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SUPERIOR COURT OF NEW JERSEY
LAW DIVISION – MERCER COUNTY

THE STATE OF NEW JERSEY, DEPARTMENT OF TREASURY, DIVISION OF INVESTMENT,

Plaintiff,

v.

RICHARD FULD, JR., CHRISTOPHER M. O'MEARA, JOSEPH M. GREGORY, ERIN CALLAN, IAN LOWITT, DAVID GOLDFARB, HERBERT H. McDADE, III, THOMAS RUSSO, MARK WALSH, MICHAEL AINSLIE, JOHN F. AKERS, ROGER S. BERLIND, THOMAS H. CRUIKSHANK, MARSHA JOHNSON EVANS, CHRISTOPHER GENT, ROLAND A. HERNANDEZ, HENRY KAUFMAN, JOHN D. MACOMBER, and ERNST & YOUNG LLP,

Defendants.

Case No.:

<u>JURY TRIAL DEMAND</u>

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Plaintiff, The State of New Jersey, Department of Treasury, Division of Investment ("Plaintiff" or the "Division"), alleges the following based on the investigation conducted by the Division and its counsel, including a review and analysis of the public filings of Lehman Brothers Holdings Inc. ("Lehman" or the "Company") with the Securities Exchange Commission ("SEC"); research reports by securities analysts; transcripts of Lehman investor conference calls; Lehman presentations at various financial conferences; press releases and media reports; publicly available filings in legal actions involving Lehman; documents related to Lehman's bankruptcy proceedings; testimony and documents presented before the United States House of Representatives' Committee on Oversight and Government Reform ("House Committee"); interviews and other documents and materials related to the Company.

I. INTRODUCTION

1. This action by the Division arises from its purchases of over $180 million of securities from Lehman as part of two offerings issued by the Company on April 1, 2008 and June 9, 2008 ("Offerings"). In conjunction with those Offerings, Plaintiff relied on the public filings of the Company, which contained its financial statements audited and reviewed by Lehman's long-time accountants, Ernst & Young ("E&Y"). The materials related to the Offerings contained significant misstatements regarding the value of Lehman's assets that Plaintiff in the exercise of reasonable care could not have known were false.

2. In addition, executives from Lehman privately disavowed to representatives of the Division Lehman's exposure to the collapsing real estate market and claimed that Lehman had sufficient liquidity, a strong capital base and superior hedging and risk management practices, distinguishing Lehman from its banking peers.

3. At the time it made these public and private representations, Lehman knew that its overvalued residential and commercial real estate portfolio was making it increasingly illiquid. Ultimately, Lehman was unable to continue to conceal its deteriorating position, and with no potential buyer willing to purchase such toxic assets, bankruptcy became the only alternative, leaving its shareholders, including Plaintiff, with virtually worthless stock.

4. Plaintiff's complaint is divided into two parts. The first part sets forth the factual allegations which form the basis for Plaintiff's claims under the federal Securities Act of 1933 (the "Securities Act"). These allegations do not involve fraud or intentional conduct. The second part sets forth the factual allegations for Plaintiff's state law claims, including violations of New Jersey's securities statute, negligent misrepresentation, breach of fiduciary duty, fraud, and aiding and abetting by E&Y, among others.

5. Lehman just did not collapse suddenly on September 15, 2008 when it filed for bankruptcy a little over three months after the June 9 Offering. Its financial situation had been worsening steadily. In 2008, Lehman's executives kept telling investors its financial position was solid when, in fact, the opposite was true. Though Lehman was a major participant in all aspects of the real estate market, originating both residential and commercial mortgages, securitizing loans, marketing and selling various asset-backed instruments and also investing directly in real estate, Lehman repeatedly assured investors that its exposure to the real estate meltdown was well contained, due, in part, to its hedging strategies. It further claimed that it had taken steps to exit the non-prime mortgage market. In September 2007, as other banks began taking losses, Lehman's then-Chief Financial Officer ("CFO") told investors: "**our liquidity position is stronger than ever**."

6. Lehman's thirst for profit led it to increase its real estate investment exposure from $9.4 billion at the end of 2006 to $21.9 billion at the end of 2007. Lehman reported record earnings of $4.2 billion for fiscal year 2007. On the year-end earnings call on December 13, 2007, Richard S. Fuld, Jr. ("Fuld"), Lehman's hard-driving Chief Executive Officer ("CEO"), stated: "our global franchise and brand have never been stronger."

7. On the heels of reporting record earnings in 2007, on January 17, 2008, Lehman announced that it would stop originating residential mortgages through wholesale channels amid continued weakness in the housing and real estate markets.

8. During the first half of 2008, Lehman raised approximately $12 billion in capital through three separate offerings in February, April and June 2008.

9. In 2008, Lehman started to move to limit its exposure to losses from its massive real estate portfolio. During the first quarter of 2008, Lehman wrote-down $4.7 billion in mortgage-related positions. Companies are required to mark-to-market their holdings, meaning to value them on their books at the level at which they could sell them right away. On June 9, 2008, the same day Lehman revealed that it was raising another $6 billion in a preferred and common share Offering from investors including the Division, Lehman announced its preliminary results for the second quarter of 2008 – an estimated loss of $2.8 billion. According to defendant Callan, this amount included "approximately $4.9 billion of mark-to-market adjustments, principal investment losses and other dynamic hedging losses." In addition to these write-downs, defendant Callan reported that Lehman had lowered its net leverage to 12.5 times shareholder equity, not including the June 9 Offering, and reduced its "exposure to asset classes such as residential and commercial mortgages, and real estate held for sale of approximately 15% to 20% in each case and acquisition and finance exposure by almost 35%."

10. Pursuant to a confidentiality agreement, the Division spoke with executives of Lehman, including defendant Callan, on June 5 and 6, 2008 regarding Lehman's second quarter results and committed to purchase in the June 9 Offering.

11. On June 12, 2008, Lehman issued a press release that defendant Callan and Joseph Gregory ("Gregory"), Lehman's Chief Operating Officer ("COO"), would be stepping down and replaced by Ian T. Lowitt ("Lowitt') as CFO and Herbert H. McDade, III ("McDade") as COO.

