FILED

MAY 20 2009

SUPERIOR COURT
BETTY J. GOULD
THURSTON COUNTY CLERK

09-2-01222-3

SUPERIOR COURT OF THE STATE OF WASHINGTON

COUNTY OF THURSTON

WASHINGTON STATE INVESTMENT BOARD, Plaintiff, vs. RICHARD S. FULD, JR., CHRISTOPHER M. O'MEARA, ERIN M. CALLAN, MICHAEL L. AINSLIE, JOHN F. AKERS, ROGER S. BERLIND, THOMAS H. CRUIKSHANK, MARSHA JOHNSON EVANS, SIR CHRISTOPHER GENT, ROLAND A. HERNANDEZ, HENRY KAUFMAN, JOHN D. MACOMBER, ANZ SECURITIES, INC., BANCA IMI S.p.A., BBVA SECURITIES INC., BANC OF AMERICA SECURITIES LLC, BNY CAPITAL MARKETS, INC., CITIGROUP GLOBAL MARKETS INC., COMMERZBANK CAPITAL MARKETS CORP., COUNTRYWIDE SECURITIES CORPORATION, DAIWA SECURITIES SMBC EUROPE LIMITED, FORTIS SECURITIES LLC,	Case No. COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAWS AND WASHINGTON STATE LAW <u>DEMAND FOR JURY TRIAL</u>

[Caption continued on following page.]

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COPY

LaSALLE FINANCIAL SERVICES INC., HYPO CAPITAL MARKETS, INC., HVB CAPITAL MARKETS, INC., SUNTRUST CAPITAL MARKETS, INC., WELLS FARGO SECURITIES, LLC, ZIONS DIRECT and ERNST & YOUNG LLP and DOES 1 through 100, inclusive,	)
Defendants.	)

NATURE OF THE ACTION

1. This is a suit involving certain notes of Lehman Brothers Holdings Inc. ("Lehman" or the "Company")[1] naming as defendants Lehman's officers and directors, its investment bankers and its accountants (collectively, "defendants") for violations of the Securities Act of 1933 ("1933 Act"), the Washington State Securities Act, breach of fiduciary duty and negligent misrepresentation, arising out of plaintiff Washington State Investment Board's ("WSIB") purchases of Lehman Subordinated Notes and/or Senior Debt Notes. For purposes of the 1933 Act, breach of fiduciary duties and negligent misrepresentation claims, plaintiff asserts only strict liability and/or negligence and does not allege fraud.

2. In 2006 and 2007, Lehman and its bankers raised billions of dollars in several offerings of investment-grade rated notes by means of a false and defective Registration Statement and Prospectuses, including offering 5.75% Subordinated Notes Due 2017 ("5.75% Notes") on October 17, 2006 (the "5.75% Notes Offering") and/or 5.25% Medium-Term Notes, Series I ("5.25% Notes") on January 11, 2007 (the "5.25% Notes Offering"). WSIB purchased $80,000,000 of the 5.75% Notes and $30,000,000 of the 5.25% Notes. WSIB's 5.75% Notes purchases included $50,000,000 purchased in 2008 when Lehman's financial position had become even more precarious.

3. As set forth herein, the Registration Statement, Prospectuses and Pricing Supplements ("Offering Documents") that were filed in connection with the offerings at issue (the "Offerings") failed to disclose the true financial condition and performance of the Company. Specifically, the documents failed to disclose Lehman's losses and exposure in connection with the Company's subprime and Alt-A lending activities and the true value of the Company's mortgage-related assets.

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[1] Lehman is not a defendant in this lawsuit due to its filing, on September 15, 2008, for bankruptcy protection under Chapter 11 of the Bankruptcy Code. Similarly, Lehman Brothers, Inc. ("LBI") is not a defendant in this lawsuit due to its forced dissolution on September 19, 2008. LBI was wholly-owned by Lehman and was Lehman's primary broker-dealer subsidiary.

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The Offering Documents further failed to disclose the risks associated with Lehman's substantial increase in its use of leverage. When Lehman's losses and exposure came to light, the revelations led to Lehman's bankruptcy and WSIB lost most of its invested capital.

OVERVIEW

4. Prior to its bankruptcy filing, Lehman provided various financial services to corporations, governments and municipalities, institutions and high net worth individuals worldwide, including equity and fixed income sales, trading and research, investment banking, asset management, private investment management and private equity.

5. From 1994 to 2006, at the direction of defendant Richard S. Fuld, Jr. ("Fuld"), Lehman became increasingly involved in the mortgage market and securitizing mortgage-related products. Furthermore, at the direction of defendant Fuld, Lehman dramatically increased its use of leverage to fund its real estate investment activities from 2004 to 2007. As a result, Lehman's revenue and earnings grew at an impressive rate. Lehman engaged in securitizing mortgage-backed securities, becoming one of the largest issuers of mortgage-backed securities by the early 2000s. Mortgage-backed securities are created by purchasing mortgages and repackaging pools of mortgages into new securities. The new securities are divided into different types of tranches or slices classified by varying levels of credit risk and sold to investors. Lehman marketed and sold its mortgage-backed securities to large pension funds and other financial institutions.

6. The demand for mortgage-related securitized transactions grew substantially from 1994 to 2005, generating a great deal of revenue for Lehman. In order to fuel the demand for its securitization transactions, Lehman purchased two mortgage lenders, BNC Mortgage ("BNC") and Aurora Loan Services LLC ("Aurora"). BNC specialized in the subprime mortgage market while Aurora specialized in the Alt-A market. An Alt-A mortgage or Alternate A-paper is a type of mortgage where the risk profile falls between prime and subprime. An Alt-A borrower has a credit score above subprime but the mortgage generally has some issues that increase its risk profile, such as higher loan-to-value or debt-to-income ratios or inadequate documentation of the borrower's

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income. Both BNC and Aurora engaged in risky lending practices in order to generate a greater number of loans for Lehman to purchase and securitize.

7. The Offering Documents failed to adequately disclose Lehman's aggressive mortgage lending activities and the risks surrounding these activities, including failing to adequately discuss Lehman's relationship with its mortgage originators, including BNC and Aurora. The Offering Documents further failed to properly value Lehman's mortgage-related assets or to provide proper risk disclosures concerning Lehman's mortgage-related exposure. Additionally, the documents failed to provide adequate disclosures regarding the risks associated with Lehman's increased dependence on leverage to fund its real estate investment activities. The Offering Documents further provided false assurances that Lehman was properly engaging in risk management strategies to minimize its real-estate related risks.

8. Ernst & Young LLP ("Ernst & Young"), which had been Lehman's outside auditor since at least 1992, repeatedly issued unqualified audit reports on Lehman's annual financial statements, which consistently concealed these problems, in addition to signing off on Lehman's quarterly results.

9. Thereafter, throughout the remainder of fiscal year 2006 and through mid-fiscal year 2008,[2] defendants continued to issue false and defective statements concerning Lehman's operations and its accounting for its real-estate related assets. Defendants further downplayed Lehman's exposure to risky real estate assets and its leverage exposure.

10. On September 10, 2008, Lehman pre-released its results for the third quarter of 2008, reporting a net loss of $3.9 billion and $7.8 billion in write-downs, which included $7 billion on its residential and commercial real estate holdings. Four days later, Lehman filed the largest bankruptcy in U.S. history, making the value of the 5.75% Notes held by plaintiff almost worthless

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[2] At all relevant times, Lehman's fiscal year ran from December 1 to November 30. Hereinafter, fiscal year will be abbreviated FY (*i.e.*, FY 2005 for fiscal year 2005) and fiscal quarter will be abbreviated Q (*i.e.*, 1Q 2006 for first quarter of fiscal year 2006).

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and the 5.25% Notes held by plaintiff worth 80%-90% less than they were worth prior to the bankruptcy.

11. On October 6, 2008, the Committee on Oversight and Government Reform held hearings to determine the causes and effects of Lehman's bankruptcy.

12. Further, in October 2008, three separate criminal investigations were launched by the U.S. Attorneys' offices in the Eastern and Southern Districts of New York as well as the District of New Jersey into the events surrounding the collapse of Lehman and whether the Company and its executives misled investors, including whether Lehman valued its assets at artificially high levels.

13. The true facts which were omitted from the Registration Statement and subsequent documents were:

(a) Lehman's true exposure to risk from mortgage-related transactions and assets was understated;

(b) Lehman's subsidiaries, BNC and Aurora, were engaging in high-risk residential mortgage lending practices, which resulted in mortgage loans that would be much more likely to end up defaulting and causing losses;

(c) Defendants failed to properly mitigate the risks associated with Lehman's mortgage financing activities;

(d) Lehman violated Generally Accepted Accounting Principles ("GAAP") in preparing and disseminating false and misleading financial statements with respect to its accounting for mortgage-related assets;

(e) The extent of Lehman's leverage exposure was misstated;

(f) Lehman's internal controls were inadequate to prevent the Company from engaging in risky lending practices; and

(g) The Company's capital base was not adequate enough to withstand the significant deterioration in the real-estate markets and, as a result, Lehman would be forced to file for bankruptcy protection due to its subprime and Alt-A exposure.

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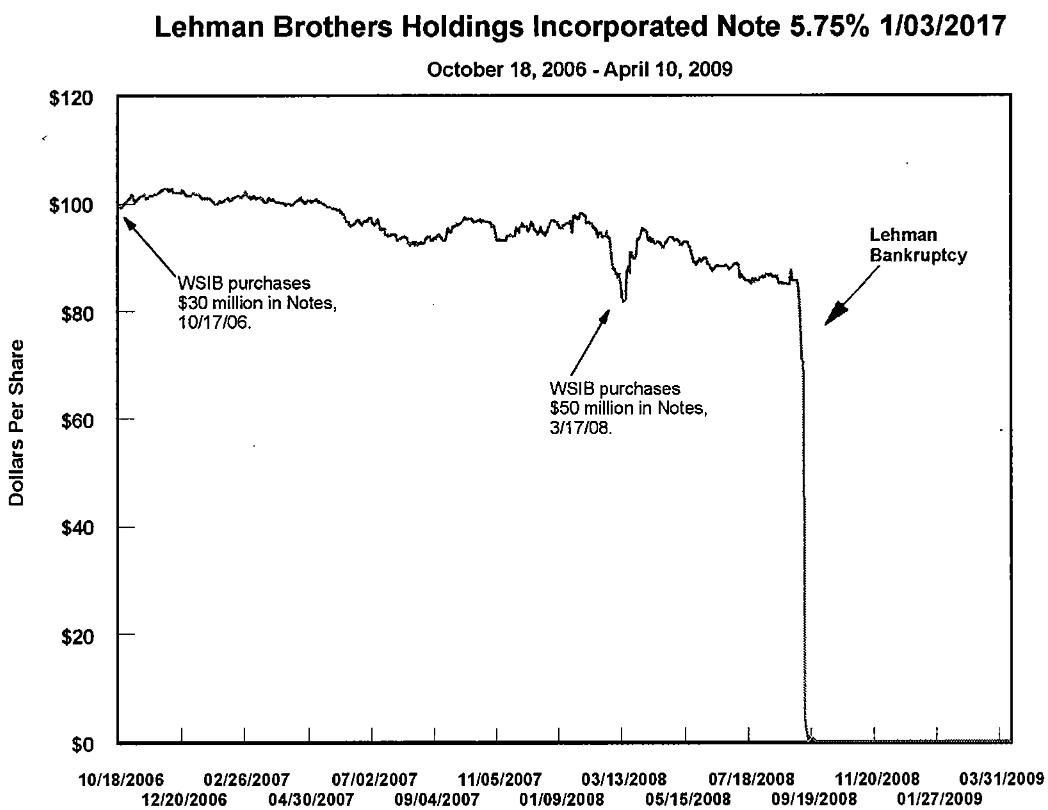
14. Following the Offerings, the Notes traded near face value of $100 per Note. The Notes declined in tandem with other financial institutions as the meltdown in the troubled financial market intensified in the first half of 2008. Thereafter, once the Company collapsed into bankruptcy, the Notes lost most of their value. The 5.75% Notes currently trade at less than $0.07 per Note and the 5.25% Notes currently trade at approximately $12.50 per Note. Note the following charts:



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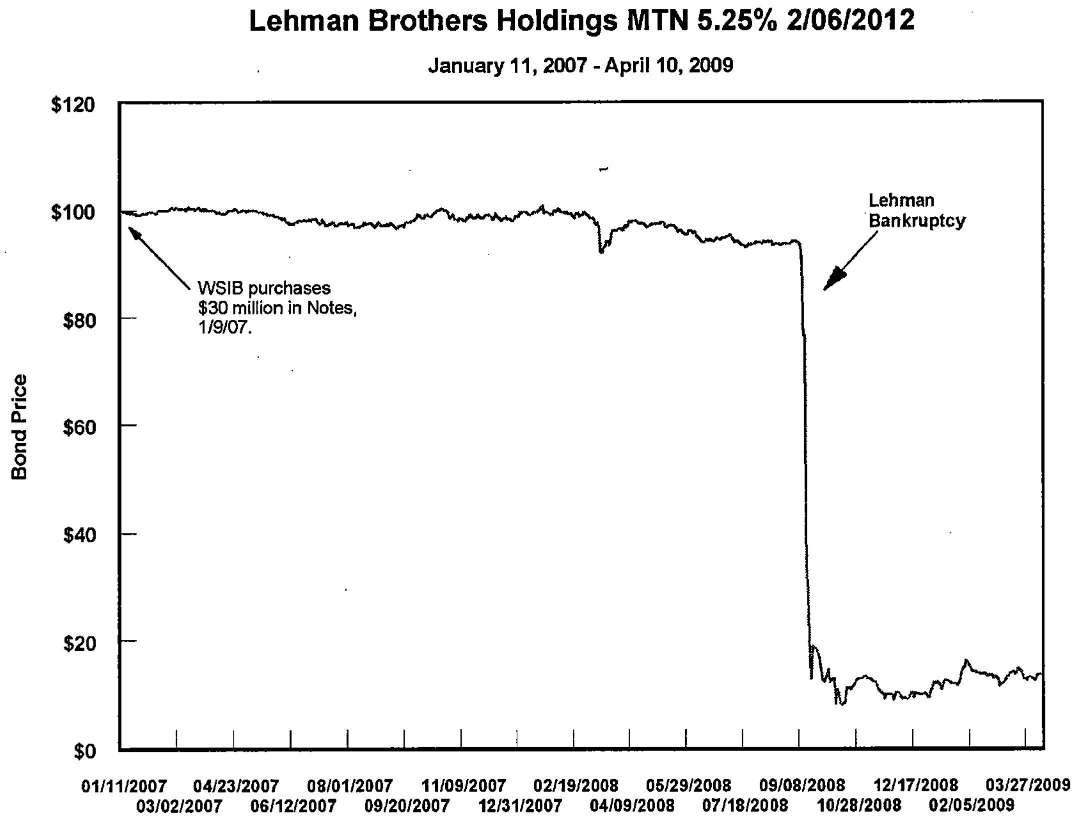

JURISDICTION AND VENUE

15. The claims alleged herein arise under §§11, 12(a)(2) and 15 of the 1933 Act [15 U.S.C. §§77k, 77l(a)(2) and 77o], as well as provisions of the Washington State Securities Act [Revised Code of Washington ("RCW") §21.20, *et seq.*] and state common law. Jurisdiction is conferred by §22 of the 1933 Act and venue is proper pursuant to §22 of the 1933 Act. Section 22 of the 1933 Act explicitly states that "[e]xcept as provided in section 16(c), no case arising under this title and brought in any State court of competent jurisdiction shall be removed to any court in the United States." Section 16(c) refers to "covered class actions," which are defined as lawsuits brought as class actions or brought on behalf of more than 50 persons asserting claims under state or common law. ***This is an individual action asserting federal and state law claims***. Thus, it does not fall within the definition of a "covered class action" under §16(b)-(c) and therefore is not removable

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to federal court under the Securities Litigation Uniform Standards Act of 1998. *See In re Waste Mgmt., Inc. Secs. Litig.*, 194 F. Supp. 2d 590 (S.D. Tex. 2002).

