not on the state of mind at the time the acts were performed); *Kendall Square*, 868 F. Supp. at 28 n.1 (participation in transaction showed knowledge but was not deceptive). Moreover, as shown

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helping make misrepresentations. In fact, to say that Lehman "enabled" Enron and others by participating in a broad scheme is to say even less than that it "aided" in making the statements, which *Central Bank* rejects.

[13] Plaintiffs' reliance on these cases as well as others such as *In re Landry's Seafood Rest., Inc. Sec. Litig.*, No. H-99-1948, slip op. at 9 n.12 (S.D. Tex. Feb. 20, 2001), and *United States v. O'Hagan*, 521 U.S. 642 (1997), for the proposition that a defendant need not have made a misrepresentation is therefore misplaced. (*See* Pls.' Mem. at 34, 61.) In those cases, as this Court explained in *BMC Software*, 183 F. Supp. 2d at 868 n.18, insider trading or misappropriation of information or funds is "deceptive" because the fiduciary relationship between shareholders and

below, the scienter allegations against Lehman here are plainly even less substantive than those rejected in *Landry's*.[14]

3. Plaintiffs' Scheme Theory Is Unsupported By Any Particularized Allegations Creating A Strong Inference That Lehman Acted With Scienter.

Scienter is a mental state embracing intent to deceive, manipulate or defraud. *McNamara v. Bre-X Minearals, Ltd.*, 57 F. Supp. 2d 396, 404 (E.D. Tex. 1999) (quoting *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994)). This requires a showing of knowledge or *severe* recklessness. *BMC Software*, 183 F. Supp. 2d at 866 n.15. The PSLRA demands that plaintiffs "state with particularity facts" raising a "strong inference" that a defendant acted with that mental state as to each alleged act or omission. 15 U.S.C. § 78u-4(b)(2). And, as the Fifth Circuit recently reaffirmed in a case not cited by plaintiffs, under the PSLRA "[a]llegations of motive and opportunity, standing alone, are no longer sufficient to plead a strong inference of scienter. . . ." *Abrams v. Baker Hughes Inc.*, No. 01-20514, 2002 WL 1018944, at *4 (5th Cir. May 21, 2002).

Seeing that this bar is too high, plaintiffs set a lower bar for themselves, and then fail to clear it, too.[15] They fail to plead the "knowledge [by Lehman] of [the] broad or general scheme"

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corporate officials, or between a client and a broker, gives rise to a duty of disclosure or abstention. No such relationship between Lehman and plaintiffs is alleged here.

[14] Plaintiffs' repeated reliance on *Landry's* is notable for the fact that the Section 10(b) claim against the underwriters was *dismissed* in that case.

[15] The vast majority of securities cases plaintiffs cite when discussing scienter requirements for scheme liability are inapplicable because they pre-date the enactment of the PSLRA (or were not covered by the PSLRA). *See, e.g.*, *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975);, *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1998); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398 (N.D. Cal. 1995); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *SEC v. First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996); *SEC v. Nat'l Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex. 1971); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558 (S.D. Fla. 1993). Many other cases relied on by plaintiffs are mail fraud or conspiracy cases that do not implicate the PSLRA. *See, e.g.*, *United States v. Read*, 658 F.2d 1225 (7th Cir. 1981); *United*

that even their theory would require. (Pls.' Mem. at 102.) Though their argument goes on for pages, shorn of its rhetoric it reduces to three points: (1) Lehman invested as a limited partner in LJM2 and "prefunded" its investment; (2) Lehman had a financial motive to invest in "the Enron Ponzi scheme"; (3) Lehman provided banking services to Enron and so had "constant access" to its "top executives." (*Id.* at 104, 108, 109.)

a. Plaintiffs' Scheme Theory Cannot Supply Its Own Strong Inference Of Scienter.

The first point is simply an exercise in bootstrapping: Lehman's investing in LJM2 itself allegedly gives rise to a strong inference that Lehman acted with scienter. And, to get there, plaintiffs simply load their characterization of the investment itself with multiple wild assumptions. Thus, Lehman's limited partnership investment becomes: "Lehman's executives' involvement in LJM2 — where they helped pre-fund LJM2 on 12/22/99 with $1.5, 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." (*Id.* at 104.) Plaintiffs exclaim in bold face that "[t]his is obviously intentional conduct — it was not and could not have been the result of negligence or inadvertence." (*Id.* at 103 (emphasis omitted).) Completing the circle, they say this "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." (*Id.* at 104 (emphasis omitted).)