12. A week later on June 16, 2008, after filing its results for the second quarter, Lehman held another conference call. Defendant Fuld explained:

> Years ago we made a decision to build out the best-in-class commercial and residential mortgage origination and distribution platforms. We created significant revenues and net income over those years that funded many of the Firm's investments that have diversified our core franchise today. We made active decisions to deploy our capital. **Some of which in hindsight were poor choices, because we really did not react quickly enough to the eroding environment.** For example, we accumulated positions in leveraged loans that we believed we could syndicate and clearly not all of those got sold. **Together, the accumulation of all these positions ultimately led to our decision this past quarter to aggressively de-lever.**

Nevertheless, Fuld also reassured investors: "**our capital and liquidity positions have never been stronger.**"

13. The newly appointed CFO, defendant Lowitt, reiterated the purported strong capital position on the June 16 call: "In conclusion I reviewed with you the strength we continue to see in our client franchise and **our strong capital and liquid position**."

14. On July 10, 2008, Lehman filed its Form 10-Q for the second quarter of 2008 with the SEC ("Second Quarter 2008 Form 10-Q") which showed that its most illiquid assets – called Level 3 assets -- assets that have no direct observable market value, had declined slightly in the second quarter of 2008 to $41.3 billion from $42 billion at year end 2007.

15. Despite this reported de-levering of its balance sheet and seeming containment of the illiquid assets categorized as Level 3, throughout the Summer of 2008, rumors persisted that Lehman was attempting to sell itself, get investments from sovereign funds, spinoff its real estate portfolio and sell its Investment Management Division ("IMD"). However, at no time during the Summer did Lehman or its senior executives disclose the truth concerning Lehman's imperiled liquidity and capital position, or the true value of its illiquid assets.

16. Lehman, its top executives and E&Y either knew or should have known of Lehman's false balance sheet and impaired liquidity and capital positions by the time of the April and June Offerings. Nevertheless, none of this was disclosed to the Plaintiff despite the fact that the Division also had direct communications with senior Lehman executives.

17. On July 25, 2008, CNBC reported that Lehman was considering a sale of at least part of its IMD.

18. On August 22, 2008, Reuters reported that state-owned Korean Development Bank ("KDB") spokesman told it: "We are studying a number of options and are open to all possibilities, which include (buying) Lehman." Lehman closed at $14.41 per share that day.

19. On September 2, reports indicated KDB was considering buying a 25% stake, however, on September 9, 2008, KDB announced it had ended talks with Lehman. Lehman's collapsed to $7.79 per share from the prior day close of $14.15.

20. On September 10, 2008, Lehman held an earnings guidance call on short notice, a week prior to its scheduled call. Lehman reported a $3.9 billion loss for the third quarter of 2008, as well as $7 billion in gross write-downs on its residential and commercial real estate holdings. Defendant Fuld stated that the "decisions announced today will best protect the core client franchise, and create a very clean, liquid balance sheet." The plans presented included

exiting commercial real estate and spinning off the unit, reducing residential and leveraged loan exposures, and raising capital by selling an equity stake in Lehman's IMD.

21. On the September 10 call, defendant Lowitt seconded defendant Fuld's sentiment, asserting: "I'll now provide an update on **our liquidity position which remains very strong.** We have maintained our strong liquidity and capital profiles even in this difficult environments and the potential sale of IMD further improves our capital position." Lowitt noted further: "Even under the scenario of limited debt issuing capacity in 2009 **we anticipate the core Lehman will have ample cash capital to sustain its business opportunities**."

22. Meanwhile, also around September 10, rumors surfaced that JP Morgan & Co. ("JPMorgan") was demanding Lehman provide it additional collateral to cover Lehman's lending positions, and separately, Barclay, p.l.c. ("Barclays") and Bank of America were reviewing Lehman's books for a possible purchase of the Company.

23. Before the markets opened on Monday, September 15, 2008, Lehman, with its share price in a rapid freefall as rumors flew, filed for bankruptcy protection. Lehman's bankruptcy filing led to decline in its share price on September 15 by over 94 percent from the previous trading day, Friday, September 12, to $0.21 per share.

24. Throughout the period of time relevant to this complaint, Lehman was audited by E&Y, which received lucrative accounting and auditing fees, estimated at $31 million in 2007 alone. E&Y received these fees for allegedly properly auditing Lehman's financial statements. Following its audit in 2007, E&Y issued an unqualified audit report on the annual financial statements of Lehman, thereby providing public investors – the intended beneficiaries of the audit report – including Plaintiff, with the assurance that Lehman was properly reporting its financial figures in 2007. E&Y also continued to review Lehman's quarterly financial

statements in 2008, as well as the press releases issued by Lehman regarding its financial results. Moreover, Lehman's financial statements and results for year-end 2007 and the first two quarters of 2008 were incorporated in the prospectuses for the Offerings with E&Y's consent.

25. In total, the Division, through Lehman Brothers, Inc. ("LBI"), Lehman's broker/dealer subsidiary, which is now in liquidation proceedings under the Securities Investor Protection Act of 1970, as amended (the "SIPA"), purchased approximately $182 million worth of Lehman securities, including $2 million in preferred stock in the April 2008 Offering and nearly $120 million of common stock at $28 per share and $60 million in preferred stock in the June 2008 Offering. Plaintiff estimates that it has lost in excess of $118 million as a result of the wrongdoing alleged in this complaint.

II. THE PARTIES

A. Plaintiff

26. Plaintiff is a political entity dedicated to serving the citizens of New Jersey and operates under New Jersey law. The Department of Treasury of the New Jersey Office of the State Treasurer administers the budget of the Division. The Division is one of the largest public money managers in the United States. The bulk of assets the Division manages are pension and retirement plan funds for over 700,000 active and retired New Jersey employees. In addition, the Division manages over 185 other separate funds, with the largest being the State of New Jersey Cash Management Fund and the Supplemental Annuity Collective Trust Fund.

27. The Division invests the portfolios of numerous New Jersey pension funds, including, among others, the Public Employees' Retirement System ("PERS"); the Teachers' Pension and Annuity Fund ("TPAF"); the Police and Firemen's Retirement System ("PFRS"); the State Police Retirement System ("SPRS"); and the Judicial Retirement System ("JRS").

28. The Division's research analysts review, among other things, regulatory filings, corporate reports, press releases, and other documents disseminated by public companies in order to invest in securities informed by the statements of those companies, their officers and directors, and their auditors. Division personnel also routinely participate in telephonic and live conferences with representatives from the companies in which the Division invests.

29. The Division is headed by its Director, William G. Clark ("Clark"), and oversight is provided by the New Jersey State Investment Council ("Council").