16. The claims alleged herein arise under provisions of Washington state law. This is an individual action asserting state law claims. Jurisdiction is conferred by provisions of Washington state law, including RCW §2.08.010. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §1331 and §22 of the 1933 Act.

17. The violations of law complained of herein occurred in this County, including the dissemination of materially false and misleading statements complained of herein into this County.

18. Venue is proper in Washington pursuant to §22 of the 1933 Act and 28 U.S.C. and §1391(b) and (c). Venue is further proper pursuant to RCW §4.12.025. Many of the acts and practices complained of herein occurred in substantial part in Washington, and defendants offered, advertised, promoted, sold, profited from or materially asserted, aided and participated in the offering, advertising, promotion, sale or realization of profits from the sale of securities in the State of Washington to plaintiff based upon false and materially misleading information and materials. Venue is proper in the County of Thurston, Washington, because plaintiff has offices located in said county.

19. Each of the defendants has minimum contacts with this state and/or conducts business here sufficient to permit the exercise of jurisdiction over them here. Thus, there is not complete diversity of citizenship and removal on diversity of citizenship is improper.

PARTIES

Plaintiff

20. Plaintiff WSIB is a state agency responsible for the prudent investment and management of public trust and public employee retirement funds. It invests for seventeen retirement plans that benefit public employees, teachers, school employees, law enforcement officers, firefighters and judges. There are approximately 450,000 active and retired members of these plans. WSIB also manages investments for twenty-two other public funds that support or

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benefit industrial insurance, colleges and universities, developmental disabilities, and wildlife protection and the agency manages a public employee deferred compensation program that supplements other retirement benefits. WSIB was created and operates under the provisions of Chapter 43.33A of the Revised Code of Washington.

Relevant Non-Parties

21. Lehman is a corporation organized under the laws of the state of Delaware with its headquarters located at 1271 Avenue of Americas, New York, New York. Lehman operated as a global investment bank and purported to be "an innovator in global finance" with a "leadership position in equity and fixed income sales, trading and research." Lehman's common stock traded on the New York Stock Exchange. On September 15, 2008, in this District, Lehman filed a voluntary petition for bankruptcy protection under Chapter 11 of the Bankruptcy Code. For this reason, Lehman is not named as a defendant in this action.

22. LBI, based in New York, New York, is a wholly-owned subsidiary of Lehman and operated as a registered broker-dealer under the Securities Exchange Act of 1934. LBI's services included brokerage, mergers and acquisitions and restructuring advice, debt and equity underwriting, market making, debt and equity research, and real estate and private equity investments. On September 17, 2008, the Securities Investor Protection Corporation ("SIPC") moved for an order commencing liquidation and protection under the automatic stay provisions of the Bankruptcy Code. The Bankruptcy Court granted the request on September 19, 2008. For this reason, LBI is not named as a defendant in this action.

Defendants

23. Defendant Richard S. Fuld, Jr. ("Fuld") was the Chairman of the Board of Directors and Chief Executive Officer ("CEO") of Lehman since 2000. Fuld received $111.8 million from FY 2003 to FY 2007 in salary, bonuses and restricted stock unit awards, including $3.75 million in salary, $36.9 million in bonuses and $71.2 million in restricted stock unit awards. Fuld's bonus amount was a substantial portion of his compensation as it was nearly ten times his base salary.

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Additionally, Fuld received $190.8 million in insider trading proceeds from FY 2003 through FY 2007. Fuld signed the May 30, 2006 Form S-3 Registration Statement ("Form S-3 Registration Statement").

24. Defendant Christopher M. O'Meara ("O'Meara") served as the Company's Chief Financial Officer ("CFO"), Controller and Executive Vice President from 2004 until December 1, 2007, when he assumed the role of Global Head of Risk Management. O'Meara received $12.4 million from FY 2005 to FY 2007 in salary, bonuses and restricted stock unit awards, including $600,000 in salary, $4.8 million in bonuses and $6.7 million in restricted stock unit awards. O'Meara's bonus amount was a substantial portion of his compensation as it was eight times his base salary. Additionally, O'Meara received $1.2 million in insider trading proceeds from FY 2003 through FY 2007. O'Meara signed the Form S-3 Registration Statement.

25. Defendant Erin M. Callan ("Callan") served as CFO, Controller and Executive Vice President from December 2007 until June 2008. Callan resigned from the Company in July 2008. Previously, Callan served in various positions at Lehman since joining the Company in 1995.

26. Defendant Michael L. Ainslie ("Ainslie") was a director of Lehman during the relevant period. Ainslie signed the Form S-3 Registration Statement.

27. Defendant John F. Akers ("Akers") was a director of Lehman during the relevant period. Akers signed the Form S-3 Registration Statement.

28. Defendant Roger S. Berlind ("Berlind") was a director of Lehman during the relevant period. Berlind signed the Form S-3 Registration Statement.

29. Defendant Thomas H. Cruikshank ("Cruikshank") was a director of Lehman during the relevant period. Cruikshank was also a director of LBI. Cruikshank signed the Form S-3 Registration Statement.

30. Defendant Marsha Johnson Evans ("Evans") was a director of Lehman during the relevant period. Evans signed the Form S-3 Registration Statement.

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31. Defendant Sir Christopher Gent ("Gent") was a director of Lehman during the relevant period. Gent signed the Form S-3 Registration Statement.

32. Defendant Roland A. Hernandez ("Hernandez") was a director of Lehman during the relevant period. Hernandez signed the Form S-3 Registration Statement.

33. Defendant Henry Kaufman ("Kaufman") was a director of Lehman during the relevant period. Defendant Kaufman signed the Form S-3 Registration Statement.

34. Defendant John D. Macomber ("Macomber") was a director of Lehman from 1996 until Lehman's bankruptcy on September 15, 2008. Defendant Macomber signed the Form S-3 Registration Statement.

35. The defendants identified in ¶¶23-34 are referred to herein as the "Individual Defendants."

36. Defendant ANZ Securities, Inc. ("ANZ") is an affiliated company of ANZ Bank based in Melbourne, Australia. ANZ provides a full range of financial products and services to business, corporate and institutional clients. ANZ was an underwriter of the 5.25% Notes Offering.

37. Defendant Banca IMI S.p.A. ("Banca IMI") is an investment bank. Its services include dealing in Italian equities, fixed-income trading and sales, macroeconomic and quantitative research, and capital markets advisory and underwriting services. Banca IMI is based in Milan, Italy, with an additional office in London, the U.K. Banca IMI was an underwriter of the 5.75% Notes Offering.

38. Defendant BBVA Securities Inc. ("BBVA") is a security broker/dealer which provides securities brokerage and research services. BBVA is based in New York, New York. BBVA was an underwriter of the 5.75% Notes Offering.

39. Defendant Banc of America Securities LLC ("Banc of America") is the investment banking arm of Bank of America. Banc of America offers trading and brokerage services; debt and securities underwriting; debt and equity research; and advice on public offerings, leveraged buyouts, and mergers and acquisitions. Banc of America was an underwriter of the Offerings.

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40. Defendant BNY Capital Markets, Inc. ("BNY") is a boutique investment banking firm that offers corporate finance advisory services and fixed-income securities. BNY is a subsidiary of The Bank of New York Mellon Corporation. BNY was an underwriter of the 5.25% Notes Offering.

41. Defendant Citigroup Global Markets Inc. ("Citigroup") is a large integrated financial services institution that through subsidiaries and divisions provides commercial and investment banking services, commercial loans to corporate entities, and acts as underwriter in the sale of corporate securities. Citigroup was an underwriter of the Offerings.

42. Defendant Commerzbank Capital Markets Corp. ("Commerzbank") provides securities brokerage and underwriting services. Commerzbank is a subsidiary of Commerzbank Aktiengesellschaft. Commerzbank was an underwriter of the 5.75% Notes Offering.

43. Defendant Countrywide Securities Corporation ("Countrywide") as a subsidiary of Countrywide Capital Markets, Inc. Countrywide was an underwriter of the 5.75% Notes Offering.

44. Defendant Daiwa Securities SMBC Europe Limited ("Daiwa") operates as an investment banking firm that provides equity, fixed income, investment banking, underwriting derivatives and strategic advisory services. Daiwa was an underwriter of the 5.25% Notes Offering.

45. Defendant Fortis Securities Inc. ("Fortis") operates as an investment bank. Fortis was an underwriter of the 5.75% Notes Offering.

46. Defendant LaSalle Financial Services, Inc. ("LaSalle") provides financial consulting services. LaSalle was formerly known as ABN AMRO Financial Services, Inc. LaSalle was an underwriter of the Offerings.

47. Defendant Hypo Capital Markets, Inc. ("Hypo") is a securities broker/dealer. Hypo was an underwriter of the 5.25% Notes Offering.

48. Defendant HVB Capital Markets, Inc. ("HVB") is a securities broker/dealer. HVB was an underwriter of the 5.25% Notes Offering.

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49. Defendant SunTrust Capital Markets, Inc. ("SunTrust") is a full-service investment banking and capital markets company that provides capital raising, strategic advisory, risk management, and investment solutions to corporate clients across the nation. SunTrust was an underwriter of the Offerings.

50. Defendant Wells Fargo Securities LLC ("Wells Fargo") is an investment services division of Wells Fargo Bank. Wells Fargo provides investment banking services in the United States and offers capital markets access through public offerings, private placements, and debt offerings, which include new issue underwriting of high yield bonds and 144A private placements, as well as market making, research, and equity trading. Wells Fargo also provides advisory services for mergers and acquisitions. Wells Fargo was an underwriter of the Offerings.

51. Defendant Zions Direct ("Zions") is a wholly owned subsidiary of Zions First National Bank. Zions is an online broker-dealer that specializes in offering securities for the self-directed and fixed income investors. Zions was an underwriter of the 5.75% Notes Offering.

52. Pursuant to the 1933 Act, the defendants referenced in ¶¶36-51 above are referred to herein as the "Underwriter Defendants."

53. The Underwriter Defendants are ***liable*** for the false and misleading statements in the Form S-3 Registration Statement. In connection with the Offerings, the Underwriter Defendants drafted and disseminated the Form S-3 Registration Statement and were paid fees in connection therewith. The Underwriter Defendants' failure to conduct an adequate due diligence investigation was a substantial factor leading to the harm complained of herein.

54. Defendant Ernst & Young acted as the Company's independent outside auditor during the relevant period. Ernst & Young audited the Company's false and misleading financial statements contained in the Form 10-Ks for 2005-2007. Ernst & Young issued materially false and misleading opinions in these statements. Ernst & Young also issued quarterly reports on Lehman's interim results, again without qualifications. Ernst & Young further consented to the incorporation of its 2005 audit opinion into the Offerings.

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55. The true names and capacities of defendants sued herein under Wash. Rule CR 10(a)(2) as Does 1 through 100, inclusive, are presently unknown to plaintiff, who therefore sues these defendants by such fictitious names. Plaintiff will seek to amend this Complaint and include these Doe defendants' true names and capacities when they are ascertained. Each of the fictitiously named defendants is responsible in some manner for the conduct alleged herein.

BACKGROUND

56. Lehman was an integrated financial services institution that provided commercial and investment banking services, commercial loans to corporate entities, and acted as an underwriter in the sale of corporate securities. Lehman is not a named defendant in this lawsuit due to its filing, on September 15, 2008, for bankruptcy protection under Chapter 11 of the Bankruptcy Code. Similarly, LBI is not a named defendant in this lawsuit due to its forced dissolution on September 19, 2008. LBI was wholly-owned by Lehman and was Lehman's primary broker-dealer subsidiary.

57. The 158-year-old firm has its roots in a dry-goods store in Montgomery Alabama. In 1850, the newly formed Lehman Brothers began accepting raw cotton as payment for its merchandise and later began trading the cotton. As the Company's cotton trading business grew, Lehman moved its headquarters to New York and began to focus on its commodities/brokerage business, including helping to launch the cotton commodities exchange. Initially, Lehman continued to focus on commodities such as cotton and coffee and later diversified to become a full-fledged investment bank.

58. In 1984, American Express purchased Lehman in the midst of a power struggle between the Company's traders and its investment bankers over the direction of the Company. At the time, defendant Fuld sided with the firm's traders. Under American Express's direction, Lehman's operations were scaled back and it became known as a stodgy old bond-trading house.