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States v. Craig, 573 F.2d 455 (7th Cir. 1977); *United States v. Elam*, 678 F.2d 1234 (5th Cir. 1982); *United States v. Alvarez*, 625 F.2d 1196 (5th Cir. 1980). While plaintiffs claim that these criminal cases are applicable because the

Plaintiffs' argument is a series of non sequiturs. There are no specific facts in the Complaint — and none cited in the brief — to show that Lehman was aware of such an alleged plan by Enron to "engage in . . . fraudulent transactions." There are no facts to show that Lehman was aware of such a plan to "create bogus income and hide debt." These scienter *assumptions* have no basis in the Complaint and are not based on any particularized facts. Yet they are used by plaintiffs as a basis to extrapolate to still further assumptions that Lehman "knew" of Enron's alleged financial misreporting. Plaintiffs simply ask the Court to take it as self-evident that Lehman knew that LJM2 would be used for "four phony" transactions that Enron would later fail to reflect correctly on its financial statements, all as part of a global scheme. (*Id.* at 103.) Plaintiffs do not point to a single specific fact in the Complaint showing that Lehman had knowledge of any scheme, or of any "phony transactions," or that Enron was misreporting transactions. No document or other communication of any kind is identified that revealed such facts to Lehman, as required by the PSLRA. *See BMC Software*, 183 F. Supp. 2d at 886 (plaintiffs must allege what actions were taken by each defendant in furtherance of the alleged scheme and "specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned"); *Lemmer v. Nu-Kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 U.S. Dist. LEXIS 13978, at *25-27 (N.D. Tex. Sept. 6, 2001) (dismissing scheme allegations where plaintiff failed to allege specific misrepresentations).

Instead, plaintiffs simply assert without a single specific fact or citation to the Complaint that "Lehman knew . . . that during 00-01 LJM2 was constantly engaging in transactions with Enron where Enron insiders . . . were on both sides" with the object of "looting Enron"; that

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civil liability requirements would be lower since an agreement is not required, this is not so. The Reform Act makes the current scienter standard for securities cases clear.

Lehman was privy to a plan by Enron to "generate artificial profits and conceal its true debt level by moving billions of dollars of debt off its balance sheet"; and that Lehman knew that unidentified Enron transactions with "secretly controlled SPEs . . . would require Enron to issue millions of shares of Enron common stock," because of stock price triggers and debt-recourse provisions. (Pls.' Mem. at 104, 107, 108 (emphasis omitted).)

None of these allegations has even a shred of specific factual support in the Complaint. It does not identify a single document, a single conversation, a single person, a single transaction, or any other specific fact of the kind required to show knowledge of these matters. The Complaint simply does not supply any facts to make any of those connections. Instead, plaintiffs ask the Court to assume scienter because "[i]t could not have happened otherwise." (*Id.* at 32.) But hindsight, conclusory allegations that defendants "must have known" cannot support a Section 10(b) claim. *See, e.g.*, *Abrams*, 2002 WL 1018944, at *5 (rejecting allegations that defendants must have known); *Kurtzman v. Compaq Computer Corp.*, No. H-99-779, slip op. at 47 (S.D. Tex. Mar. 30, 2002) (Harmon, J.) (same); *Collmer*, 2001 U.S. Dist. LEXIS 23518, at *96-98.

b. Plaintiffs' Generic Motive Allegations Fail Under Controlling Law.

Plaintiffs cite no cases for their motive theory and do not attempt to confront or distinguish the many cases cited by Lehman showing that allegations of a desire to earn banking and other professional fees simply do not support any inference of scienter, let alone a strong one. Plaintiffs instead argue that "**[t]hese were huge securities offerings** — $500 million in notes sold in 7/98; $870 million raised from the sale of common stock in 2/99;[16] $500 million

[16] The statute of repose bars any claim relating to these offerings. 15 U.S.C. § 78i(e).

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," and that "surely the size and continuity of the investment banking fees here" demonstrates motive. (Pls.' Mem. at 109 (emphasis omitted).)