30. The Division, through its personnel, relied upon the accuracy, veracity, and completeness of Lehman's public filings, quarterly and annual reports, corporate disclosures, announcements, press releases, and other statements in making investment recommendations and decisions concerning the investments in Lehman securities for the public pension and other public monies it manages. Moreover, the Division, through its personnel, relied upon the accuracy, veracity and completeness of the representations and statements made by Lehman's officers and directors in public filings, quarterly and annual reports, corporate disclosures, announcements, press releases, teleconferences, analyst conferences and in-person meetings in making investment decisions concerning the investment in Lehman securities for the public pension and other public monies it manages.

31. The Division, on behalf of Common Pension Fund A, purchased 2000 shares of Lehman 7.25% Non-Cumulative Perpetual Convertible Preferred Series P at $1000 per share on April 1, 2008 in the April Offering for a cost of $2 million. On June 12, 2008, the Division, on behalf of Common Pension Fund A, purchased 60,000 shares of Lehman 8.75% Non-Cumulative Mandatory Convertible Preferred Series Q at $1000 per share for a cost of $60 million, and

4,285,714 shares of Lehman common stock at $28 per share on June 12, 2008 for a cost of slightly less than $120 million in the June Offerings.

32. The Division was solicited to make these purchases by representatives of Lehman, as alleged more fully below. Several members of the Division, including Clark, spoke personally on several occasions with representatives from Lehman, including defendant Callan, and relied directly on these representations and Lehman's public statements in making the investment decisions.

B. Defendants

1. Unnamed Culpable Parties

33. Lehman and LBI were involved as sellers, offerors and solicitors of the Offerings to Plaintiff. Lehman is in bankruptcy and direct claims against it are barred under bankruptcy law. LBI is in dissolution under the SIPA and claims against it are stayed by court order. But for Lehman's bankruptcy filing and LBI's SIPA proceedings, both LBHI and LBI would have been named as defendants by the Division in this action.

2. Officer Defendants

34. Defendant Fuld joined Lehman full time in 1968 at the age of 23. He rose steadily through the Company's ranks, becoming Chairman of the Board of Directors ("Board") of the Company in April 1994 and CEO of the Company in November 1993. Between 2000 and September 15, 2008, Fuld received nearly $500 million in total compensation from Lehman.

35. Defendant Christopher M. O'Meara ("O'Meara") served as Lehman's CFO, Controller and Executive Vice President from 2004 until December 1, 2007. O'Meara joined Lehman in 1994, and prior to serving as CFO was Lehman's Global Controller. As Controller, O'Meara supervised Lehman's internal accounting programs and procedures. Beginning on

December 1, 2007, O'Meara served as head of Worldwide Risk Management. In his role as head of Risk Management, O'Meara was also responsible for supervising Lehman's risk mitigation strategies and procedures. For the fiscal 2007 year, O'Meara received an annual salary of $200,000, a cash bonus of $2,650,000 and a restricted stock award of $6,642,857, for total compensation of $9,492,857.

36. Defendant Gregory joined Lehman in 1974 and served as Lehman's President and Chief Operating Officer ("COO") from May 2004 until resigning in June 2008. From May 2002 to May 2004, Gregory was Lehman's Co-COO. In his role as COO, Gregory oversaw the day-to-day management of Lehman's operations, while defendant Fuld handled the external duties. From 2000 until May 2002, Gregory was Lehman's Chief Administrative Officer, and from 1996 to April 2000, he was head of Lehman's Global Equities Division, in charge of the overall equities business. For the fiscal year 2007, Gregory received an annual salary of $450,000, a cash bonus of $4.5 million and a massive restricted stock award of $29 million, for total compensation of $34 million.

37. Defendant Callan joined Lehman in 1995 and served as Lehman's CFO and Global Controller from December 2007 until June 12, 2008 when she was demoted. She resigned later that month. Callan had served in various capacities at Lehman, including head of the Investment Banking Global Hedge Fund Coverage Group, the Global Finance Solutions Group and Global Finance Analytics Group, but never as a comptroller, the Treasury function that is the usual training ground for CFOs. Defendant Callan is now head of Credit Suisse's global hedge fund business.

38. Defendant Lowitt joined Lehman in 1994 and replaced Callan as CFO on June 12, 2008 and also served as the Co-Chief Administrator Officer since October 2006, overseeing

Lehman's finance organization, including Financial Control, Investor Relations, Planning and Analysis, Product Control, Tax and Treasury. In his role as Co-Chief Administrator Officer, he was responsible for global oversight of Risk Management. Lowitt served as Treasurer and Global Head of Tax from 2000 until 2005. For the fiscal year 2007, Lowitt received an annual salary of $200,000, a cash bonus of $2.65 million and a restricted stock award of $6.64 million, for a total compensation of $9.49 million.

39. Defendant David Goldfarb ("Goldfarb") joined Lehman in 1993, after 14 years in E&Y's Financial Services practice, where he was a partner. He became Lehman's Global Controller in 1995, and in April 2000 was promoted to CFO. He served in that capacity until 2004, when he was promoted to Chief Administrative Officer, responsible for Finance, Risk Management and Investor Relations. He also oversaw Strategy, Technology and Operations, Corporate Communications and Corporate Real Estate. In 2006, Goldfarb served as the global head of Strategic Partnerships, Principal Investing and Risk, and in June 2008, Goldfarb assumed the position of Chief Strategic Officer.

40. Defendant McDade joined Lehman in 1983. He became co-head of the Fixed Income Division in 2000 and in 2002, became global head of the Fixed Income Division. In 2005, he was named global head of the Equities Division. In June 2008, McDade assumed the position of President and COO, replacing Gregory.

41. Defendant Thomas Russo ("Russo") was Chief Legal Officer of Lehman since 1993 and is an Executive Vice President of the Company and a member of, and counsel to, the Executive Committee. He has been a Vice Chairman of LBI since July 1999. In addition, Russo is a member of the Federal Reserve Bank of New York's International Advisory Committee and the Committee on Capital Markets Regulation. For the fiscal year 2007, Russo received an

annual salary of $450,000, a cash bonus of $4,550,000 and a restricted stock award of $9 million, for a total compensation of $14 million.