59. In 1994, Lehman became a public company once again after being spun-off from American Express with defendant Fuld at the helm. As CEO, defendant Fuld was determined to diversify the firm away from being a second-tier bond-trading shop and turn it into a full service

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investment bank. Fuld, known as "The Gorilla" of Wall Street given his relentless style, steered the Company into the budding mortgage-backed securities market and eventually deep into risky subprime and Alt-A mortgages.

60. The decision initially paid off and Lehman soon became one of the dominant players in the real estate market, being engaged in all aspects of the mortgage market from originating the mortgages to securitization of the loans. Through its subsidiaries, Aurora and BNC, Lehman was one of the ten largest mortgage lenders in the U.S. These subsidiaries in turn sold nearly all of their loans to Lehman, making Lehman one of the largest issuers of mortgage-backed securities. From 2004 to 2007, Lehman securitized $480 billion in mortgages, with Aurora originating one third of the securitized loans and BNC originating another 20% of them.

61. Lehman's real estate activities and in particular the fees generated from the sale of its mortgage-backed securities helped the Company report record earnings in 2005, 2006 and 2007. Sales in its capital markets business segment, which included its mortgage origination and securitization activities, increased 56% from 2004 to 2006, a faster growth rate than in Lehman's two other business segments.

62. Nonetheless, in order to continue fueling the unprecedented growth, Lehman began employing high-risk, deceptive lending practices in originating subprime and Alt-A loans at least as early as 2004 and continuing through 2007. These high-risk loans were then bundled together into mortgage-backed securities and either sold to investors or held by Lehman if it was unable to sell them on.

63. In addition, due to an SEC change which relaxed the rule limiting the amount of leverage that Lehman and other investments banks were allowed to use, Lehman substantially increased its use of leverage to fund its real-estate investment activities beginning in 2004. The increase in leverage aggravated Lehman's risk exposure making it more vulnerable to deteriorations in the real-estate market.

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64. Partly as a result of Lehman's mortgage-related risks and increasing exposure to risky subprime and Alt-A mortgages and its dramatic increase in its reliance on leverage, Lehman collapsed into bankruptcy in September 2008. Statements made by defendants from at least 2006 through mid-September 2008, including statements made in the Offering Documents prepared, reviewed and/or disseminated by defendants, failed to adequately disclose the Company's mortgage-related activities and exposures and the risks associated with these activities and exposures.

Mortgage Origination Business

65. The Offering Documents and subsequent Lehman statements were false and misleading as to Lehman's mortgage origination business in that the statements failed to disclose that Lehman had employed high risk lending practices in originating subprime and Alt-A loans and the true risks associated with its aggressive mortgage practices.

66. In order to fuel its securitization pipeline, the Individual Defendants caused Lehman to provide a great deal of assistance to aggressive mortgage lending companies. Lehman would provide the mortgage companies with assistance in going public. Lehman would further provide these companies with warehouse lines of credit in order for the companies to be able to originate loans to home buyers. Lehman would then buy the loans originated with its lines of credits from the mortgage companies and bundle them into securities to resell to investors. Many of these loans were issued by questionable lenders, such as First Alliance – a mortgage lender that collapsed in 2000 due to its deceptive mortgage practices.[3] Nonetheless, Lehman continued to do business with these lenders in order to meet the demand for its securitizations.

67. Later, as the market for mortgage-backed securities continued to grow, the Individual Defendants caused Lehman to purchase interests in mortgage lending companies in order to meet its

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[3] In a California class-action case, a jury reached a verdict in June 2003, finding Lehman partially responsible for First Alliance's conduct and ordering the Company to pay $5 million in damages.

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ever increasing demand for real-estate loans. In 2003 and 2004, with the housing boom underway, Lehman acquired five mortgage lenders, including Alt-A lender Aurora and subprime lender BNC.

Aurora

68. Lehman purchased a stake in Aurora in 1997 and acquired a controlling interest in the company in February 2003. According to the Company's FY 2003 10-K:

> During the second quarter of 2003, the Company acquired a controlling interest in Aurora Loan Services ("ALS"), a residential mortgage loan originator and servicer. The Company believes this acquisition adds long-term value to its mortgage franchise by allowing further vertical integration of the business platform. ***Mortgage loans originated by ALS are intended to provide a more cost efficient source of loan product for the Company's securitization pipeline.*** . . . In July 2003, the Company acquired a controlling interest in another residential mortgage loan originator. The strategic objective of this acquisition mirrors that of ALS–to increase the vertical integration of the Company's mortgage business by expanding the pipeline of loan product for securitization.

69. Thereafter, the Individual Defendants attempted to conceal Lehman's relationship with Aurora by failing to provide any mention of Aurora in the Company's financial press releases, conference calls and public filings. The Individual Defendants further concealed Lehman's interest in Aurora from homebuyers who obtained home loans through Aurora in order to insulate Lehman from any negative publicity generated from Aurora's deceptive lending practices.

70. Aurora was a wholesale and correspondent lender, underwriting loans originated for it by independent brokers and mortgage banks. It was a major player in Alt-A loans. On the spectrum of risk, Alt-A mortgages lie between prime and subprime. Alt-A borrowers have credit scores above subprime but do not otherwise meet the underwriting guidelines of government lenders Fannie Mae and Freddie Mac. Many of these loans were stated-income loans which allowed borrowers to simply state their monthly income on mortgage documents without requiring verification of the actual amounts by having the borrowers furnish pay stubs or tax returns as required with traditional prime loans.

71. As competition increased for the Alt-A loans, Aurora loosened its lending standards as its underwriters felt increasing pressure to approve mortgages that did not meet company guidelines. Many loans were approved from 2004 through 2006 with higher loan-to-value and debt-

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to-income ratios, key measures of risks. Many of these loans were approved based on terms that would have been rejected a few years earlier.

72. Aurora further began to offer new and riskier products in order to gain market share in the competitive Alt-A market, often offering loans with little or no money down, piggyback loans or interest only loans. Aurora further offered many of these products in the over-heated California real-estate market. For example, in 2006, Aurora began making no-money-down loans to investors buying multiple-unit properties without proof of income. Loans made to buyers of investment property rather than to traditional homebuyers carry additional risk as people who live in a property are less likely to default than investors.

73. Furthermore, in many instances, the borrowers or brokers inflated the income reported on the stated-income loans or "liar loans." The brokers and mortgage bankers had every incentive to make the loans as they were paid generously no matter whether the loan later went into default or not. Many of the borrowers accepted the risky loans with no money down and loans with low "teaser" interest rates, knowing that they would be unable to make the payments once the interest rates reset. Nonetheless, the borrowers were told they would easily be able to refinance or sell the property at the time of the reset as real-estate prices were continuing to rise.

74. As a result, the Alt-A market grew substantially from $190 billion in 2004 to $400 billion in 2006. The Individual Defendants were fully aware of the risk practices being employed by Aurora but permitted them to continue in order to continue obtaining loans for the Company's lucrative securitization transactions. An article in *The Globe and Mail* dated December 22, 2008, entitled "Lehman's Rise and Fall," provided in pertinent part:

> Mark Golan was getting frustrated as he met with a group of auditors from Lehman Brothers.
>
> It was spring, 2006, and Mr. Golan was a manager at Colorado-based Aurora Loan Service LLC, which specialized in "Alt A" loans, considered a step above subprime lending. Aurora had become one of the largest players in that market, originating $25-billion worth of loans in 2006. It was also the biggest supplier of loans to Lehman for securitization.

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> Lehman had acquired a stake in Aurora in 1998 and had taken control in 2003. ***By May, 2006, some people inside Lehman were becoming worried about Aurora's lending practices.*** The mortgage industry was facing scrutiny about billions of dollars worth of Alt-A mortgages, also known as "liar loans"– because they were given to people with little or no documentation. In some cases, borrowers demonstrated nothing more than "pride of ownership" to get a mortgage.
>
> ***That spring, according to court filings, a group of internal Lehman auditors analyzed some Aurora loans and discovered that up to half contained material misrepresentations. But the mortgage market was growing too fast and Lehman's appetite for loans was insatiable. Mr. Golan stormed out of the meeting, allegedly yelling at the lead auditor: "Your people find too much fraud."***

75. Beginning in 2006 (the same time as the Offering Documents were being prepared), cracks began to show in the mortgage market. Lehman's own traders saw signs of trouble in the housing market and in late 2006 even began to bet against the price of home loans. Nonetheless, Aurora continued its risky lending practices and continued making Alt-A loans. Although it was at a somewhat lower level, Aurora continued making Alt-A loans throughout 2007. It was not until January 2008 that Lehman suspended its wholesale and correspondent lending activities at Aurora.

BNC Mortgage

76. In 2004, Lehman purchased BNC, which specialized in subprime loans. According to the Company's FY 2004 10-K:

> *Capital Markets.* During 2004, we acquired three mortgage banking platforms for an aggregate cost of approximately $184 million. In addition, we sold our reverse mortgage originator for approximately $42 million. The gain on the sale was not significant. ***We believe the acquisitions add long-term value to our mortgage franchise by allowing further vertical integration of the business platform. Mortgage loans originated by the acquired companies are intended to provide a more cost efficient source of loan product for our securitization pipeline.*** During 2003, we acquired controlling interests in two mortgage loan originators for an aggregate cost of approximately $35 million. Headcount associated with these acquisitions were approximately 1,300 and 2,000 for 2004 and 2003, respectively.

77. Similar to Aurora, the Individual Defendants attempted to conceal Lehman's relationship with BNC by failing to provide any mention of BNC in the Company's financial press releases, conference calls and public filings. The Individual Defendants further concealed Lehman's interest in BNC from homebuyers who obtained home loans through BNC in order to insulate Lehman from any negative publicity generated from BNC's deceptive lending practices.

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78. BNC was a major player in the subprime mortgage market. Subprime lending is the riskiest type of lending as it involves lending to borrowers with low credit scores and high debt ratios. During the housing boom, the subprime market flourished. It increased 292% from 2003 to 2007. As competition increased for subprime loans, BNC in similar fashion to Aurora loosened its lending standards and began to offer new and riskier products in order to gain market share in the competitive subprime market, including offering many of these products in the risky California real-estate market where BNC was based.

79. When housing prices began to decline in 2006 and 2007, refinancing became more difficult at the same time that risky adjustable rate mortgages and interest-only loans began to reset at higher rates. As a result, mortgage delinquencies increased sparking the subprime mortgage crisis. BNC like many subprime lenders suffered substantial losses in 2007. In August 2007, Lehman announced it was shutting down BNC.

Mortgage Securitization Business

80. The Individual Defendants concealed that Lehman had failed to engage in proper due diligence in securitizing high risk loans. The Individual Defendants further caused Lehman to fail to properly value its mortgage-related assets.

81. The high demand for and the lucrative fees generated by Lehman's mortgage securitization practice fueled its high risk mortgage origination activities as Lehman needed more and more loans in order to continue putting together mortgage-backed securities at increasing rates. Similar to the compensation system in place in Lehman's mortgage origination practice, the compensation in its mortgage securitization practice was paid based on how many mortgage-backed securities were put out ever year, thus providing incentives to not engage in proper due diligence in assessing the quality of the loans underlying the securitized transactions.

82. In connection with some of its securitization transactions, Lehman would often times hold onto certain of the lower-rated/higher-risk tranches of its mortgage-backed securitization

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transactions if it was unable to sell the higher risk slices to other investors or if it wanted to add to its own investment returns.

83. Beginning in late 2006 as default rates on subprime loans spiked, the securitization market began to dry up. By August 2007, investors' appetite for these securities was diminished significantly. Nonetheless, Aurora continued making Alt-A loans which Lehman was no longer able to securitize and sell on. As a result, Lehman began to accumulate additional large amounts of Alt-A mortgages and mortgage-backed assets. However, Lehman failed to properly write down those assets as their value declined. Indeed, Lehman's failure to properly write down its Alt-A and mortgage-related exposure is illustrated by the much larger write-downs recorded by its peers in the same time period with regard to similar assets.

84. For example, in the third quarter of 2007, Merrill Lynch recorded a $7.9 billion write-down against $28.8 billion of certain mortgage-related securities, while UBS wrote down roughly $3.7 billion of its $19 billion in mortgage-backed securities. In comparison, Lehman took a net write-down of $700 million in the same quarter against its $88 billion in mortgage-related holdings.

85. In the fourth quarter of 2007, Citigroup wrote down $17.4 billion, against $44.4 billion in subprime-related assets and Merrill Lynch wrote down $11.5 billion against $28.9 billion in such assets. In the same quarter, Lehman took a total net write-down of only $1.5 billion on its mortgage- and asset-backed holdings of over $70 billion. Thus, while Citigroup's and Merrill Lynch's write-downs equaled 39% and 40% of their respective subprime assets, Lehman wrote down only 2% of its subprime assets.

86. Finally, on September 10, 2008, Lehman pre-announced a staggering $7 billion gross write-down of its mortgage-related holdings for the third quarter of 2008, stating: "The majority of our write-downs were in Alt-A driven by an increase in Alt-A delinquencies and loss expectations which were specific to Alt-A prices . . . ."

87. The failure to timely write down the impaired Alt-A assets was due in part to improper shifts in large amounts of Lehman's mortgage assets into the Level 3 accounting category

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in order to avoid writing them down, which overstated the value of Lehman's Alt-A assets, and inflated certain real estate and mortgage holdings far above what many were sold for shortly thereafter.

88. Level 2 assets are valued using, *inter alia*, objective market data such as the market prices of mortgage-related assets as reflected in the ABX and CMBX indices. In contrast, Level 3 assets are valued at management's discretion using internal models instead of objective market data. By improperly categorizing assets as Level 3 and by using inappropriate models to inflate the reported values of those assets, Lehman reported inflated values for billions of dollars in assets.