As the Complaint itself shows, Lehman was only one of many banks that underwrote these offerings (Compl. ¶ 48), which is at odds with plaintiffs' assertion that Lehman underwrote "billions of dollars of Enron securities." (Pls.' Mem. at 45.) In addition to the Complaint's overstatement, plaintiffs' brief baldly and erroneously asserts that Lehman "made and was making hundreds of millions of dollars," (*id.* at 38), and even "*billions* of dollars of fees, commissions, interest and other charges" (*id.* at 35-36 (emphasis added)) from Enron. There are no facts in the Complaint (or in plaintiffs' brief for that matter) to support these claims.

Moreover, the size of alleged securities offerings does nothing to change the reality recognized by the Fifth Circuit even before passage of the PSLRA that such allegations are a "mockery of Rule 9(b)." *Melder v. Morris*, 27 F.3d 1097, 1104 (5th Cir. 1994). They totally fail to create a strong inference of scienter that complies with the PLSRA. In this Circuit, the law is that financial motive standing alone does not plead scienter. *Abrams*, 2002 WL 1018944, at *4.

c. <u>Plaintiffs' Generic Access Allegations Fail By Any Standard.</u>

Using adjectives, bold typeface and an exclamation point, plaintiffs make another conclusory claim: that "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!**" (Pls.' Mem. at 109.) This situation was made all the more sinister, they say, because "the bank's executives were secretly investing in" LJM2. (*Id.* (emphasis omitted).)

But, as Lehman pointed out in its opening brief, the Complaint fails to identify a single person, conversation, document or other fact of any kind that shows what, how and when Lehman learned whatever it supposedly learned. Such allegations of general access do not create a strong inference of scienter under the PSLRA. *BMC Software*, 183 F. Supp. 2d at 887 (scienter allegations found insufficient when based on executive positions, day-to-day involvement in business, access to internal corporate documents, conversations with officers and employees, and attendance at Board meetings); *see also In re Azurix Corp. Sec. Litig.*, No. H-00-4034, 2002 WL 562819, at *23 (S.D. Tex. Mar. 21, 2002) ("Merely alleging that the defendants knew or had access to information by virtue of their board or managerial positions is not sufficient to plead scienter.").

Plaintiffs themselves quote this Court's instructive language from *Landry's*, slip op. at 66:

> 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 give rise to speculation . . . .

(Pls.' Mem. at 77.) Plaintiffs then assert that their "allegations against Lehman in this case are much more detailed . . . ." (*Id.*) Nothing could be further from the truth. Again, plaintiffs do not identify a single document, a single conversation, a single meeting, or any other *specific* means by which Lehman learned of fraud. They do not identify a single person at Lehman who had knowledge of fraud, let alone the specific facts he or she knew. Nor do they identify a single

Enron person (or anyone else) who gave Lehman information revealing fraud. Plaintiffs' conclusory allegations of scienter are insufficient. *E.g., Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015 (5th Cir. 1996); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994).

d. Plaintiffs' Scienter Theories Remain Irrational.

Lehman's demonstration that plaintiffs' entire scienter theory is irrational stands unrebutted by plaintiffs. They offer no explanation for the irrationality and do not counter the cases cited by Lehman. They respond solely that "Wall Street is deranged," and that "if it is irrational to violate the law," all wrongdoers would have a ready defense. (*Id.* at 1-2 n.3; *see also id.* at 112 (comparing Lehman to a gambler at a craps table).) This is not, of course, Lehman's argument. The problem with plaintiffs' case is that it ascribes to Lehman the irrational behavior of lending "hundreds of millions" to Enron when Lehman allegedly knew that Enron was a financial house of cards. (Compl. ¶¶ 18, 767.)[17] As many courts have recognized, a securities fraud claim based on such irrational allegations is inherently flawed. *See, e.g., Kalnit v. Eichler*, 264 F.3d 131, 140-41 (2d Cir. 2001); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990); *Coates v. Heartland Wireless Communications, Inc.*, 55 F. Supp. 2d 628, 643 (N.D. Tex. 1999); *Cogan v. Triad Am. Energy*, 944 F. Supp. 1325, 1331 (S.D. Tex. 1996).