42. Defendants Fuld, O'Meara, Gregory, Callan, Lowitt, Goldfarb, McDade and Russo are collectively referred to herein as the "Officer Defendants," and all served on Lehman's Executive Committee, chaired by defendant Fuld. The Executive Committee was responsible for assessing Lehman's risk exposure and related disclosures, reportedly meeting at least twice a week for two hours at a time at which they regularly spoke about managing risk.

43. Defendant Mark Walsh ("Walsh") joined Lehman in 1988. By 1995, he was a managing director and head of the Commercial Real Estate Principal Transaction Group. In 2004, Walsh was made co-head of Lehman's Global Real Estate Group, becoming the sole head of the group in 2008, when the other co-head, Raymond Mikulich retired at the year end 2007. Walsh was a member of Lehman's Management Committee and had primary responsibility for Lehman's real estate portfolio.

3. <u>Director Defendants</u>

44. Defendant Michael Ainslie ("Ainslie") was at all relevant times a director of Lehman and signed the registration statement and the Annual Report on Form 10-K filed with the SEC for the fiscal year ending November 30, 2007 ("2007 Form 10-K") in his capacity as a director of Lehman. Ainslie served on Lehman's Board for 22 years. He is the former President and CEO of Sotheby's Holdings, retiring in 1994. He is also a director of the St. Joe Co. and a Trustee of Vanderbilt University. For the fiscal year of 2007, he received total compensation of $397,538 from Lehman.

45. Defendant John F. Akers ("Akers"), age 74, was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a

director of Lehman. Akers joined Lehman's Board in 1996, and served as Chairman of the Compensation and Benefits Committee and a member of the Finance and Risk Committee. He is the former Chairman and CEO of International Business Machine Corp., from which he retired in 1993. For the fiscal year of 2007, he received total compensation of $360,538 from Lehman.

46. Defendant Roger S. Berlind ("Berlind"), age 78, was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. Berlind joined Lehman's Board in 1985, and also served as a member of the Audit Committee and the Finance and Risk Committee. Berlind is a theatrical producer. For the fiscal year 2007, he received total compensation of $352,538 from Lehman.

47. Defendant Thomas H. Cruikshank ("Cruikshank"), age 77, was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. Cruikshank joined Lehman's Board in 1996, and served on the Audit Committee and Nominating and Corporate Governance Committee. Cruikshank served as the Chairman and CEO of Halliburton Energy Services, retiring in 1995. For the fiscal year 2007, he received total compensation of $385,038 from Lehman.

48. Defendant Marsha Johnson Evans ("Evans") was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in her capacity as a director of Lehman. Evans joined Lehman's Board in 2004. She served as Chairperson of the Nominating and Corporate Governance Committee, a member of the Compensation and Benefits Committee, and member of the Finance and Risk Committee. She is also a director of Weight Watchers International, Inc., Office Depot, Inc. and Huntsman Corporation. For the fiscal year 2007, she received total compensation of $373,038 from Lehman.

49. Defendant Christopher Gent ("Gent") was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. Gent joined Lehman's Board in 2003 and served as a member of the Audit Committee and Compensation and Benefits Committee. From 1997, he had been the CEO of Vodafone, retiring in 2003. He is currently the Non-Executive Chairman of GlaxoSmithKline plc. He is also a director of Ferrari SpA and senior advisor to Bain & Company, Inc. For the fiscal year 2007, he received total compensation of $365,538 from Lehman.

50. Defendant Roland A. Hernandez ("Hernandez") was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. Hernandez joined Lehman's Board in 2005, and served on the Finance and Risk Committee. He is the former Chairman and CEO of Telemundo Group, Inc., a Spanish language television station, retiring in December 2000. He is also a director of MGM Mirage, the Ryland Group, Inc., Vail Resorts, Inc. and Wal-Mart Stores, Inc. For the fiscal year 2007, he received total compensation of $325,038 from Lehman.

51. Defendant Henry Kaufman ("Kaufman"), age 81, was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. Kaufman joined Lehman's Board in 1995 and served as the Chairman of the Finance and Risk Committee. For 26 years, Kaufman was with Salomon Brothers, Inc., where he was a Managing Director, Member of the Executive Committee, and in charge of Salomon's various research departments. He is also Treasurer and former Trustee of the Economist Club of New York. He received $349,388 in compensation from Lehman for 2007. In 2007, the Finance and Risk Committee, which Kaufman chaired, met twice.

52. Defendant John D. Macomber ("Macomber"), age 81, was at all relevant times a director of Lehman and signed the registration statement and the 2007 Form 10-K in his capacity as a director of Lehman. He joined Lehman's Board in 1994 and served on the Compensation and Benefits Committee, Executive Committee and Nominating and Governance Committee. Macomber has been a principal of JDM Investment Group since 1992. Macomber is also a director of Collexis Holdings, Inc. and Stewart & Stevenson, LLC., and a Trustee at Carnegie Institution in Washington and Folger Library in Washington, DC. For the fiscal year 2007, he received total compensation of $377,038 from Lehman.

53. Defendants Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez, Kaufman and Macomber are collectively referred to herein as the "Director Defendants." The Director Defendants, among other responsibilities, were charged with reviewing significant capital transactions and the respective risks involved. The Officer Defendants, defendant Walsh, and the Director Defendants are collectively referred to herein as the "Lehman Defendants."

54. The Lehman Defendants, because of their senior positions at Lehman, were controlling persons of the Company and were empowered with the authority to control the contents of Lehman's reports to the SEC, press releases, and presentations to securities analysts, money and portfolio managers, institutional investors and individual investors. As set forth below, the Officer Defendants, through defendant Callan, had direct contact with Plaintiff regarding its investments in Lehman.

4. <u>Auditor Defendant</u>

55. Defendant E&Y is a public accounting firm with offices throughout the world, including offices in the State of New Jersey. Pursuant to the Sarbanes-Oxley Act of 2002 ("SOX"), E&Y is subject to oversight and annual inspection by the Public Company Accounting

Oversight Board ("PCAOB") as a registered public accounting firm that regularly provides audit reports for more than 100 issuers. E&Y served as Lehman's outside auditor for years and at all times relevant to the events at issue in this complaint. Lehman engaged E&Y to audit its financial statements, as well as to provide a written report as to whether the financial statements were fairly presented. E&Y also reviewed Lehman's quarterly financial results. For its work, E&Y earned tens of millions of dollars in annual fees, including over $31 million in 2007 alone. E& Y's audit opinion on the consolidated financial statements of Lehman for the year ending November 30, 2007 is incorporated by reference in each of the offering prospectuses which were issued in connection with the Offerings Plaintiff purchased. E&Y had to consent to this incorporation and by doing so, lent its endorsement to the April and June 2008 Offerings.