89. During 2007, the ABX index declined significantly, as did the CMBX. As a result, Level 2 assets that had to be valued in relation to market prices should have been marked down accordingly. Instead of doing so, however, Lehman improperly recategorized large swaths of assets as Level 3 and maintained their inflated valuations using models instead of market prices. Indeed, the percentage of mortgage- and asset-backed securities Lehman categorized as Level 3 increased from $20.8 billion (12.5%) in 2Q 2007 to $37.9 billion (28%) a year later. This shift allowed Lehman to avoid huge write-downs that would otherwise have been required due to the decline in market prices for mortgage-related assets.

Commercial and Other Real Estate Holdings

90. In addition to Lehman's lending and securitization activities, Lehman also held investments in commercial and other types of real-estate related assets. As the real-estate market declined, Lehman further suffered substantial losses in it commercial real estate portfolio. Lehman was required to "mark to market" its commercial real estate holdings, meaning to value the assets at the level at which they could be sold right away. Nonetheless, the Individual Defendants failed to aggressively mark down the value despite the substantial decline in Lehman's portfolio, causing Lehman's portfolio to be vastly overstated.

91. In late August/early September 2008, Lehman sought to extricate itself from its toxic commercial real estate by selling it to an outside investor. Lehman approached Barclays, Bank of

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America, Goldman Sachs and Credit Suisse to consider purchasing the Company's commercial real-estate portfolio. Upon review of Lehman's internal documents, executives at several of the companies were able to quickly surmise that the portfolio was substantially overvalued. As a result, Lehman remained unable to find a buyer for its troubled portfolio.

92. On October 6, 2008, *The Wall Street Journal* reported on the results of negotiations concerning the sale of Lehman and/or some of its assets. According to Lehman documents reviewed in connection with the article by *The Wall Street Journal*, Lehman reported the value of its commercial real-estate holdings to be $32.6 billion at the time. According to several Wall Street executives who reviewed Lehman's documents and analyzed the valuations, they believed the portfolio to be overstated by as much as 35%. Lehman further reported the value of certain European real-estate loans at nearly $0.98 on the dollar, but valued substantially similar U.S. assets at only $0.56 on the dollar. While the European real-estate market had been slightly better than the U.S. market, it had also suffered substantial declines. As a result of these and other inflated valuations, no suitors for Lehman or its assets were found. Further, neither the U.S. Federal Reserve nor the Treasury would agree to bail Lehman out in part due to similar over-valuations.

93. One example of the type of risky real-estate deals that Lehman was involved in was bridge equity financing. Bridge equity financing involves equity or short-term debt financing raised within 6 to 18 months of an anticipated deal. It is temporary financing as it is meant to "bridge" a company to the next round of financing. Typically bridge financing deals have been used in the context by companies just prior to going public or just prior to completing a private placement transaction.

94. While Lehman had been engaged in bridge equity transactions since the mid-90s, Lehman's use of these types of deals increased substantially beginning in 2003. Lehman engaged in bridge equity financing transactions in the real-estate context by allowing real-estate developers to purchase commercial real-estate property with financing from Lehman's bridge equity transactions. The fees associated with these types of deal were lucrative as they were twice the amount of the fees

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earned by a loan securitization transaction, and bridge equity deals soon became a signature product for the Company. Nonetheless, while these deals did provide Lehman with a good return, they also provided Lehman with increased risks and exposure to the commercial real-estate market.

95. For example, Lehman engaged in deals with SunCal Companies ("SunCal"), a Southern California company. SunCal purchased property and then sought government approval for residential development. If it received the approval, then it would often times sell the land to builders for an enormous profit. Lehman established a $2 billion bridge financing deal with SunCal in order to permit SunCal to engage in its real-estate purchases. Ultimately, due to the turmoil in the commercial real-estate market, this deal left Lehman with substantial holdings of illiquid commercial real-estate in Southern California.

96. Another example was Lehman's deal to purchase Archstone-Smith Trust ("Archstone"), an owner of residential apartment buildings. Despite the obvious cracks in the real-estate market, Lehman persisted and closed the deal in October 2007. The $22 billion transaction only required the purchaser to put up $250 million of its own equity. The remaining portion was put up by Lehman and Bank of America, in a 50-50 partnership, involving $17.1 billion in debt and $4.6 billion in bridge equity financing. Lehman sold off portions of its exposure but in the end it was left with a $5.4 billion exposure.

97. Lehman failed to timely and adequate write down its investment dealings with SunCal and Archstone. As of the time of its filing for bankruptcy, Lehman continued to substantially overvalue its investments in SunCal and Archstone.

Leverage

98. Lehman further took on additional unnecessary risks by significantly increasing its leverage exposure. Leverage is the total ratio of assets to shareholder value. It involves using borrowed funds or debt to increase returns to equity. The Company leveraged its net assets by borrowing money using its assets as collateral and then using the proceeds to pursue its high risk real-estate investments. While the use of leverage greatly increases a company's potential gain from

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an investment, it also greatly increases a company's potential loss as the company is exposed to loss on its new investments in addition to loss associated with its original assets. Moreover, the use of off-balance-sheet vehicles to create leverage may conceal from investors the full extent of a company's risk exposure.

99. In 2004, the SEC relaxed a rule limiting the amount of leverage that Lehman and other investments banks were allowed to use. Previously, longstanding SEC rules required banks to limit their debt-to-net capital ratio to 15-to-1, meaning that for every $15 of debt, the banks were required to have $1 of equity. Nonetheless, in 2004, the SEC relaxed the minimum capital requirement for investment banks that voluntarily participated in a program in exchange for the participating banks agreeing to additional SEC oversight of their broker-dealer and holding company operations. Lehman and the other large investment banks voluntarily agreed to the program.

100. As a result, Lehman's use of leverage greatly increased. Between 2004 and 2007, Lehman's balance sheet increased by almost $300 billion through the purchase of securities often backed by residential and commercial real estate loans. During the same time frame, the firm only added $6 billion in equity. The increased use of leverage added to Lehman's achieving four years of record breaking financial results.

101. Nonetheless, Lehman's use of leverage made it vulnerable to declines in the value of its assets. As the real estate market imploded, Lehman's leverage began to consume a substantial amount of its capital. By early 2008, Lehman's leverage was still more than 30-to-1, meaning a decline of only 3.3% in the value of its assets could wipe out the entire value of the Company's equity and make the company insolvent.

102. Moreover, Lehman's leverage risk was exacerbated by its use of short-term debt financing. While short-term debt is cheaper than long-term debt and thus provides a company with greater profit potential, strong reliance on short-term debt creates additional risks as the short-term debt needs to be constantly refinanced, including the risk of a bank run when a financial institution is rumored to be insolvent.

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103. More than 50% of Lehman's assets were financed by short-term borrowings. Given a large amount of Lehman's assets were tied up in illiquid mortgage-related securities due to the subprime mortgage crisis, Lehman was unable to sell its assets except at a substantial loss. This caused pressure on Lehman as the credit markets tightened up and the Company began having trouble rolling over its short-term debt.

104. In early September 2008, as rumors persisted about Lehman's solvency, many of the firm's hedge fund clients began to pull large amounts of money out of the Company at a rapidly increasing pace. In addition, on September 11, 2008, J.P. Morgan Chase & Co. ("J.P. Morgan"), who acted as the financial middleman between Lehman and many of its clients, demanded Lehman provide J.P. Morgan with $5 billion in additional collateral to cover lending positions that J.P. Morgan's clients had with Lehman. Due to its inability to obtain new financing, the Company was so weakened by the cash outflows that it filed for bankruptcy four days later, unable to cover many of its outstanding collateral positions.

THE FALSE AND DEFECTIVE REGISTRATION STATEMENT AND PROSPECTUSES

105. On or about May 30, 2006, Lehman filed with the SEC a Form S-3 Registration Statement and Prospectus (the "Registration Statement") using a "shelf" registration or continuous offering process. Under the shelf, Lehman would be permitted to sell securities described in the Prospectuses in one or more offerings up to a total dollar amount of $2.75 billion. The Prospectuses were a part of the Registration Statement. The securities were to be issued by Lehman. The Registration Statement incorporated Lehman's Form 10-K for the fiscal year ended November 30, 2005:

> The SEC allows us to "incorporate by reference" the information it files with the SEC, which means that it can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be part of this prospectus. Information that we file after the date of this registration statement and prior to the effecitveness [sic] of this registration statement shall be deemed to be incorporated by reference into this prospectus and information that we file later with the SEC will automatically update information in this prospectus. In all cases, you should rely on the later information over different information included in this prospectus or the prospectus supplement or supplements. We incorporate by

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reference the documents listed below and any future filings made with the SEC under Section 13(a), 13(c), 14, or 15(d) of the Securities Exchange Act of 1934 (other than information in the documents or filings that is deemed to have been furnished and not filed):

- Annual Report on Form 10-K for the year ended November 30, 2005;

- Quarterly Report on Form 10-Q for the quarter ended February 28, 2006;

- Current Reports on Form 8-K filed with the SEC on February 21, 2006, February 24, 2006, March 3, 2006, March 10, 2006 (two Form 8-K filings), March 15, 2006, March 16, 2006, March 24, 2006, March 28, 2006, March 31, 2006 (two Form 8-K filings), April 4, 2006, April 25, 2006, May 3, 2006 and May 24, 2006; and

- Registration Statement on Form 8-A, filed on April 29, 1994

106. The Registration Statement also incorporated by reference subsequently filed prospectuses:

That, for the purpose of determining any liability under the Act, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

107. The Registration Statement also included assurances that the Registrant would

reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the Registration Statement.

108. Lehman's FY 2005 10-K filed on February 13, 2006 and incorporated into the Registration Statement provided in the Management Discussion and Analysis ("MD&A") section as follows concerning the Company's mortgage-related activities:

Capital Markets

* * *

Net revenues totaled $9.8 billion, $7.7 billion and $6.0 billion in 2005, 2004 and 2003, respectively. Capital Markets net revenues in 2005 represent the seventh consecutive year of record performance in Fixed Income and the second highest revenue level in Equities. Fixed Income revenues rose 28% in 2005 compared with 2004 on improved client-flow activities, an increased contribution from the non-US regions and record revenues across a number of products.... Fixed Income revenues improved in 2004 compared with 2003 as a favorable interest rate environment

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helped drive strength in mortgage originations and securitizations as well as interest rate products and the declining dollar drove higher foreign exchange activity....

Fixed Income net revenues were a record $7.3 billion in 2005, increasing 28% compared with 2004 driven by double digit revenue increases from each geographic region and record revenues across a number of businesses including commercial mortgage and real estate, residential mortgage origination and securitization, and interest rate products. Revenues from our commercial mortgage and real estate businesses increased substantially in 2005 reaching record levels, as the strong demand for commercial real estate properties, the recovery in certain property markets and relatively low interest rates drove asset sales and robust levels of securitizations. ***Revenues from our residential mortgage origination and securitization businesses increased in 2005 from the robust levels in 2004, reflecting record volumes and the continued benefits associated with the vertical integration of our mortgage origination platforms***. We originated approximately $85 billion and $65 billion of residential mortgage loans in 2005 and 2004, respectively. We securitized .approximately $133 billion and $101 billion of residential mortgage loans in 2005 and 2004, respectively, including both originated loans and those we acquired in the secondary market. While the performance in our mortgage businesses reached record levels, these businesses were affected by somewhat lower levels of mortgage origination volumes and revenues in the U.S. in the latter half of 2005, partly offset by stronger volumes and revenues outside the U.S. We originated approximately $27 billion and $13 billion of commercial mortgage loans in 2005 and 2004, respectively, the majority of which has been sold through securitization or syndication activities during both 2005 and 2004. Interest rate product revenues increased in 2005 on higher activity levels, as clients repositioned portfolios in light of rising global interest rates and a flattening U.S. yield curve. Credit product revenues also increased in 2005 as compared to 2004 driven by strength in both high yield and high grade credit products. Fixed Income net revenues increased 31% in 2004 compared with 2003, reflecting generally favorable market conditions. The mortgage securitization business was notably strong, with revenues in mortgage products benefiting from the low rate environment as well as the continued vertical integration of our mortgage origination platforms.

* * *

Mortgages, mortgage-backed and real estate inventory positions. Mortgages and mortgage-backed positions include mortgage loans (both residential and commercial), non-agency mortgage-backed securities and real estate investments. We are a market leader in mortgage-backed securities trading. We originate residential and commercial mortgage loans as part of our mortgage trading and securitization activities. We originated approximately $85 billion and $65 billion of residential mortgage loans in 2005 and 2004, respectively. We securitized approximately $133 billion and $101 billion of residential mortgage loans in 2005 and 2004, respectively, including both originated loans and those we acquired in the secondary market. In addition, we originated approximately $27 billion and $13 billion of commercial mortgage loans in 2005 and 2004, respectively, the majority of which has been sold through securitization or syndicate activities during both 2005 and 2004. See Note 3 to the Consolidated Financial Statements for additional information about our securitization activities. We record mortgage loans at fair value, with related mark-to-market gains and losses recognized in Principal transactions in the Consolidated Statement of Income.

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Management estimates are generally not required in determining the fair value of residential mortgage loans because these positions are securitized frequently. Certain commercial mortgage loans and investments, due to their less liquid nature, may require management estimates in determining fair value. Fair value for these positions is generally based on analyses of both cash flow projections and underlying property values. We use independent appraisals to support our assessment of the property in determining fair value for these positions. Fair value for approximately $3.6 billion and $3.8 billion at November 30, 2005 and 2004, respectively, of our total mortgage loan inventory is determined using the above valuation methodologies, which may involve the use of significant estimates. Because a portion of these assets have been financed on a non-recourse basis, our net investment position is limited to $3.5 billion and $2.9 billion at November 30, 2005 and 2004, respectively.

We invest in real estate through direct investments in equity and debt. We record real estate held for sale at the lower of cost or fair value. The assessment of fair value generally requires the use of management estimates and generally is based on property appraisals provided by third parties and also incorporates an analysis of the related property cash flow projections. We had real estate investments of approximately $7.9 billion and $10.7 billion at November 30, 2005 and 2004, respectively. Because significant portions of these assets have been financed on a non-recourse basis, our net investment position was limited to $4.8 billion and $4.1 billion at November 30, 2005 and 2004, respectively.