B. Plaintiffs Fail To State A Claim Based On Any Alleged Misrepresentations Of Lehman.

Although plaintiffs repeat the conclusory legal argument that all statements made by Enron in its registration statements "are statements made by Lehman as an underwriter" (Pls.' Mem. at 46 (emphasis omitted)), they fail to cite any legal support for this position, and for good

[17] Highlighting plaintiffs' disregard for facts, they inflate this unparticularized allegation to "billions of dollars of loans" in their opposition brief. (Pls.' Mem. at 29.)

reason — it is not the law. As Lehman has demonstrated, it is not responsible for any of the alleged misrepresentations in Enron's registration statements regardless of whether the "bright line" or "substantial participation" test is employed, because there are no specific allegations showing Lehman's authorship. *See Zishka v. Am. Pad & Paper Co.*, No. 3:98-CV-0660-M, 2000 WL 1310529, at *3 (N.D. Tex. Sept. 13, 2000) (dismissing section 10(b) claim against underwriters for plaintiffs' failure to plead facts showing underwriters' participation in making false statements in the registration statement); *In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1394 n.18 (N.D. Ill. 1990) (allegations that underwriters were responsible for preparing or issuing the prospectuses were not supported by allegations of fact, and amounted at most to aiding and abetting allegations); *Eickhorst v. Am. Completion & Dev. Corp.*, 706 F. Supp. 1087, 1092 (S.D.N.Y. 1989) (dismissing under Rule 9(b) for failure to allege that defendant broker was involved in preparing or drafting challenged offering materials).[18] Thus, the only actual statements by Lehman put at issue by the Complaint are those in analysts' reports. Plaintiffs' allegations about these statements are totally inadequate under the PSLRA.

1. Plaintiffs Fail To Plead Actionable Analysts' Statements With Particularity.

With respect to the analysts' statements, plaintiffs merely pluck the Lehman excerpts out of the Complaint, where they are interspersed with the statements of all other defendants (and many statements by non-defendants as well), follow them with the same randomly spaced

[18] Plaintiffs argue that, "[w]hile 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 [Complaint's] allegations that Lehman Brothers knew those annual certified financial statements were false, they may not do so now at the 12b-6 [sic] stage," implying that underwriters are liable under Section 10(b) for all registration statements. (Pls.' Mem. at 97 n.50 (citing *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23).) That holding in *Murphy* dealt with scienter; it did not purport to hold that all underwriters are always responsible under Section 10(b) for the content of registration statements. In fact, *Murphy* rejected that position. *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23 n.10 (must show that underwriter was direct, knowing participant in drafting of documents).

laundry lists of supposedly "true but concealed" facts listed in the Complaint, and say that is good enough. It is not. The job of deciphering just what statements were false and why is still left to the reader — and good luck to the reader. This puzzle-pleading is wholly inadequate. *See, e.g.*, *Schiller v. Physicians Res. Group, Inc.*, No. 3:97-CV-3158-L, 2002 WL 318441, at *5 n.3 (N.D. Tex. Feb. 26, 2002) (Rule 9(b) not satisfied where plaintiff alleged scores of purportedly false statements but claimed them to be misleading only in several interspersed paragraphs that failed to match facts with specific statements); *In re Splash Tech. Holdings, Inc., Sec. Litig.*, 160 F. Supp. 2d 1059, 1073-75 (N.D. Cal. 2001) (defendants and court should not be forced to try to figure out exactly what are misleading statements and then match them to the reasons they are claimed to be false and misleading); *Chan v. Orthologic Corp.*, No. 96-1514 PHX RCV, 1998 WL 1018624, at *14 n.11 (D. Ariz. Feb. 5, 1998) (plaintiffs cannot list all false and misleading statements then provide a laundry list of reasons why the statements are troublesome); *see also Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997) (dismissing similarly structured "puzzle" complaint, and noting that such pleading is a "mask for an absence of detail"). As the Fifth Circuit recently affirmed, plaintiffs are required to specify each false statement and the reasons that statement was false when made, and plead specific facts such as names of sources and specific documents (or their equivalent) on which the allegations of falsity are based. *ABC Arbitrage Group v. Tchuruk,* No. 01-40645, 2002 WL 975299, at *11 (5th Cir. May 13, 2002). Plaintiffs' restated version of their omnibus Complaint is as defective as the original.[19]

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[19] Plaintiffs argue that all post-12/99 analyst reports were false because they did not specifically disclose the small LJM2 investment of "Lehman and/or its top executives." (Pls.' Mem. at 96.) Their charges that the investment created a "very significant and serious conflict of interests" (*id.*) are no more than conclusory innuendo and do not show why the investment was [a] material fact. Plaintiffs also deliberately fail to quote the reports' other disclosures that, *e.g.*, "Lehman Brothers Inc. makes a market in the securities of [Enron]," and that "The Lehman