56. E&Y and the Lehman Defendants are collectively referred to herein as the "Defendants."

III. JURISDICTION AND VENUE

57. The Division was solicited to purchase Lehman securities in New Jersey by Lehman representatives and the purchases were consummated in New Jersey. The Division held the Lehman securities in its custodial account in New Jersey.

58. Each of the Defendants has sufficient contacts with New Jersey, is a citizen of New Jersey, or otherwise purposely availed himself, or herself or itself of benefits from New Jersey, or has property in New Jersey, so as to render the exercise of jurisdiction over each by the New Jersey courts consistent with due process of law. Prior to its bankruptcy, Lehman conducted substantial business in New Jersey. Lehman maintained several offices and data centers in New Jersey. E&Y also conducts substantial business in New Jersey, and presently maintains several offices in the state.

59. This is an action brought by the Division on its own behalf and reference is made to Section 16(d)(2) of the Securities Act. This action may not be removed to federal court under this provision of the Securities Act and also may not be removed because of the prohibition on removal set out in § 22 of the Securities Act. In addition, this action may not be removed to federal court on the basis of alleged diversity of citizenship under 28 U.S.C. §§ 1332 and 1441 or otherwise. *See, e.g., Moor v. County of Alameda*, 411 U.S. 693 (1973); *State Highway Comm'n of Wyoming v. Utah Constr. Co.*, 278 U.S. 194 (1929); *Blake v. Kline*, 612 F.2d 718 (3d Cir.), *cert. denied*, 447 U.S. 921 (1979).

60. Venue is proper in Mercer County pursuant to N.J. Ct. R 4:3-2(a) because the Division's causes of actions arose, in material part, in that county. Specifically, critical acts and transactions that constitute the violations of law alleged herein, including Lehman's dissemination of untrue statements of material facts about Lehman's securities, and the ultimate sale of the securities, occurred in Mercer County, New Jersey, where the Division is located.

IV. FACTUAL ALLEGATIONS REGARDING CAUSES OF ACTION UNDER THE SECURITIES ACT

61. Lehman was founded 158 years ago by two Alabama cotton traders. For much of its history, Lehman focused on bond trading and built a reputation as a first-rate investment banking financial firm.

62. Lehman was acquired in 1984 by American Express Co. ("American Express"). In 1994, the Company unit was spun off by American Express with defendant Fuld as CEO. Since 1994, defendant Fuld doubled the number of employees in the firm and led it through an impressive increase in assets, revenue and stock value.

63. Since the late 1990s, and especially in the past 5 years, Lehman participated in all aspects of the residential and commercial mortgage markets. Indeed, Lehman's mortgage-

related business ultimately comprised its single largest revenue component. Billing itself as a "market leader in securitization transactions, including securitizations on residential and commercial loans," and a "fully vertically integrated mortgage business" that was "involved in every step of the financial process," Lehman originated mortgages, purchased mortgages, packaged mortgages into securities, and marketed the securities to investors.

A. Lehman Made Substantial Investments in Residential and Commercial Mortgage Backed Securities

64. Lehman participated in the origination and securitization of non-prime residential mortgages. Non-prime mortgages are categorized as "Subprime" and "Alt-A." "Subprime" describes residential mortgages to borrowers who do not qualify for prime interest rates because they exhibit one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios. "Alt-A" describes residential mortgages to borrowers whose income may not be documentable, or have other credit problems, although their financial circumstances are better than borrowers in the subprime category. The subprime mortgage market grew from $40 billion in 1994 to $600 billion in 2005, totaling about 20 percent of the total residential loan originations in 2005. According to a report by Standard & Poor's ("S&P"), Alt-A originations increased from less than $20 billion in 2000 to more than $300 billion in 2005.

65. In tandem with the growth of the residential real estate market, the commercial real estate market also enjoyed explosive growth over the past decade. This in turn led to a sharp increase in the valuations of commercial properties and the commercial mortgage amounts financed by lenders.

66. Both residential mortgages and commercial mortgages were packaged into residential mortgaged-backed securities ("RMBSs") and commercial mortgage-backed securities ("CMBSs") and other complicated derivative structures for sale to investors. These MBSs are typically divided into senior, mezzanine and equity tranches, each of which possesses a different risk profile and credit rating based on the priority of the cash flow from payments on the underlying mortgages. The senior tranches are to be paid first and were generally rated higher by the rating agencies (such as Moody's, Fitch and S&P). After the senior tranche is fully paid, the middle tranches – i.e. the lower rated mezzanine tranches – receive their share of the proceeds, with the process of distributing the mortgage proceeds continuing through to the bottom, lowest-rated tranches. The equity tranches bear the risk of any shortfalls from the underlying collateral.

67. These MBSs are extremely dependent on interest rates. In general, rising interest rates negatively affect all borrowers, especially those whose interest rates are adjustable. In such situations, for example, if the RMBS is backed by a pool of subprime adjustable rate mortgages, a rise in the interest rates increases the borrowers' monthly payments, increasing the likelihood that some borrowers will default on their mortgages, thereby decreasing the overall value of the RMBS. Similarly, falling interest rates also have a negative effect on RMBSs backed by fixed-rate residential mortgages. Many borrowers chose to refinance leaving the less credit-worthy borrowers who cannot refinance in the remaining mortgage pool.

68. The risk of default likewise extended to commercial borrowers. Commercial lenders frequently provided mortgages for almost the entire value of a property. Compounding problems, some commercial lenders originated mortgages with monthly payments greater than the projected monthly income on the commercial properties. For example, commercial

mortgages originated in the first quarter of 2007 exceeded the estimated value of the underlying properties by 11 percent. Moreover, Moody's reported in 2007 that the vast majority of commercial mortgages allowed for interest-only payments and many included secondary financing.

69. Lehman promoted its acumen for managing the risks associated with MBSs, claiming that its vertically-integrated mortgage business minimized risks associated with holding mortgage-related assets on its balance sheet. In other words, Lehman told the market that it knew and could manage the risks of the mortgages it held because it had originated many of those mortgages.