109. The FY 2005 10-K further provided in the MD&A section as follows concerning Lehman's liquidity and risk management practices:

Liquidity, Funding and Capital Resources

Management's Finance Committee is responsible for developing, implementing and enforcing our liquidity, funding and capital policies. These policies include recommendations for capital and balance sheet size as well as the allocation of capital and balance sheet to the business units. Management's Finance Committee oversees compliance with policies and limits with the goal of ensuring we are not exposed to undue liquidity, funding or capital risk.

Liquidity Risk Management

We view liquidity and liquidity management as critically important to the Company. Our liquidity strategy seeks to ensure that we maintain sufficient liquidity to meet all of our funding obligations in all market environments. Our liquidity strategy is centered on five principles:

- We maintain a liquidity pool available to Holdings that is of sufficient size to cover expected cash outflows over the next twelve months in a stressed liquidity environment.
- We rely on secured funding only to the extent that we believe it would be available in all market environments.

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- We aim to diversify our funding sources to minimize reliance on any given providers.

- Liquidity is assessed at the entity level. For example, because our legal entity structure can constrain liquidity available to Holdings, our liquidity pool excludes liquidity that is restricted from availability to Holdings.

- We maintain a comprehensive Funding Action Plan that represents a detailed action plan to manage a stress liquidity event, including a communication plan for regulators, creditors, investors and clients.

* * *

Risk Management

As a leading global investment bank, risk is an inherent part of our business. Global markets, by their nature, are prone to uncertainty and subject participants to a variety of risks. The principal risks we face are credit, market, liquidity, legal, reputation and operational risks. Risk management is considered to be of paramount importance in our day-to-day operations. Consequently, we devote significant resources (including investments in employees and technology) to the measurement, analysis and management of risk.

While risk cannot be eliminated it can be mitigated to the greatest extent possible through a strong internal control environment. Essential in our approach to risk management is a strong internal control environment with multiple overlapping and reinforcing elements. We have developed policies and procedures to identify, measure, and monitor the risks involved in our global trading, brokerage and investment banking activities. Our approach applies analytical rigor overlaid with sound practical judgment working proactively with the business areas before transactions occur to ensure appropriate risk mitigants are in place.

We also seek to reduce risk through the diversification of our businesses, counterparties and activities in geographic regions. We accomplish this objective by allocating the usage of capital to each of our businesses, establishing trading limits and setting credit limits for individual counterparties. Our focus is balancing risk versus return. We seek to achieve adequate returns from each of our businesses commensurate with the risks they assume. Nonetheless, the effectiveness of our approach to managing risks can never be completely assured. For example, unexpected large or rapid movements or disruptions in one or more markets or other unforeseen developments could have an adverse effect on our results of operations and financial condition. The consequences of these developments can include losses due to adverse changes in inventory values, decreases in the liquidity of trading positions, increases in our credit exposure to clients and counterparties and increases in general systemic risk.

Our overall risk limits and risk management policies are established by the Executive Committee. On a weekly basis, our Risk Committee, which consists of the Executive Committee, the Chief Risk Officer and the Chief Financial Officer, reviews all risk exposures, position concentrations and risk-taking activities. The Global Risk Management Division (the "Division") is independent of the trading

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> areas and reports directly to the Firm's Chief Administrative Officer. The Division includes credit risk management, market risk management, quantitative risk management, sovereign risk management and operational risk management. Combining these disciplines facilitates a fully integrated approach to risk management. The Division maintains staff in each of our regional trading centers as well as in key sales offices. Risk management personnel have multiple levels of daily contact with trading staff and senior management at all levels within the Company. These discussions include reviews of trading positions and risk exposures.

110. The 10-K did not specifically identify Aurora or BNC as subsidiaries of the Company. The 10-K further failed to mention the term "Alt-A" and only made limited reference to the term "subprime" in connection with a discussion of the First Alliance class action referenced above in footnote 3.

111. In addition, defendant Fuld, as CEO, and defendant O'Meara, as CFO of Lehman, as required by the securities laws, signed and filed certifications on behalf of themselves and Lehman with the SEC relating to Lehman's Form 10-K for FY 2005, which stated that the report was truthful, the financial statements in it were accurate and Lehman's internal disclosure and accounting controls were designed to be effective to detect and prevent fraud and had been tested and found to be effective.

112. The FY 2005 10-K further included two letters from defendant Ernst & Young: an unqualified audit opinion and a letter attesting to the effectiveness of Lehman's internal controls.

113. Lehman's 10-Qs for 1Q-3Q FY 2006, which were incorporated by reference into the Company's Registration Statement for the Offerings, contained substantially similar statements concerning the Company's mortgage operations, liquidity and risk management practices. The 10-Qs further failed to identify Aurora or BNC or to mention the terms Alt-A or subprime.

114. In addition, defendants Fuld and O'Meara signed similar certificates contained in the 10-Q's for 1Q-3Q FY 2006 attesting to the accuracy of the financial statements and the effectiveness of Lehman's internal disclosure and accounting controls.

115. On October 19, 2006, Lehman filed its Prospectus Supplement for the 5.75% Notes Offering, which forms part of the Registration Statement and which became effective on October 17, 2006, and at least $1.25 billion of Lehman's 5.75% subordinated debt securities were sold to the

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public at an issue price of 99.659% of the $1.25 billion principal amount. WSIB purchased $30 million in 5.75% Notes on October 17, 2006.

116. On January 11, 2007, Lehman filed a pricing supplement for the 5.25% Notes Offering, which forms part of the Registration Statement and which became effective on January 9, 2007, and at least $1.5 billion of Lehman's 5.25% Medium-Term Notes were sold to the public at an issue price of 99.894% per note of the principal amount.[4] WSIB purchased $50 million in 5.25% Notes on January 9, 2007.

117. The Prospectuses omitted important information about Lehman's exposure to the subprime and Alt-A markets, including its risky lending practices, and how the changes in the market were affecting Lehman by the time of the Offerings, including omitting information about how this exposure could affect the Company's capital base. The Prospectuses failed to disclose serious impairments in Lehman's portfolio of subprime mortgage securities and concealed liabilities associated with the marketing of high-risk securities, such as mortgage-backed securities.

118. The Registration Statement/Prospectuses contained untrue statements of material fact or omitted to state other facts necessary to make the statements made therein not misleading and was not prepared in accordance with applicable SEC rules and regulations.

119. The statements above were false and/or misleading because they failed to disclose the true risks surrounding the Company's real-estate related assets by misrepresenting the risky management practices in place at Lehman and by downplaying the risks associated with its subprime and Alt-A lending practices, which significantly increased the risk level of the Notes.

120. Thereafter, despite the subprime mortgage crisis, throughout the remainder of FY 2006 and throughout FY 2007 and into FY 2008, the Individual Defendants and defendant Ernst &

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[4] The pricing supplement was to a Prospectus Supplement Lehman filed on May 30, 2006 in connection with Medium-Term Notes, Series 1. The Prospectus Supplement formed part of the Registration Statement.

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Young continued to issue false and defective statements concerning Lehman's operations and its accounting for its real-estate related assets.

121. Moreover, the Individual Defendants downplayed the Company's exposure to the real-estate crisis and provided assurances that Lehman had engaged in proper hedging strategies and other risk management tactics in order to mitigate the Company's exposure

122. On March 14, 2007, Lehman announced record 1Q 2007 results in spite of the growing concerns in the subprime market. In the press release announcing the first quarter results, defendant Fuld, touting the record results, stated, "[b]y expanding our global footprint, building our capabilities and partnering with our clients, we have again posted record net revenues, net income and earnings per share. Our results clearly demonstrate that we are better positioned than ever to create value for our clients and our shareholders."

123. Later that same day on a conference call with analysts and investors, defendant O'Meara downplayed the effect the disruption in the subprime market had on Lehman's business. According to O'Meara:

> Before we move on to our outlook I want to take a minute to discuss recent market events and provide a bit more color on the topic of mortgages. Recent market adjustments have represented a repricing of risk with a widening of credit spreads, increased levels of volatility, and pricing adjustments in the equity markets. Given our diversified business model, parts of our business actually benefit from wider spreads and higher volatility. We expect clients to remain active in managing their portfolios through this part of the cycle and we stand ready to service this activity flow.
>
> The current dislocations in the subprime mortgage market are consistent with late cycle trends where credit standards and pricing are lowered to maintain volumes when liquidity is ample. The situation has clearly been exacerbated by a wave of early payment defaults and more recently the bankruptcy of a number of monoline subprime mortgage lenders. ***While we are not immune to these events, we believe we have done a very good job of managing the risks within our securitization business including the active hedging strategies we employed to mitigate our risks.*** This is demonstrated by the fixed income results we have reported today.
>
> ***The subprime components of our mortgage business which include origination, securitization, and trading in the U.S. together account for a small portion of our revenues***. To put this into perspective, into context, over the past six quarters on average, these businesses, these three businesses all taken together, accounted for less than 3% of our firm-wide revenues. Additionally, our mortgage origination platform is very flexible because of its integration with our mortgage

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> securitization platform in terms of intelligence on deal structure, collateral type, and pricing terms. In the U.S. subprime space, we have adhered to our origination standards. In terms of origination, we remain far more active in the prime and Alt A space which accounted for 75% of our origination volumes in the third quarter.
>
> ***From a balance sheet perspective, we believe we are well protected. We actively hedged the interest rate and credit components of our inventory positions including our non-investment grade retained interest in securitizations. The majority of which are prime mortgage related.*** Recent market developments, such as the introduction of single name and index credit derivatives on asset backed products have helped us significantly mitigate our risk. It is important to note at this point, we see the subprime challenges as being a reasonably contained situation. The broader economy is still very strong. Unemployment is low, inflation is in check, and consumer confidence is still strong.
>
> We expect that the U.S. subprime mortgage market will continue to face headwinds in the near term; however, we are now seeing a significant decrease in industry wide capacity in the subprime sector and the beginnings of the return of pricing power. ***So we believe we are well positioned to benefit from this evolving situation given our experience in this sector as well as our ample liquidity and risk management practices.*** In addition, we expect to see various opportunities as a result of the market dislocations.
>
> Looking forward, although we are expecting continued challenges in part of the U.S. mortgage market, our outlook remains optimistic for the rest of our businesses.

124. On June 12, 2007, Lehman again announced record results for 2Q 2007. Defendants Fuld and O'Meara continued to emphasize the "record" results and the Company's strong liquidity and risk management practices and further continued to downplay Lehman's exposure to the growing troubles in the real-estate market.

125. On September 18, 2007, Lehman announced positive results for 3Q 2007 at a time when many of the Company's competitors began to announce massive write-downs and substantial losses and despite Lehman's announcement that it would be forced to close BNC, its subprime lender. Defendant Fuld remained upbeat concerning Lehman's results and outlook, stating: "[d]espite challenging conditions in the markets, our results once again demonstrate the diversity and financial strength of the Lehman Brothers franchise, as well as our ability to perform across cycles. . . . We remain focused on delivering significant long term value for our clients and shareholders." Defendant O'Meara in a conference call attributed these strong results to "Our strong risk management culture with regard to the setting of risk limits, and the management of market and

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counter-party credit risks, and our strong liquidity framework." O'Meara further represented concerning Lehman's liquidity as follows:

> ***Next I would like to discuss our liquidity position, which is now stronger than ever.*** As we have discussed with you in the past, we have structured our liquidity framework to cover our funding commitments and cash outflows ***for a 12-month period***, without raising new cash in the unsecured markets, or selling assets to generate cash. . . .
>
> . . . Our conservative liquidity framework is based on the following principles: No reliance on short-term unsecured funding, including asset-backed commercial paper. Illiquid assets are funded with long term capital with a remaining life of 12 months or longer.

126. On December 13, 2007, Lehman announced positive 4Q and year end 2007 results. Defendant Fuld continued emphasizing the positive results. Later in a conference call, defendants O'Meara and Callan once again downplayed the effect of the mortgage crisis on Lehman's operations. Further, O'Meara and Callan continued to represent Lehman's "strong" liquidity position and how Lehman's conservative liquidity framework was structured to cover the Company's funding commitments and cash outflows for a 12-month period.

127. In January 2008, an internal presentation was made to the Lehman board concerning the real-estate crisis and its impact on Lehman. During the presentation, the Individual Defendants were warned that the Company's liquidity could disappear fast. The internal analysis questioned "WHY DID WE ALLOW OURSELVES TO BE SO EXPOSED?" The analysis indicated that the "CONDITIONS [WERE] CLEARLY NOT SUSTAINABLE" and that Lehman "SAW WARNING SIGNS" but "DID NOT MOVE EARLY/FAST ENOUGH," and further that the Company lacked "DISCIPLINE ABOUT CAPITAL ALLOCATION."

128. After Bear Stearns Companies Inc. collapsed in March 2008, rumors began circulating that Lehman faced a similar cash crunch, and many Wall Street observers believed Lehman would be the next investment bank failure after Bear Stearns and, as a result, Lehman stock took a hit. Nonetheless, defendants denied the rumors and maintained that Lehman remained a strong and viable Company.

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129. On March 17, 2008, as a result of defendants' assurances, WSIB purchased an additional $50 million face value in 5.75% Notes.

130. On March 18, 2008, Lehman again announced positive 1Q 2008 results. During the conference call held the same day, defendant Callan went to great lengths to assure investors that Lehman was not in fact going to be the next Bear Stearns and had maintained strong risk management practices which helped to insulate the Company from its Alt-A and subprime exposure. Defendant Callan further maintained the Company had a strong liquidity and capital base:

> We saw a quarter where our risk management discipline allowed us to avoid any single outsize loss. And it's been our operating philosophy for a decade, which many people are very familiar with, that we remain closely focused on our liquidity, our long-term capital position, precisely for the purpose of weathering a difficult market environment that we've seen surfacing in recent weeks. So we're set up for that.
>
> *   *   *
>
> ***We had disciplined liquidity and capital management, which we consider to be a core competency, and maintained robust liquidity to date,*** and we've executed close to two-thirds of our full-year capital plan at the end of the first quarter.
>
> *   *   *
>
> Next, I'd like to review our liquidity position in a different way than we typically do and give you a lot more information. And I'm going to give you information that takes you through the quarter end and actually takes you through end of day yesterday. ***And I think that, given the environment we're in, we've tried to add a lot more transparency here, as we've tried to relay the strengths and robustness of the liquidity position of the Firm.***
>
> As we've discussed in the past, we have structured our liquidity framework for a decade to cover expected cash outflows for the next 12 months. And we do so without being able to raise new cash in the unsecured markets, or without having to sell assets that are outside our liquidity pool, and the liquidity pool is comprised of basically cash and cash equivalents. ***The framework I'm describing was specifically designed after 1998 and our experiences then, for this type of environment, so I want to be clear about that.***
>
> *   *   *
>
> Also, for those who saw it, Moody's reaffirmed our A1 credit rating yesterday, with some very good commentary about the strength of the capital base in the franchise and the liquidity.
>
> ***So that's a fair amount of color I tried to give you about how we fund ourselves, why we feel comfortable with our liquidity, even absent the fed facility,***

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> ***would feel very comfortable***. The fed facility is a great addition to the equation, and why we think we're in a good position in today's market. So wanted to make sure everybody was fully engaged and had all the information that they needed on that front.