As Lehman also pointed out in its opening brief, the analysts' statements consist of opinions, recommendations, and restatements of Enron information in the public record, none of which was material, and none of which plaintiffs are able to show with specific facts was anything other than an accurate reflection of the analysts' true view. Plaintiffs retort that "none of the cases cited by Lehman hold [sic] 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." (Pls.' Mem. at 78.) In fact, such statements are not actionable. *Raab v. General Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1983) (once information has reached the market, further statements are immaterial); *Kurtzman*, slip op. at 52 ("Vague optimistic statements are not actionable because reasonable investors do not rely on them in making investment decisions."). *See also* Lehman Mem. at 26-27. Plaintiffs cite no authority for their contrary position.

2. Plaintiffs Fail To Plead Scienter With Respect To Analysts' Statements.

Plaintiffs inexplicably say that the scienter allegations with respect to their scheme theory and their misrepresentation theory can stand or fall independently (Pls.' Mem. at 98, 103), but identify no scienter allegations different than those asserted for their scheme theory.[20] The end result is that plaintiffs' misrepresentation claim is even one step beyond the scheme theory in its lack of the specific allegations necessary under the PSLRA to create a "strong inference" of scienter. Indeed, the Complaint is barren of a single allegation that the analysts who wrote

(continued...)

Brothers analyst who covers this company also has a position in its securities." (Pls.' App. Ex. 3.) Any "conflict" allegedly created by the LJM2 investment is hardly meaningful in comparison to these disclosures.

[20] Plaintiffs do not dispute that they must plead specific facts showing that the forward-looking statements in analysts' reports were made with actual knowledge of their falsity. *See* 15 U.S.C. § 78u-5(c)(1)(B) (actual knowledge required for forward-looking statements).

reports — or any Lehman analysts at all — had knowledge any statements were false. Plaintiffs do not even venture to make a conclusory allegation of that nature. Thus, while plaintiffs allege that "executives" involved in lending or underwriting services provided to Enron had "access," there is not even that defective allegation as to analysts.

Plaintiffs instead resort to a rote and conclusory attempt to negate Lehman's "Chinese Wall" between analysts and its commercial and investment bankers, which they now try to bolster with a discussion of what they call the "Collective Knowledge Doctrine" and its broad "imputation" of knowledge. There are two problems with this. First, Lehman is presumed by law to comply with its "Chinese Wall" legal obligation under 15 U.S.C. § 78o(f). *See City of Los Angeles v. Lyons*, 461 U.S. 95, 103 (1983) (parties are presumed to comply with legal requirements). Moreover, plaintiffs' imputation theory of scienter is wrong as a matter of law. *See Abbell Credit Corp. v. Bank of Am. Corp.*, No. 01 C 2227, 2002 WL 335320, at *4-5 (N.D. Ill. Mar. 1, 2002) (declining to impute knowledge from lender to brokerage subsidiary without "any concrete factual basis for doing so").[21]

Plaintiffs rely on *Cooper*, a pre-PSLRA Ninth Circuit case, for their contention that their assertions about the lack of a "Chinese Wall" gets them by the PSLRA. (Pls.' Mem. at 71-72, 110 n.57.)[22] But even *that case* shows that the personal scienter of analysts must be pleaded.

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[21] This is particularly so since plaintiffs have, indeed, sued the wrong company by naming Lehman Brothers Holdings Inc. *See Chill v. Gen. Elec. Co.*, 101 F.3d 263 (2d Cir. 1996) (refusing to assume parent's knowledge of subsidiary's actions). Plaintiffs baldly assert that a corporate parent is liable for all the actions of a subsidiary. (Pls.' Mem. at 3 n.6.) That is obviously an incorrect statement of law. *See United States v. Bestfoods*, 524 U.S. 51, 61 (1998) ("It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries.") (citations omitted). The Complaint contains no allegations to support ignoring the separate corporate existence of Lehman Brothers Holdings Inc. and its subsidiaries.

[22] The PSLRA's scienter pleading section was, of course, specifically intended to abrogate the Ninth Circuit's earlier lax scienter pleading standard represented by *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994), which *Cooper* followed.

See Cooper, 137 F.3d at 629 ("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."). There are no such allegations in the Complaint about Lehman's analysts, let alone the particularized allegations now required to meet the higher standard of the PSLRA. Not once do plaintiffs ever allege that Lehman's analysts knew that any statements they made lacked a reasonable basis, or that they made them without genuine belief.