70. Defendant Callan articulated this exact point with regard to RMBSs when explaining during an investor conference on February 6, 2008, that Lehman "didn't look at participating in the residential mortgage market as taking a directional bet one way or the other way." Comparing Lehman to other investment banks, defendant Callan stated:

> It doesn't come from Goldman's model of taking a proprietary bet, or Morgan Stanley's model, or even Merrill's model of warehousing a significant amount of product. It just comes from a basic focus and philosophy that we really didn't want to go long the product or short the product. **We wanted to originate to distribute and we hedged that origination capability.**

71. Lehman acquired two large residential nonprime mortgage originators in order to generate loans that, according to Lehman's website, would "serve as a direct source of 'raw product' to the Firm's securitization and trading platforms." In 2000, Lehman acquired BNC Mortgage LLC ("BNC"), a large subprime lender which Lehman initially helped take private, and which Lehman described as its "subprime origination platform." Until its closure in August 2007, BNC was heavily involved in the subprime industry, reportedly selling roughly 75 percent

of its production to Lehman. In 2007, as the market for nonprime loans deteriorated, Lehman purchased an even higher percentage of BNC's loans, until it closed BNC in August 2007.

72. In 2003, Lehman purchased another residential nonprime loan originator, Aurora Loan Services ("Aurora"), which specialized in lending and servicing Alt-A mortgage products. Eventually, nearly all of Aurora's production went to Lehman, as Aurora rapidly expanded and held an $80 billion mortgage portfolio, making it one of the largest loan originators and servicers in the U.S. Aurora bought mortgages from about 10,000 brokers and originators around the country. Upon purchasing loans from Aurora, Lehman packaged the mortgages into securities and marketed the RMBSs to investors.

73. Aurora's lending guidelines permitted loans for the full value of a property (*i.e.*, no down payment) to persons with low credit scores. Credit scoring is a mathematical model to assess an individual's credit worthiness based on their credit history and current payment. Credit scores range from 375 to 900 points. A score above 650 is considered good under average residential mortgage underwriting standards. A score below 650 suggests that the lender should evaluate the potential borrower to assess any credit risks before extending credit. Aurora also allowed mortgage payments up to half of a borrower's gross monthly income, leaving little room for other expenses or almost no margin of error for emergencies or disruptions in a borrower's income. Aurora's guidelines even allowed borrowers with credit scores as low as 620 to obtain multi-million dollar mortgages, including a one million dollar mortgage at 95 percent of a property's value without documentation, and up to $4 million for borrower's with credit scores as low as 600. Regarding no documentation loans, Aurora's guidelines simply indicated that the type of job must be one that "reasonably supports" the ability to repay the mortgage debt.

74. According to its 2007 Form 10-K, Lehman originated approximately $60 billion in residential mortgages during 2006 and $47 billion during 2007. Approximately 25 percent of the loans Lehman originated through its subsidiaries were subprime loans.

75. As a result of its many roles in all aspects of residential and commercial real estate finance, Lehman became one of leaders in underwriting MBSs. The Federal Reserve Bank of New York ranked Lehman eighth in volume of MBSs in 2006. In 2007, according its 2007 Form 10-K, Lehman securitized more than $100 billion in residential mortgages and $20 billion in commercial mortgages, making it the MBS leader in the world.

76. Fueled by its dominance in the MBS area, Lehman purportedly achieved record profits, earning net income of $3.260 billion in 2005, $4.007 billion in 2006, and $4.192 billion in 2007.

77. However, Lehman achieved these record profits by substantially increasing its risk exposure for real estate-related securities it held. The aggregate value of Lehman's mortgage and asset-backed securities totaled $57.7 billion at the end of 2006, and increased by a whopping 54 percent to over $89.1 billion by year-end 2007, almost four times its $22.5 billion in shareholder equity.

B. <u>Lehman Aggressively Invested Directly and Indirectly in High-Risk Commercial Properties</u>

78. Likewise, Lehman aggressively increased its commercial real estate investments. In 2005, it originated approximately $27 billion in commercial mortgages, with that number jumping to $34 billion in 2006 and an astonishing $60 billion in 2007. In addition to its MBS position of over $89.1 billion ($38.9 of which related to commercial whole loans and securities), Lehman also held directly real estate inventory valued at $21.9 billion at year end 2007. According to a Goldman Sachs analyst, as of March 2008, Lehman had more commercial

holdings than any other firm, including over $10 billion more than its nearest competitor, Citigroup, and more than double the holdings of Morgan Stanley, Bear Stearns and JPMorgan.

79. One of the largest CMBS issues undertaken by Lehman was a $1.5 billion single-asset issue called Windermere XII secured by Europe's biggest real estate office development, Coeur Defense, in Paris. Lehman and its partner, Atemi, paid Unibail and Goldman Sachs in early 2007 €2.1 billion for the complex, and then securitized over 70% of the investment. The CMBS issue drew little interest from securities buyers and Lehman retained much of the Windermere XII issuance on its books in 2007 and 2008. In addition, Lehman retained about 71% of the equity in the project.

80. Defendant Walsh headed Lehman's Global Real Estate Group. Defendant Walsh led Lehman into originating new loans for real estate developers, a business Lehman had never been in, to the point that Lehman developed a reputation for being one of the most aggressive lenders in the commercial space. Defendant Walsh pushed Lehman into riskier loans and also into making direct real estate investments. He would sometimes combine Lehman's exposure in a single deal through equity, mezzanine financing and senior secured debt. He was one of the earliest and most aggressive lenders of so-called bridge equity. Bridge equity involved short term loans of equity that helped deals close quickly with the intent that Lehman would replace its loan or equity position with new equity partners after the deal closed and Lehman collected its fees. His approach is said to have generated huge returns for Lehman in the boom times, however, there was a huge risk if the market turned and Lehman was unable to exit from its positions.

81. As head of Global Real Estate, defendant Walsh "had extraordinary authority to commit capital as he saw fit." Defendant Walsh did not have to go through Lehman's normal

risk management channels, enjoying a broad swath of authority to commit large amounts of capital to projects without being second guessed by senior Lehman executives. All of the different aspects of real estate reported to him. This reported concentration of power and authority in a single individual was dramatically different than other firms and also dangerous and risky, especially as the real estate market declined.