131. On June 3, 2008, several executives from Lehman's money management subsidiary, Neuberger Berman, sent an email to Lehman's executive committee recommending that Lehman's top management forego bonuses for the year. According to the email, "***Many believe that a substantial portion of the problems at Lehman are structural rather than merely cyclical in nature***." The executive committee member who was in charge of the Neuberger division responded to the executive committee as follows:

> I am not sure what's in the water at 605 Third Avenue today, but Amato and I clearly have some work to do (given the [sic] today's similar emails from Marvin Schwartz, Michael Kaminsky and now Judy).
>
> The compensation issue she raises (Judy Vale and Benjamin Segal on one hand versus Marvin Schwartz and Jeff Bolton on the other) is a particular issue for a small handful of people at Neuberger and hardly worth the EC's time now.
>
> I'm embarrassed and I apologize.

132. The email was forwarded the same day to defendant Fuld, who responded "Don't worry-they are only people who think about their own pockets."

133. On June 9, 2008, Lehman pre-announced its expected 2Q 2008 results, announcing its first quarterly loss since being spun off from American Express. However, defendants maintained the Company had a strong liquidity and capital position. Defendant Fuld stated, "I am very disappointed in this quarter's results. Notwithstanding the solid underlying performance of our client franchise, we had our first-ever quarterly loss as a public company. However, with our strengthened balance sheet and the improvement in the financial markets since March, we are well-positioned to serve our clients and execute our strategy."

134. On June 12, 2008, Lehman announced that defendant Callan was being replaced as CFO by Ian Lowitt.

135. On June 16, 2008, Lehman announced its 2Q 2008 results. According to defendant Fuld, "Since we announced our expected second quarter earnings last week, ***we have begun to take***

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the necessary steps to restore the credibility of our great franchise and ensure that this quarter's unacceptable performance is not repeated. We have raised an additional $6 billion of capital. I have asked Bart McDade, our best operator, to serve as the Firm's president and chief operating officer. I have also asked Ian Lowitt, our co-chief administrative officer, to be our chief financial officer. With these actions and our continued commitment to our client-driven franchise, we are positioned to take advantage of opportunities that lie ahead, and we are focused on maximizing shareholder value." As his predecessors did, newly named CFO Ian Lowitt stated in a conference call in which defendant Fuld participated as follows: "Next, let me review our liquidity position which has never been stronger."

136. Then, in September 2008, Lehman announced additional billions of dollars in losses and that it would need to raise billions of dollars of additional capital. Thereafter, the price of Lehman securities continued to react adversely as it was disclosed that Lehman was in fact almost insolvent. When it became apparent the federal government would not rescue Lehman, the Company was forced to file Chapter 11 bankruptcy on September 15, 2008, essentially wiping out its equity and debt holders. The Notes in the Offerings immediately dropped from above 80% of par to 1% of par. This was the largest corporate bankruptcy in the history of the United States.

137. The true facts which were omitted from the Registration Statement and subsequent documents were:

(a) Lehman's true exposure to risk from mortgage-related transactions and assets was understated;

(b) Lehman's subsidiaries, BNC and Aurora, were engaging in high-risk residential mortgage lending practices, which resulted in mortgage loans that would be much more likely to end up defaulting and causing losses;

(c) Defendants failed to properly mitigate the risks associated with Lehman's mortgage financing activities;

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(d) Lehman's violated GAAP in preparing and disseminating false and misleading financial statements with respect to its accounting for mortgage-related assets;

(e) The extent of Lehman's leverage exposure was misstated;

(f) Lehman's internal controls were inadequate to prevent the Company from engaging in risky lending practices; and

(g) The Company's capital base was not adequate enough to withstand the significant deterioration in the real-estate markets and, as a result, Lehman would be forced to file for bankruptcy protection due to its subprime and Alt-A exposure.

LEHMAN'S FALSE FINANCIAL REPORTING

138. Lehman's financial statements, including its financial statements for FY 2005 and interim results for FY 2006, which were incorporated by reference into the Registration Statement and Prospectuses, were not a fair presentation of the Company's results and were presented in violation of GAAP and SEC rules. Lehman's financial statements for FY 2007 and interim FY 2008 were similarly false and misleading.

139. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. SEC Regulation S-X (17 C.F.R. §210.4-01(a)(1)) states that financial statements filed with the SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate, despite footnote or other disclosure. Regulation S-X requires that interim financial statements must also comply with GAAP, with the exception that interim financial statements need not include disclosure which would be duplicative of disclosures accompanying annual financial statements. 17 C.F.R. §210.01(a).

140. A fundamental precept of GAAP is that impairment of financial securities which is deemed to be other than temporary should be recorded as a charge against earnings. Defendants failed to properly account for Lehman's impaired investments in violation of GAAP.

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141. Due to these accounting improprieties, Lehman's financial results and statements for FY 2005 through FY 2008 violated GAAP, including the following fundamental accounting principles:

(a) The principle that interim financial reporting should be based upon the same accounting principles and practices used to prepare annual financial statements was violated (APB No. 28, ¶10);

(b) The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions was violated (FASB Statement of Concepts No. 1, ¶34);

(c) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources was violated (FASB Statement of Concepts No. 1, ¶40);

(d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it was violated. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general (FASB Statement of Concepts No. 1, ¶50);

(e) The principle that financial reporting should provide information about an enterprise's financial performance during a period was violated. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance (FASB Statement of Concepts No. 1, ¶42);

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(f) The principle that financial reporting should be reliable in that it represents what it purports to represent was violated. That information should be reliable as well as relevant is a notion that is central to accounting (FASB Statement of Concepts No. 2, ¶¶58-59);

(g) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions was violated (FASB Statement of Concepts No. 2, ¶79); and

(h) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered was violated. The best way to avoid injury to investors is to try to ensure that what is reported represents what it purports to represent (FASB Statement of Concepts No. 2, ¶¶95, 97).

142. Further, the undisclosed adverse information is the type of information which, because of SEC regulations, regulations of the national stock exchanges and customary business practice, is expected by investors and securities analysts to be disclosed and is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

Failure to Disclose Known Trends and Uncertainties

143. The defendants caused Lehman to fail to disclose known trends and uncertainties related to its true risk exposure to risky subprime and Alt-A related assets in violation of SEC regulations. Defendants caused Lehman to provide misleading disclosures concerning the risks surrounding the Company's real-estate related assets by misrepresenting the risk management practices in place at Lehman and by downplaying the risks associated with subprime and Alt-A lending practices. Defendants further caused Lehman to fail to disclose known trends and uncertainties related to its increased use of leverage.

144. Under SEC Regulations, Item 7 of Form 10-K and Item 2 of Form 10-Q, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), require the issuer to furnish information required by Item 303 of Regulation S-K (17

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C.F.R. §229.303). In discussing results of operations, Item 303 of Regulation S-K requires the registrant to:

> Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

145. The instructions to paragraph 303(a) further state:

> The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results . . . .

146. In addition, in its May 18, 1989 Interpretive Release No. 34 26831, the SEC has indicated that registrants should employ the following two-step analysis in determining when a known trend or uncertainty is required to be included in the MD&A disclosure pursuant to Item 303 of Regulation S-K:

> A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have a material effect on the registrant's financial condition or results of operation.

147. The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future. As *Concept Release on Management's Discussion and Analysis of Financial Condition and Operations*, Securities Act of 1933, Release No. 33-6711, 1987 SEC LEXIS 2001, at *6-*7 (Apr. 21, 1987), states:

> The Commission has long recognized the need for a narrative explanation of the financial statements, because a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.

148. Section 229.303 (Item 303) MD&A states:

> To the extent that the financial statements disclose material increases in net sales or revenues, provide a narrative discussion of the extent to which such increases are attributable to increases in prices or to increases in the volume or amount of goods or services being sold or to the introduction of new products or services.

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149. And the instructions to paragraph 303(a) further state:

> Where the consolidated financial statements reveal material changes from year to year in one or more line items, the causes for the changes shall be described to the extent necessary to an understanding of the registrant's businesses as a whole . . . .

150. According to *Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 6349 (Sept. 28, 1981):

> It is the responsibility of management to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company.

151. Nonetheless, in violation of both GAAP and SEC rules, Lehman's FY 2005 through FY 2008 Forms 10-K and 10-Q reports failed to disclose known trends and uncertainties related to Lehman's operations. Defendants caused Lehman to misrepresent Lehman's risk management practices and to minimize the Company's true risk exposure associated with its real-estate related assets and its leverage exposure.

152. In Lehman's FY 2005 10-K, Lehman failed to provide any discussion of its subprime and Alt-A lending activities and provided only a brief discussion concerning its mortgage origination business. Lehman failed to provide any disclosures concerning the high risk lending practices being engaged in at Aurora and BNC. Lehman further provided misleading disclosures concerning its leverage exposure and its risk management practice claiming the Company had engaged in adequate risk management to mitigate its risk to the "greatest extent possible." Lehman's 1Q-3Q FY 2006 10-Qs provided the same misleading disclosures. Lehman's misleading disclosures contained in its FY 2005 10-K and interim 10-Qs for FY 2006 were incorporated into the Offering Documents.

153. Thereafter, Lehman continued providing inadequate and misleading disclosures concerning its subprime and Alt-A lending practices and the risks associated with its real-estate related holdings, including the risks associated with its increased use of leverage throughout FY 2006 and FY 2007 and even into FY 2008. Even when Lehman began to acknowledge some of the risks, it continued to downplay the risks. Lehman failed to disclose known trends and uncertainties

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in violation of SEC regulations by not providing full and adequate disclosures. Lehman's failure provided investors with a false and misleading depiction of the Company's operations.

ERNST & YOUNG'S PARTICIPATION IN THE ISSUANCE OF FALSE FINANCIALS

154. Ernst & Young, a firm of certified public accountants, was engaged by Lehman to provide independent auditing and accounting services at all times relevant to this action. Ernst & Young has been Lehman's auditor since at least FY 1992. Ernst & Young was engaged to examine and report on Lehman's financial statements for FY 2005-FY 2007 and to perform review services on Lehman's interim results for FY 2006, FY 2007 and FY 2008. The extensive amount of work provided to Lehman by Ernst & Young is demonstrated by the lucrative fees it received for its work. For FY 2005-FY 2007, Ernst & Young received $86.1 million in fees for audit, tax and other services it provided to the Company. As a result of the far-reaching scope of services provided by Ernst & Young, Ernst & Young personnel were intimately familiar with Lehman's business, including Lehman's accounting for its real-estate related assets.

Ernst & Young's False Statements as to Lehman's FY 2005-FY 2007 Financial Statements

155. Ernst & Young falsely represented that Lehman's financial results for FY 2005 through FY 2007 were presented in accordance with GAAP and that Ernst & Young's audits and reviews of Lehman's financial statements had been performed in accordance with Generally Accepted Auditing Standards ("GAAS"). Ernst & Young consented to the incorporation of its false reports on Lehman's financial statements in Lehman's Form 10-Ks for FY 2005, FY 2006 and FY 2007, which were filed with the SEC. Ernst & Young further consented to the incorporation of its false report on Lehman's 2005 financial statements in the Registration Statement filed in connection with the Offerings. Ernst & Young's issuance of and multiple consents to reissue materially false reports on Lehman's FY 2005-FY 2007 financial statements were themselves violations of GAAS.

156. The SEC has stressed the importance of meaningful audits being performed by independent accountants:

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> [T]he capital formation process depends in large part on the confidence of investors in financial reporting. An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest. The quality of information disseminated in the securities markets and the continuing conviction of individual investors that such information is reliable are thus key to the formation and effective allocation of capital. ***Accordingly, the audit function must be meaningfully performed and the accountants' independence not compromised.***

Relationships Between Registrants and Independent Accountants, SEC Accounting Series Release No. 296, 1981 SEC LEXIS 858, at *8-*9 (Aug. 20, 1981).

157. GAAS, as approved and adopted by the AICPA, relate to the conduct of individual audit engagements. Statements on Auditing Standards (codified and referred to as AU §___) are recognized by the AICPA as the interpretation of GAAS.

158. With respect to Lehman's financial statements for FY 2005, Ernst & Young represented, in its Report of Independent Registered Public Accounting Firm dated February 13, 2006 and included in the Company's FY 2005 Form 10-K, the following:

> We have audited the accompanying consolidated statement of financial condition of Lehman Brothers Holdings Inc. (the "Company") as of November 30, 2005 and 2004, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended November 30, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.
>
> We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lehman Brothers Holdings Inc. at November 30, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended November 30, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the

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> basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.
>
> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Lehman Brothers Holdings Inc.'s internal control over financial reporting as of November 30, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 13, 2006 expressed an unqualified opinion thereon.

159. Ernst & Young issued nearly identical unqualified audit reports with respect to Lehman's financial statements for FY 2006 and FY 2007, in letters dated February 13, 2007 and January 28, 2008, respectively. These audit reports were included in the Company's FY 2006 and FY 2007 Form 10-Ks.