The second problem is that the Complaint fails to identify any Lehman personnel — not a single person — who allegedly had knowledge to "impute" to analysts across "the wall." The "collective knowledge" of Lehman alleged in the Complaint is none whatsoever. Plaintiffs' arguments for ignoring the wall and imputing knowledge are thus completely beside the point. Moreover, the focus of plaintiffs' scienter allegations on LJM2 and related "transactions" has no apparent connection in the first place to the vast bulk of the allegedly "true but concealed" facts catalogued after each grouping of Lehman analysts' reports. Virtually all of those "reasons" why the statements were allegedly untrue concern Enron's "WEOS business," "EES," "Chewco/JEDI," and "Enron Broadband Operating System," and other topics that have no relationship to the LJM2 investment by Lehman that plaintiffs say is the linchpin of scienter. (Pls.' Mem. at 80, 82-84, 86-87, 91-93.)

The scienter allegations of the Complaint are not just weak instead of "strong," but are incoherent.[23]

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[23] In addition, while plaintiffs' scienter theory revolves entirely around the LJM2 limited partnership investment, and conclusory allegations about the future use of LJM2 by Enron, those allegations obviously cannot be used to suggest scienter as to any statements by Lehman prior to that investment. Lehman allegedly participated in pre-funding LJM2 on 12/22/99. Thus any knowledge imputed to Lehman by way of its limited partner status from LJM2 could not have affected Lehman's allegedly false and misleading analysts' reports issued on 5/7/99 or 9/21/99. It also could not have affected the analysts' reports from 12/9/98 and 4/7/99, claims based on which are barred by the statute of limitations in any event. Finally, the alleged LJM2-derived knowledge could not have affected a Lehman executive's alleged 10/1/99 statement in the *CFO Magazine* article.

C. Plaintiffs Do Not Dispute That Their Section 11 Claims Sound In Fraud.

Plaintiffs completely fail to respond to Lehman's argument that their Section 11 claims must be pled with particularity because they are based on and expressly incorporate all of plaintiffs' underlying fraud allegations. They do not even deny that the claims incorporate and are based on the fraud allegations. In fact, they assert that dismissal of their Section 11 claims is precluded because they allege that Lehman knew that Enron's financial statements were false, and argue that Enron's misstatements "could not have happened" without the knowing help of banks and lawyers. (Pls.' Mem. at 32, 53 n.33, 112.) Because the fraud allegations are not pleaded with particularity, the Section 11 claims must also be dismissed. *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 368-69 (5th Cir. 2001) (reaffirming *Melder*, 27 F.3d at 1100 n.6 ("When 1933 Securities Act claims are grounded in fraud rather than negligence . . ., Rule 9(b) applies."); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1405 n.2 (9th Cir. 1996) (holding that efforts to disclaim fraud for purposes of Section 11 claims "are unconvincing where the gravamen of the complaint is plainly fraud and no effort is made to show any other basis for the claims levied at the Prospectus"); *Azurix*, 2002 WL 562819, at *11 (holding that "claims sound[ing] in fraud . . . must satisfy the strict pleading requirements" of Rule 9(b)); *Collmer v. U.S. Liquids, Inc.*, No. H-99-2785 *et al.*, 2001 U.S. Dist. LEXIS 23518, at *9 n.6, *104-05 (holding that where Section 11 or Section 12 claims sound in fraud "the plaintiff is required to plead the circumstances constituting the alleged fraud with particularity under Rule 9(b)"); *In re Am. Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 440 (S.D.N.Y. 2000) (holding

(continued...)

Similarly, this knowledge cannot be used with regard to Lehman's underwriting activities in connection with securities offerings in 8/97, 5/98, 7/98 and 2/99 (also barred by the statute of limitations), or 5/99. Nor does it affect the registration statements for the 5/00 and 6/00 offerings if plaintiffs are correct that the registration statement for those offerings was dated 2/5/99. (*See* Pls.' Mem. at 53.)

that "boilerplate disclaimer of fraud" as to 1933 Act claims was ineffective where they were based on the same "scheme of fraud" allegations underlying Section 10(b) claim).[24]

D. The Complaint Fails To Allege A Sufficient Nexus Between The Sale Of Securities And Texas To Permit the Maintenance Of A Claim Under The Texas Securities Act.