82. In 2006, Lehman invested a total of $2.3 billion in deals with SunCal Companies ("SunCal"), a southern California developer that suffered severely from the housing downturn. Part of that investment included Lehman's investing heavily in SunCal's McAllister Ranch development in Los Angeles, which according to press reports following Lehman's bankruptcy, already had cost Lehman $235 million by 2007, since SunCal has defaulted on much of the debt and the project had been halted for months on end, leaving three square miles of land fenced off and a golf course and buildings unfinished. According to press reports, Lehman held $1.6 billion of SunCal assets on its books at the end of the second quarter of 2008, and was projecting a return of 15% on these assets. These valuations were incorrect, as demonstrated by the fact that 18 of the 24 SunCal projects financed by Lehman have since filed for bankruptcy protection.

83. In 2007, Lehman continued to invest heavily in the commercial property sector. In May 2007, Lehman partnered with Tishman Speyer to enter an agreement to pay $22.2 billion for a leveraged buyout of Archstone-Smith ("Archstone"), one of the largest owners of apartment buildings in the country. Despite the fact that both residential and the commercial real estate markets were plummeting at the time, Walsh went forward with the deal in October 2007 rather than paying a break-up fee that amounted to a fraction of the purchase price. Specifically, Lehman contributed $250 million in equity and led a group of lenders providing $4.6 billion in

bridge equity. As of October 1, 2008, Lehman still held more than $2 billion in bridge equity in Archstone on its books that it was unable to sell.

84. Other projects in the New York area financed by Lehman included:

- 313-17 E. 46th Street, 18 story, 75 unit condominium project
- 45 Broad Street, Nobu Hotel and Residences, 65 story tower with 77 condominium units and 128 room hotel
- 520 W. 28th Street, known as Plus Arts Building, reportedly with $30 million in cost overruns
- 55 Bank Street, White Plains
- 1133 Westchester Avenue, White Plains.

85. Lehman also aggressively lent in Florida. Lehman financed close to $2 billion in South Florida real estate projects. The majority of the loans came after 2006 when the real estate market was in decline in Florida. On these loans made after 2006, Lehman exacted higher interest rates from the developers increasing the fees and profit potential for the loans but also increasing its loss exposure. Among the projects that Lehman financed in Florida are:

- Florida Hotels Holding, Inc., corporation created for Ian Shrager's investment in the Riande Hotel chain, $21.5 million
- Aventura Mall expansion, Aventura, Florida, $230 million
- Courvoisier Centre, $112 million
- Eden Roc Hotel, Miami Beach, Florida, $75 million
- Gables Marquis Condominium on Coral Way, Coral Gables, Florida, $46.8 million
- Key Biscayne Retail Center, Key Biscayne, Florida, $18.7 million
- KRA Tower, Coconut Grove, Florida, $36 million
- Admiral Port Apartments, Las Olas Boulevard, Fort Lauderdale, Florida, $52.5 million
- Canyon Ranch Resort, Collins Avenue, Miami Beach, Florida, $47 million
- Trump Condominium Tower, Hollywood, Florida, $226.5 million
- WSG Hollywood Development, Hollywood, Florida, $20 million
- EL-AD San Michele LLC, corporation undertaking condominium project, Weston, Florida, $293.2 million
- Acquiport Amsdell, warehouse development, Broward County, Florida, $45 million
- Courtyard by Marriott, Plantation, Florida, $120 million
- Tishman Speyer Archstone Smith Delray Beach LP, developer of Cameron Park, Delray Beach, Florida, $29.9 million
- MS LPC South Congress Holdings, LLC, developer of Terraces at Centre Delray, Delray Beach, Florida, $84.2 million

- 215 Brazilian Holding LLC, conversion of the Brazilian Court Hotel to condominium, $18 million
- T-Rex Corporate Center, Boca Raton, Florida, $100 million
- Alexan Club at metro West and Towne Place at Hunter's Creek, condominium conversion by Zohouri Florida Holdings LLC financed by Lehman
- Greenwich Place and Greenwich Oaks, Greenwich, Connecticut, condominium conversion by Antares.

86. Other projects financed or purchased by Lehman around the world included:

- Drapers Gardens, London, 300,000 square foot office complex, $344 million loan
- 90 Long Acre, London, equity
- Devonshire House, London, equity
- City Lofts in London, 25% owned by Lehman Brothers. Project put into receivership on July 1, 2008
- One Las Vegas, Las Vegas, Nevada, 542 residential units, $500 million
- Moonlight Basin Ranch Ski Development, Big Sky, Montana
- Prairie House and River Bend, Chicago Illinois
- Cap Cana Resort, Dominican Republic, $250 million
- Logwood Hotel Development Co., West Caicos, Turks and Caicos Island, 125 room hotel, marina and condominium project
- King Kalakaua Plaza, Waikiki, upscale retail project in foreclosure
- Kapalua Resort, Hawaii, $370 million
- Arlington, Virginia 10-building office complex, $1.3 billion
- Austin, Texas office complex, $1 billion
- Shadow Lake Shopping Center, Houston, Texas
- Acquisition of Landmark portfolio and 17 other Dutch properties acquired by Kenmore Property Group of Scotland, $300 million Euro
- Acquisition of $72 million Euro portfolio of Cattolica Assicusazioni by La Giana, 80% financed by Lehman
- 71 Robinson Road, Singapore, $164.3 million
- Joint venture with Prologis, national warehouse portfolio, $1.85 billion.
- Hyderabad, India, IT park project, $36 million
- Investment in Indian real estate company, DLF Assets Ltd., $200 million
- Mumbai, India one million square foot office project on Western Expressway, 50% owned by Lehman, $175 million
- Investment with Shore Capital Group in Central and Eastern European real estate fund, $50 million.

87. In 2008, prior to the bankruptcy petition, Lehman reportedly marked down commercial real estate investments by $3.6 billion, and sold about $7 billion of commercial mortgages and mortgage securities at losses up to 20%.

C. The Collapse of the Real Estate Market Had a Dramatic Impact on Lehman's Capital Positions, but Lehman Continued to Assure Investors of its Liquidity and Effective Risk Management

88. By 2007, the downturn in housing prices had spread to the commercial real estate market, and further worsened in the residential real estate market, wreaking havoc on the market value of the billions of dollars of whole mortgages and MBSs on Lehman's balance sheet, as well as the value of real estate held for sale.

89. The rising delinquencies and defaults in the MBS markets led the three main credit rating agencies – S&P, Moody's and Fitch – to downgrade some MBSs in 2007, reflecting the overall reduced value of the securities.