160. Ernst & Young also signed off on and approved Lehman's quarterly financial results prior to their issuance to the public at all relevant times. With respect to Lehman's financial statements for 1Q 2006, Ernst & Young represented, in a report dated April 10, 2006 and included in the Company's 1Q 2006 Form 10-Q, the following:

> We have reviewed the consolidated statement of financial condition of Lehman Brothers Holdings Inc. (the "Company") as of February 28, 2006, and the related consolidated statements of income and cash flows for the three month periods ended February 28, 2006 and 2005. These financial statements are the responsibility of the Company's management.
>
> We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.
>
> We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of November 30, 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended and in our report dated February 13, 2006, we expressed an unqualified opinion on those consolidated financial statements.

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161. Ernst & Young issued nearly identical reports with respect to Lehman's interim financial statements for 2Q 2006 through 2Q 2008.

162. Furthermore, in connection with the Offerings, Ernst & Young consented to the incorporation of its audit reports into the Offering Documents. Ernst & Young represented, in a letter dated May 23, 2006 and included in the Registration Statement, the following:

> We consent to the reference to our firm under the caption "Experts" in the Registration Statement (Form S-3) and related Prospectuses of Lehman Brothers Holdings Inc., and to the incorporation by reference therein of our reports dated February 13, 2006, with respect to the consolidated financial statements and financial statement schedule of Lehman Brothers Holdings Inc., Lehman Brothers Holdings Inc. management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Lehman Brothers Holdings Inc., incorporated by reference in its Annual Report (Form 10-K) for the year ended November 30, 2005, filed with the Securities and Exchange Commission.

163. Ernst & Young's reports and approval of the financial results were false and misleading due to its failure to comply with GAAS and because Lehman's financial statements were not prepared in conformity with GAAP so that issuing the reports or approving Lehman's quarterly financial results was in violation of GAAS and SEC rules. Ernst & Young knew its reports and approval of the financial statements would be relied upon by the Company as well as by present and potential investors in Lehman's securities.

Ernst & Young Ignored the Audit Evidence It Gathered

164. GAAS, as set forth in AU §326, *Evidential Matter*, requires auditors to obtain sufficient competent evidential matter through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit:

> In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he or she should recognize the possibility that the financial statements may not be fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or

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> she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion.

AU §326.25 (footnotes omitted).

165. Ernst & Young's responsibility, as Lehman's independent auditor, was to obtain "[s]ufficient competent evidential matter . . . to afford a reasonable basis for an opinion regarding the financial statements under audit" as to "the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles." AU §§110.01, 150.02.

166. In violation of GAAS, and contrary to the representations in its report on Lehman's financial statements, Ernst & Young did not obtain sufficient, competent evidential matter to support Lehman's assertions regarding its valuation of its real-estate related assets.

167. During the summer of 2008, Lehman executives approached a number of financial institutions in an attempt to sell Lehman's troubled commercial real-estate portfolio. The potential suitors had access to the same internal documents that Ernst & Young had access to in connection with its audits and reviews. However, unlike Ernst & Young, all of the potential suitors quickly determined that the portfolio was grossly overvalued and declined to buy the portfolio.

Ernst & Young Failed to Design Its Audit to Identify the Alleged Improprieties

168. As one of the largest audit firms in the world, Ernst & Young was well aware of the strategies, methods and procedures required by GAAS to conduct a proper audit. Also, Ernst & Young knew of the audit risks inherent at Lehman and in the industries in which Lehman operated because of the comprehensive services it provided to Lehman and its experience with many other clients. In connection with Lehman's operations, Ernst & Young had virtually limitless access to information concerning the Company's true operations as:

- Ernst & Young had been Lehman's auditor since at least FY 1992;
- Ernst & Young representatives were present at Lehman's headquarters and divisions frequently;

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- David Goldfarb, Lehman's Chief Administrative Officer ("CAO") until his retirement in October 2006, had been a partner with Ernst & Young until he joined the Company in 1993. Goldfarb served in various executive positions within Lehman during his tenure there, including serving as CFO from April 2000 until 2004 when he was promoted to CAO;

- Ernst & Young had frequent conversations with Lehman management and employees about the Company's operations and financial statements;

- Ernst & Young audited and reviewed Lehman's financial statements at all relevant times and knew or should have known that Lehman's financial statements were not accurate or prepared in compliance with GAAP or GAAS; and

- Ernst & Young also audited some of Lehman's largest competitors and was familiar with the financial services industry and the significant changes to the real-estate market.

169. Ernst & Young's intentional failure to comply with GAAS in Ernst & Young's performance on the Lehman audits rose to the level of deliberate recklessness, as the following paragraphs demonstrate. Ernst & Young abandoned its role as independent auditor by turning a blind eye to each of the above indications of improper accounting, including Lehman's accounting for its real-estate related assets. Despite this knowledge, Ernst & Young did not insist upon adjustments to Lehman's audited financial statements. Pursuant to GAAS, Ernst & Young should have issued a qualified or adverse report, or it should have insisted that Lehman comply with GAAP. Furthermore, Ernst & Young should have refused to approve Lehman's quarterly financial results.

170. As to its audits of Lehman, Ernst & Young was required to perform its audit in conformity with the Statement of Accounting Standard ("SAS") No. 82, *Consideration of Fraud in a Financial Statement Audit*, which includes auditing for misstatements arising from the misappropriation of assets. Ernst & Young failed to comply with SAS No. 82 in its audit of Lehman's financial statements. During the course of its audit of Lehman's financial statements, Ernst & Young knew of or should have discovered the irregularities which caused Lehman's financial results to be misstated for years. The very risk of fraud was a potential reportable condition which should have been reported to the audit committee and possibly senior management.

171. Ernst & Young's failure to adequately perform its audit procedures to identify the improprieties alleged herein and its failure to report the problems permitted the accounting

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irregularities and improprieties to continue over a period of several years, leading to false and misstated financial statements and the eventual collapse of the Company.

172. Furthermore, Ernst & Young recklessly disregarded numerous red flags that should have alerted Ernst & Young that Lehman's financial statements were materially false and misleading, including the following:

- Lehman's top executives received lucrative compensation packages that were based on how well the Company performed. Defendant Fuld was paid handsomely for his position of CEO at the Company. Fuld even received a bonus for FY 2007 despite the subprime mortgage crisis.

- The compensation in Lehman's mortgage lending practice provided incentives for mortgage brokers and bankers to engage in high risk lending practices as they were paid based on the amount of loans they were able to complete no matter whether the loan later went into default. Moreover, given that Lehman purchased the loans from the mortgage brokers and lenders, they had very little incentive to assure the quality of the loans.

- The compensation in Lehman's mortgage securitization practice provided incentives for the people engaged in packaging the loans to overstate the quality of the loans underlying the mortgage-backed securities as they were paid based on the amount of securitization transactions they were able to complete, thus providing very little if any incentive to engage in proper due diligence.

- Lehman was experiencing tremendous growth in its mortgage securitization practice, leading to the Company reporting record earnings for 2005, 2006 and 2007. The mortgage securitization practice was based on high risk Alt-A and subprime loans.

- Lehman purchased Aurora, BNC and several other mortgage lenders solely to provide a platform for fueling its securitization pipeline.

- Prior to its purchase of Aurora and BNC, Lehman had been purchasing mortgages from certain mortgage lenders that were known for being engaged in deceptive lending practices.

- Lehman, once known as a bond trading company, had changed its strategy and began getting into more lucrative and riskier businesses with higher profit potential, ultimately becoming the largest issuer of mortgage-backed securities.

- Lehman was engaging in aggressive accounting by failing to write down impaired assets. At a time when other firms were writing down billions of dollars in impaired real-estate related assets, Lehman continued to value its assets at high levels. Further, Lehman recategorized billions of dollars of assets as Level 3 assets in order to avoid taking write-downs.

- Lehman's use of leverage increased exponentially beginning in 2004 causing Lehman to take on additional risk.

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- A relatively small decline in the value of Lehman's assets could have a devastating impact on the Company's leverage position.

- Lehman was dominated by defendant Fuld. Fuld, known as the Gorilla, had a reputation for being the scariest man on Wall Street and having a very aggressive style. Fuld dominated and controlled the Company since becoming its CEO in 1994, including steering the Company into the real-estate market.

- The tone at the top indicated that Lehman's management failed to display an appropriate attitude towards internal controls and the financial reporting process. During 2006, when Lehman posted record revenue due in large part to its mortgage activities, the Board's finance and risk committee met only twice. In 2007, despite the serious turmoil in the real-estate market and Lehman's exposure to it, the finance and risk committee again met only twice.

- Aurora and BNC intentionally engaged in high risk behavior by failing to follow proper underwriting guidelines and by providing Alt-A and subprime borrowers with risky mortgage products.

- Lehman's internal auditors questioned Aurora's lending practices as early as May 2006 after analyzing some of Aurora's loan documentation and discovering that up to half of the loans analyzed contained material misrepresentations.

173. Many of these red flags mirrored the risk factors Ernst & Young was required to consider according to AU §316, *Fraud in a Financial Statement Audit*, including:

- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.

- Specific indicators that include a motivation for management to engage in fraudulent financial reporting.

- An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.

- A practice by management of committing to analysts, creditors, and other third parties to achieve what appears to be unduly aggressive or clearly unrealistic forecasts.

- Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.

- Management failing to display an appropriate attitude towards internal controls and the financial reporting process.

- Claims against the entity or its senior management alleging fraud or violations of securities laws.

- Management setting unduly aggressive financial targets and expectations for operating personnel.

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- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

174. Here, Ernst & Young did not miss just one item or two items, but numerous items. There was not just one form of manipulation, but several, which Ernst & Young was aware of, or which Ernst & Young would have been aware of had it not recklessly ignored numerous red flags.

Ernst & Young Failed to Identify Material Weaknesses in Internal Controls

175. Ernst & Young, as Lehman's auditors, were obligated to assess Lehman's internal disclosure, financial and accounting controls and whether such controls had been placed in operation, were effective and complied with the Sarbanes-Oxley Act of 2002, including controls to provide assurance about the safeguarding of assets, financial reporting, operations and compliance with regulations. Ernst & Young was required to evaluate whether poor controls might lead to or contribute to the risk that fraud might not be detected.

176. Internal controls are essential to a company's financial reporting, as adequately designed internal controls provide a company with reasonable assurance on the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with applicable laws and regulations. AU §319.06. Under auditing standards, as set forth in §319.02:[5]

> In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation.

177. If an auditor identifies any material weaknesses in a company's internal controls during an audit, then the auditor must communicate these weaknesses to the company's audit

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[5] The original SAS which formed the basis for AU §319 was SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, issued in 1988. AU §319 was amended in 1995 by SAS No. 78, which applies to audits of financial statements of periods beginning after January 1, 1997. This standard applies to Ernst & Young's audits conducted for FY 2001 and thereafter. AU §319 was further amended by SAS No. 94, issued May 2001, for audits of financial statements for periods beginning after June 30, 2001. This standard applies to Ernst & Young's audits conducted for FY 2002 and thereafter. A key requirement under both standards is that an auditor is obligated to assess the company's internal controls.

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committee. AU §325. Further, the auditor should identify any limitations related to the internal control weaknesses in his or her audit opinion in accordance with the procedures proscribed by the professional standards.

178. With respect to Lehman's internal controls for FY 2005, Ernst & Young represented, in its Report of Independent Registered Public Accounting Firm dated February 13, 2006 and included in the Company's FY 2005, the following:

> We have audited management's assessment, included in the accompanying *Management's Assessment of Internal Control over Financial Reporting*, that Lehman Brothers Holdings Inc. (the "Company") maintained effective internal control over financial reporting as of November 30, 2005, based on criteria established in *Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.
>
> We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.
>
> A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.
>
> Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become

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inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Lehman Brothers Holdings Inc. maintained effective internal control over financial reporting as of November 30, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Lehman Brothers Holdings Inc. maintained, in all material respects, effective internal control over financial reporting as of November 30, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of Lehman Brothers Holdings Inc. as of November 30, 2005 and 2004 and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended November 30, 2005 of Lehman Brothers Holdings Inc. and our report dated February 13, 2006 expressed an unqualified opinion thereon.

179. Despite Ernst & Young's "clean" audit reports for FY 2005 through FY 2007, its assessment as to the effectiveness of Lehman's internal controls and approval of Lehman's interim financial statements and press releases, including its review and approval of Lehman's financial statements for 2Q 2008, Lehman collapsed in September 2008 due to its subprime and Alt-A holdings.

180. In October 2008, three separate criminal investigations were launched by the U.S. Attorneys' offices in the Eastern and Southern Districts of New York as well as the District of New Jersey into the events surrounding the collapse of Lehman and whether the Company and its executives misled investors, including whether Lehman valued its assets at artificially high levels. Defendant Fuld and 11 other Lehman executives received grand jury subpoenas in connection with the investigations.

181. The reasons for Lehman's collapse and the U.S. Attorneys' investigations involve periods during which Lehman's financial results had been audited and/or reviewed by Ernst & Young and for which Ernst & Young had issued unqualified opinions and approved of Lehman's publicly announced results.

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Ernst & Young's Audit Violated Fundamental Concepts of GAAS

182. Ernst & Young's failure to adequately perform its audit procedures to identify the improprieties alleged herein and its failure to report the problems permitted the accounting irregularities and improprieties to continue over a period of several years, leading to false and misstated financial statements. Due to Ernst & Young's false statements and failure to identify and modify its report to identify Lehman's false financial reporting, Ernst & Young violated the following GAAS standards:

(a) The first general standard is that the audit should be performed by persons having adequate technical training and proficiency as auditors;

(b) The second general standard is that the auditors should maintain an independence in mental attitude in all matters relating to the engagement;

(c) The third general standard is that due professional care is to be exercised in the performance of the audit and preparation of the report;

(d) The first standard of field work is that the audit is to be adequately planned and that assistants should be properly supervised;

(e) The second standard of field work is that the auditor should obtain a sufficient understanding of internal controls so as to plan the audit and determine the nature, timing and extent of tests to be performed;

(f) The third standard of field work is that sufficient, competent evidential matter is to be obtained to afford a reasonable basis for an opinion on the financial statements under audit;

(g) The first standard of reporting is that the report state whether the financial statements are presented in accordance with GAAP;

(h) The second standard of reporting is that the report shall identify circumstances in which GAAP has not been consistently observed;

(i) The third standard of reporting is that informative disclosures are regarded as reasonably adequate unless otherwise stated in the report; and

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(j) The fourth standard of reporting is that the report shall contain an expression of opinion or the reasons why an opinion cannot be expressed.