Plaintiff Washington Board ignores the clear requirement that there must be a meaningful nexus between the sale of securities and the state of Texas for the Texas Securities Act (the "TSA") to apply. (Pls.' Mem. at 114-16.) Instead, Washington Board focuses on what it characterizes as the alleged "misconduct at issue." (*Id.* at 113.) Washington Board lists various actions taken by or on behalf of the issuer, Enron, that allegedly occurred in Texas, such as, *inter alia*, the formation of JEDI/Chewco by Vinson & Elkins attorneys, Enron and Enron employees, and Arthur Andersen employees; the creation of the allegedly false offering documents by Texas lawyers in Houston; Enron's general counsel's review in Texas of the opinion letter on the validity of the notes; and the preparation and auditing of financial statements by Arthur Andersen accountants in Texas. (*Id.* at 113-15.) None of this conduct involves Washington Board or the underwriters (Lehman and JP Morgan Chase), much less demonstrates a sufficient nexus between the sale of securities to Washington Board and the State of Texas. Accordingly, the TSA does not apply here. *See, e.g., In re Revco Sec. Litig.*, No. 89CV593, 1991 WL 353385, at *14 (N.D. Oh. Dec. 12, 1991).

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[24] Plaintiffs also fail to respond to Lehman's argument that they lack standing to bring claims under Section 11 because they have not alleged that they purchased any shares in any initial offering. *See Azurix*, 2002 WL 562819, at *25-26 (plaintiffs failed to state actionable Section 11 claim where they had not purchased their shares pursuant to the initial public offering). *See also Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691 (3d Cir.) (Section 11 deals with initial distributions), *cert. denied*, 502 U.S. 820 (1991); *Brosious v. Children's Place Retail Stores*, 189 F.R.D. 138, 144 (D.N.J. 1999) (aftermarket purchasers do not have standing under Section 11). Nor do plaintiffs dispute that they do not state any claim against Lehman under Sections 15 or 20(a).

Further, Washington Board makes no response to Lehman's argument that its TSA claim fails because it is not pled with sufficient particularity under Rule 9(b). For this reason also, Washington Board's TSA claim must be dismissed.

E. Plaintiffs Admit That Claims Based On Pre-4/8/99 Representations And Conduct Are Time-Barred.

Plaintiffs admit that claims relating to representations and conduct prior to April 8, 1999, are time-barred. Accordingly, plaintiffs cannot maintain claims based on Lehman's analysts' reports issued on December 9, 1998, or April 7, 1999, or for the Enron securities offerings in July 1998 or February 1999.[25] These claims should be dismissed.

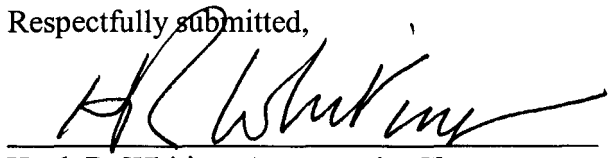
CONCLUSION

For the reasons cited herein as well as in Lehman's opening brief, plaintiffs' Complaint fails to state a claim against Lehman and should be dismissed with prejudice and such other relief granted to Lehman as the Court deems appropriate.

[25] Plaintiffs argue, however, that the statute does not foreclose the use of evidence of such events for other purposes. (Pls.' Mem. at 42-43.) Since Lehman did not make the argument that plaintiffs seek to refute, this is apparently another example of plaintiffs' cookie-cutter briefing gone awry. The admissibility of such evidence would obviously be governed by the rules of evidence — particularly those concerning relevance and prejudice. But since the claims against Lehman should never pass the pleading stage, this should never become an issue.

Dated: June 24, 2002

Respectfully submitted,



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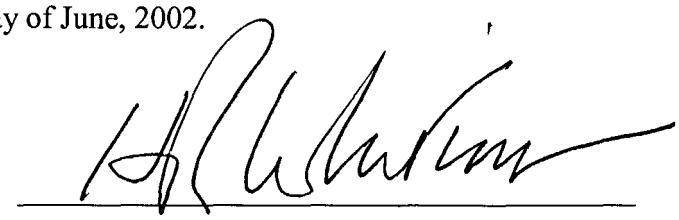
CERTIFICATE OF SERVICE

I certify that true and correct copies of the Reply Memorandum In Support Of Motion To Dismiss Of Lehman Brothers Holdings Inc. were served upon all known parties as identified in the attached Service List on this the 24th day of June, 2002.



The Service List

Attached

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