FIRST CAUSE OF ACTION

Violations of Section 11 of the 1933 Act
Against All Defendants Except Defendant Callan

183. Plaintiff repeats and realleges each and every allegation contained above. For purposes of this claim, plaintiff expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct, as this claim is based solely on claims of strict liability and/or negligence under the 1933 Act.

184. This claim is brought pursuant to §11 of the 1933 Act, 15 U.S.C. §77k, on behalf of the plaintiff, against all defendants except defendant Callan.

185. The Registration Statement and Offering Documents were false and misleading, contained untrue statements of material facts, omitted to state other facts necessary to make the statements made not misleading, and omitted to state material facts required to be stated therein.

186. Lehman was the registrant for the Notes.

187. The Individual Defendants named herein were responsible for the contents and dissemination of the Registration Statement. Each of the Individual Defendants signed or authorized the signing of the Registration Statement or were identified in the Prospectuses and Offering Documents.

188. The Underwriter Defendants named herein were responsible for the contents and dissemination of the Registration Statement and Offering Documents.

189. Ernst & Young acted as Lehman's auditor and was named by consent as having certified a part of the Registration Statement as well as Lehman's financial results included in its FY 2005 Form 10-K. Ernst & Young further reviewed Lehman's financial results included in its 1Q-3Q 2006 Form 10-Qs, which were incorporated into the Prospectuses.

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190. None of the defendants named herein made a reasonable investigation or possessed reasonable grounds for the belief that the statements contained in the Registration Statement and Offering Documents were true and without omissions of any material facts and were not misleading.

191. By reason of the conduct herein alleged, each defendant violated, and/or controlled a person who violated, §11 of the 1933 Act.

192. Plaintiff acquired the Notes pursuant and/or traceable to the Registration Statement for the Offerings.

193. Plaintiff has sustained substantial damages. At the time of its purchases of the Notes, plaintiff was without knowledge of the facts concerning the wrongful conduct alleged herein and could not have reasonably discovered those facts prior to September 2008. Less than three years has elapsed between the time that the securities upon which this claim is brought were offered to the public and the time plaintiff filed this complaint. Less than one year has elapsed between the time of discovery of the true facts and the filing of this complaint.

SECOND CAUSE OF ACTION

Violations of Section 12(a)(2) of the 1933 Act Against the Underwriter Defendants

194. Plaintiff repeats and realleges the allegations set forth above as if set forth fully herein. For purposes of this claim, plaintiff expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct, as this claim is based solely on claims of strict liability and/or negligence under the 1933 Act.

195. By means of the defective Prospectuses, the Underwriter Defendants assisted in the sale of shares of the Notes to plaintiff.

196. The Underwriter Defendants were sellers, offerors and/or solicitors of sales of the Offerings at issue.

197. The Prospectuses contained untrue statements of material fact, and concealed and failed to disclose material facts, as detailed above. The Underwriter Defendants owed plaintiff, who purchased Lehman Notes pursuant to the Prospectuses, the duty to make a reasonable and diligent

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investigation of the statements contained in the Prospectuses to ensure that such statements were true and that there was no omission to state a material fact required to be stated in order to make the statements contained therein not misleading. Defendants, in the exercise of reasonable care, should have known of the misstatements and omissions contained in the Prospectuses as set forth above.

198. Plaintiff did not know, nor in the exercise of reasonable diligence could have known, of the untruths and omissions contained in the Prospectuses at the time plaintiff acquired Lehman Notes.

199. By reason of the conduct alleged herein, defendants violated §12(a)(2) of the 1933 Act. As a direct and proximate result of such violations, plaintiff sustained substantial damages in connection with its purchases of Lehman Notes.

200. Plaintiff has brought this action within one year after discovery of the misstatements and omissions alleged herein and within three years after the subject Offerings.

THIRD CAUSE OF ACTION

Violations of Section 15 of the 1933 Act Against the Individual Defendants Except Defendant Callan

201. Plaintiff repeats and realleges each and every allegation contained above. For purposes of this claim, plaintiff expressly excludes and disclaims any allegation that could be construed as alleging fraud or intentional or reckless misconduct, as this claim is based solely on claims of strict liability and/or negligence under the 1933 Act.

202. This claim is brought pursuant to §15 of the 1933 Act against the Individual Defendants except defendant Callan.

203. Each of the Individual Defendants was a control person of Lehman and LBI by virtue of his/her position as a director, senior officer and/or major shareholders of Lehman which allowed each of these defendants to exercise control over Lehman and LBI and their operations.

204. Each of the Individual Defendants was a culpable participant in the violations of §11 of the 1933 Act alleged in the claim above, based on their having signed or authorized the signing of

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the Registration Statement and having otherwise participated in the process which allowed the Offerings to be successfully completed.

FOURTH CAUSE OF ACTION

For Violations of RCW §21.20.010 and §21.20.430 and/or Aiding and Abetting Against All Defendants

205. Plaintiff repeats and realleges each and every allegation contained above.

206. Plaintiff brings this claim against all the defendants in connection with plaintiff's purchases of Lehman Notes.

207. As alleged herein, defendants, directly or indirectly, in the State of Washington, employed devices, schemes, or artifices to defraud; made untrue statements of material fact and omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and/or engaged in acts, practices or courses of business which operated as a fraud or deceit upon plaintiff.

208. As alleged herein, defendants directly and indirectly employed and engaged in a scheme and artifice to defraud by participating in a continuous course of conduct to provide false information to plaintiff and to conceal from plaintiff material facts, as described above. Such misrepresentations and material omissions were made in connection with the offer to sell and sale of the Lehman Notes in the State of Washington. The defendants engaged in acts, practices and a course of conduct that included the making of, or participation in the making of, untrue and misleading statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances which they were made, not misleading.

209. Defendants had actual knowledge of the misrepresentations and omissions of material facts, or acted with reckless disregard for the truth in that they failed to disclose such facts, even though such facts were available to them.

210. Plaintiff did not know of the omissions and misstatements described above when it acquired the Notes. Plaintiff could not in the exercise of reasonable diligence have known of the actual facts. In reliance upon the superior knowledge of the defendants, plaintiff was induced to

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acquire the Notes. Plaintiff relied, among other things, upon statements made by or authorized by defendants in the Offering Documents, filings incorporated by reference in the Offering Documents, press releases, and conference calls and other statements made by defendants to the media analysts and others in making its investment decisions.

211. As a result of defendants' violations of RCW §21.20.010 and §21.20.430, plaintiff suffered damages and is entitled to damages in an amount to be determined at trial.

212. The defendants named herein are jointly and severally liable to plaintiff for damages in an amount to be determined at trial.

213. As to plaintiff's purchases pursuant to Offering Documents, this action is brought within three years after discovery of the misstatements and omissions alleged herein and within three years of such transactions.

FIFTH CAUSE OF ACTION

Claim for Breach of Fiduciary Duties and/or Aiding and Abetting Breach of Fiduciary Duty Against the Individual Defendants and Ernst & Young

214. Plaintiff repeats and realleges each allegation set forth herein.

215. Defendants have violated the fiduciary duties of care, loyalty, candor, good faith and independence owed under Washington state law to plaintiff as a purchaser of Lehman securities and have acted to put their personal interests ahead of the interests of plaintiff, and/or have aided and abetted therein.

216. By the acts, transactions and course of conduct alleged herein, defendants Fuld and O'Meara, aided and abetted by the remaining defendants, failed to exercise the care required, and breached their duties of loyalty, good faith, candor and independence owed to plaintiff by failing to disclose all material information known to them at the time plaintiff purchased the Notes and by making misrepresentations and omissions of material facts to induce plaintiff to purchase and continue to hold Lehman Notes.

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217. Ernst & Young consented to the inclusion of its FY 2005-FY 2007 audit opinions in Lehman's financial statements. Ernst & Young further consented to the incorporation of its FY 2005 audit opinion in the Offering Documents.

218. Ernst & Young aided and abetted and materially assisted the breach of fiduciary duty by the Lehman officers and directors by failing to conduct its audit in accordance with GAAS and by falsely representing that it had audited the financial statements in accordance with GAAS and that those financial statements were fairly presented in accordance with GAAP.

219. By reason of the foregoing acts, practices and course of conduct, defendants have failed to exercise ordinary care and diligence in the exercise of their fiduciary obligations toward plaintiff, and/or have aided and abetted therein.

220. As a direct and proximate result of these breaches of fiduciary duty, plaintiff suffered damages in connection with its investment in Lehman Notes.

SIXTH CAUSE OF ACTION

Claim for Negligent Misrepresentation Against the Individual Defendants

221. Plaintiff incorporates the above paragraphs and allegations.

222. This cause of action is brought against the Individual Defendants for negligence.

223. Defendants made material false statements, including, but not limited to, those representations and omissions as to the financial results of Lehman, and the Company's prospects for continued growth. These material misrepresentations and omissions are contained in and reflected in the Registration Statement, Prospectuses and other Offering Documents, as well as press releases, analysts' reports, financial statements, and other disclosures made by defendants.

224. These representations were false in that the financial statements were not prepared in accordance with GAAP. Because of the fraudulent accounting of Lehman, the financial statements showed inflated results for FY 2005 through FY 2007.

225. When these defendants, and each of them, made the representations and failed to disclose and suppressed information they had a duty to disclose, as set forth hereinbefore, defendants

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were negligent as to the falsity of their representations and were negligent as to the failure to disclose material facts which they had a duty to disclose.

226. At the time of the misrepresentations and omissions of material facts by the Individual Defendants, plaintiff and its agents were ignorant of their falsity and believed them to be true. If plaintiff and/or its agents had been aware of the true facts, they would not have purchased or continued to hold the Lehman Notes and/or would have disposed of them immediately.

227. Neither plaintiff nor its agents knew of any of the false and/or misleading statements and omissions and reasonably relied upon the representations made by the defendants.

228. The Individual Defendants' conduct constitutes the making of negligent misrepresentations (including negligent omissions to state facts in connection with statements that were made) under applicable Washington state law.

229. As a direct and proximate result of the negligent misrepresentations (and omissions) by the Individual Defendants, and in reliance thereon, plaintiff suffered damages in connection with its investment in Lehman Notes.

SEVENTH CAUSE OF ACTION

Claim for Professional Negligence and Negligent Misrepresentation Against Defendant Ernst & Young

230. Plaintiff incorporates the above paragraphs and allegations.

231. This cause of action is brought against Ernst & Young for negligence.

232. Ernst & Young is in the business of auditing financial statements of public companies, issuing opinion letters concerning the financial statements audited, and providing and certifying such information for the benefit of investors and others to use in their dealings with others.

233. As the independent auditor of Lehman, Ernst & Young had a duty to examine the financial statements of Lehman in accordance with GAAS to determine, among other things, whether they were fairly presented and in accordance with GAAP.

234. Ernst & Young knew and intended that its reports concerning Lehman's financial statements would be distributed to prospective purchasers of Lehman Notes and that such purchasers

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would rely, and had a right to rely, upon the information provided by Ernst & Young concerning the financial condition of Lehman in making their investment decisions. Ernst & Young knew and intended that its audit opinions and the annual financial statements of Lehman to which they related would be included in Lehman's financial statements and would further be incorporated by reference in and constituted a material part of the Offerings and Ernst & Young expressly consented to such inclusion and incorporation. Ernst & Young understood that a primary intent of Lehman was for Ernst & Young's professional services to benefit or influence prospective purchasers of Lehman Notes, including plaintiff, since one of the primary purposes of having an accounting firm certify financial statements is to provide independent certification of the accuracy thereof to those who must rely on those financial statements when deciding whether to transact in the company's securities.

235. Ernst & Young owed plaintiff a duty of reasonable care in connection with the provision of information concerning the financial condition of Lehman, including Ernst & Young's certifications that the companies' financial statements fairly and accurately reported their financial condition and were presented in accordance with GAAP, which certifications were included (or incorporated) into the Company's financial statements and into the Offerings.

236. Ernst & Young breached these duties knowingly, wantonly, recklessly, or at least negligently, by including untrue statements of material facts and/or omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in Lehman's financial statements disseminated to plaintiff and its agents. Among other things, Ernst & Young falsely represented that it had audited Lehman's financial statements in accordance with GAAS and that those financial statements were fairly presented in accordance with GAAP.

237. At the time of the misrepresentations and omissions of material facts by Ernst & Young, plaintiff and its agents were ignorant of their falsity and believed them to be true. Plaintiff and its agents relied upon the superior knowledge and expertise of Ernst & Young and justifiably relied (to their detriment) on the financial statements audited and certified by Ernst & Young, and on

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the unqualified opinions issued by Ernst & Young in connection with Lehman's financial statements. Had plaintiff and/or its agents been aware of the true facts, they would not have purchased or continued to hold Lehman Notes and/or would have disposed of them immediately.

238. Neither plaintiff nor its agents knew of any of the false and/or misleading statements and omissions and reasonably relied upon the representations made by the defendants.

239. Ernst & Young's conduct constitutes the making of negligent misrepresentations (including negligent omissions to state facts in connection with statements that were made) under applicable Washington state law.

240. As a direct and proximate results of the negligent misrepresentations (and omissions) by Ernst & Young, and in reliance thereon, plaintiff suffered damages in connection with its investment in Lehman Notes.

PRAYER FOR RELIEF

WHEREFORE, plaintiff prays for relief and judgment, as follows:

A. Awarding compensatory damages in favor of plaintiff against all defendants, jointly and severally, for all damages sustained as a result of defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

B. Awarding plaintiff its reasonable costs and expenses incurred in this action, including counsel fees and expert fees;

C. Awarding plaintiff its reasonable costs and expenses, including interest at eight percent per annum, counsel fees and expert fees as permitted by RCW §21.20.430; and

D. Such equitable/injunctive or other relief as deemed appropriate by the Court.

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JURY DEMAND

Plaintiff hereby demands a trial by jury.

DATED: May 18, 2009

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