90. The systematic downgrades of MBSs by the credit rating agencies only exacerbated the implosion of the residential and commercial real estate markets, creating a frenzied cycle in which the declining value of MBSs led the rating agencies to downgrade even more MBS tranches.

91. In 2007, various hedge funds with significant exposure to MBSs and other sophisticated securities linked to the real estate market collapsed. On May 3, 2007, UBS announced that it was closing Dillon Read Capital Management, an in-house fund formed in 2005, after suffering huge losses investing in the U.S. mortgage securities industry.

92. More significantly, two hedge funds run by Bear Stearns Companies Inc. ("Bear Stearns"), which reportedly at one point held $20 billion in MBSs and other exotic securities linked to the subprime market, collapsed in July 2007.

93. The collapse of the two Bear Stearns hedge funds led to speculation that Lehman would announce it had greater exposure to subprime mortgages and that it would start recognizing losses on these assets. On July 18, 2007, in response to the rumors, Lehman

spokesperson Kerrie Cohan stated: "[t]he rumors regarding [Lehman's] subprime exposure are totally unfounded."

94. Lehman's mortgage originator, BNC, which had large subprime mortgage portfolios, experienced a dramatic increase in delinquencies in 2007. On August 17, 2007, Lehman closed BNC.

95. Given the increasing problems in the mortgage market at the end of 2006 and in 2007, Lehman's origination and securitization businesses declined substantially, decreasing from $36 billion in mortgage origination and nearly $43 billion in mortgage securitization in the second quarter of 2007, to $26 billion in mortgage origination and approximately $36.6 billion in securitization in the third quarter of 2007, to $17 billion in mortgage origination and a bit more than $15 billion in securitization in the last quarter of 2007. In the first quarter of 2008, Lehman originated $4 billion in mortgages and approximately $6.8 billion in securitizations. By the second quarter of 2008, Lehman originated only $2.5 billion worth of mortgages and securitized about $6.8 billion worth of mortgages.

96. Faced with a slowing securitization market, Lehman was forced to account for many of the securitization deals as secured transactions instead of sales. Normally, securitizers, such as Lehman, prefer to account for securitization deals as sales rather than secured financings, since secured financings do not allow for the removal of securitized assets from the balance sheet. This inability to remove the assets becomes important when these assets become non-performing or decrease in value. Starting in 2007, Lehman's inventory that did not qualify for sales treatment jumped from $5.5 billion at the end of 2006 to $12.8 billion at the end of 2007.

97. The delinquent and defaulting mortgage assets accumulating on Lehman's balance sheet in 2007 also had a negative impact on Lehman's liquidity and capital resources.

Because Lehman purchased many of its mortgage-related assets using secured credit obtained under tri-party agreements, Lehman faced significant liquidity problems once the value of its mortgage-related assets started to drop. As the market value of the pledged mortgage-related assets declined, secured lenders imposed "haircuts" – i.e. discounts – on Lehman, thereby forcing it to draw upon its own liquidity pool in order to execute transactions.

98. Accordingly, Lehman's reported cash capital surplus declined significantly between year-end 2006 and the second quarter of 2007, dropping from \$6 billion to \$2.5 billion. With the third quarter of 2007, Lehman's cash capital surplus appeared to stabilize – with \$7 billion at year end 2007 and \$8 billion in the first quarter of 2008. When Lehman executives made statements about its liquidity position in 2008, these statements were material to the market, since the implication was that the market values of Lehman's mortgage-related assets were being properly reported and having no negative impact on its liquidity position.

99. By January 2008, Lehman also halted Aurora's wholesale and correspondent lending. According to Lehman's January 17, 2008 press release:

> Lehman Brothers announced today that it will substantially reduce its resources and capacity in the U.S. residential mortgage origination space in light of the dislocation in the mortgage markets. As a result, the Firm is suspending its Wholesale and Correspondent lending activities at its Aurora Loan Services subsidiary. Aurora will continue to originate loans through its direct lending channel, and will maintain its servicing business.

100. On a September 17, 2007 conference call to discuss Lehman's quarterly results, defendant O'Meara said about mortgage market in general that "[b]arring any unforeseen circumstances, *we feel that the worst of this credit correction is behind us*. We have taken significant negative marks across all asset classes this period, and we have taken actions to resize our mortgage origination platform in-line with what we believe will be a smaller securitization market for the foreseeable future." (Emphasis added).

101. On December 1, 2007, defendant O'Meara stepped down as CFO to head the global risk management division and was succeeded by defendant Callan.

102. On December 13, 2007, Lehman issued a press release filed with the SEC on Form 8-K announcing its financial results for the fourth quarter and full year ending November 30, 2007 ("December 13, 2007 Form 8-K"), which reported fourth quarter net income of $886 million and full-year earnings of $4.2 billion.

103. On the December 13, 2007 earnings conference call, defendant O'Meara, the former CFO, spoke in his new role as Global Head of Risk Management on the record earnings of $4.2 billion:

> We attribute this performance to several factors. From the business standpoint, it reflects our growing footprints in Investment Banking, Equities, and Investment Management, as well as in Europe and Asia, which have reduced the proportional contribution of any one business or region. It also reflects our commitment to customer flow activities versus proprietary as a primary source of revenues, which has helped us mitigate the impact of difficult market environments, as institutional and high-net-worth investors remain active.
>
> More fundamentally, it reflects the strength of our risk management culture in terms of managing our overall risk appetite, seeking appropriate risk/reward dynamics and exercising diligence around risk mitigation. And lastly, it reinforces the importance of our disciplined liquidity and capital management framework, **which sets us up to operate our business through periods of market stress.**

104. Following Lehman's earnings announcement, Deutsche Bank Global Markets Research Mike Mayo maintained Deutsche Bank's "Buy" rating for Lehman's stock and issued a report stating: "Our sense is that Lehman is in position for market share gains given a more consistent culture, greater stability with risk management, and benefits from investment spending, especially non-U.S. (now half of the firm)." Mayo based his recommendation on information from his meeting with newly appointed CFO defendant Callan, stating: "Most importantly for the long-term, Lehman has a stable culture. As opposed to several of its peers,

Lehman needed no capital injection or dramatic downsizing (head count should remain flattish this year). The culture showed that risk management is effective, with business managers seeming more integrated than its peers." Additionally, "***Lehman's culture of risk management starts with the CEO…The bottom line is that the CEO seems involved in ensuring that potential upside justifies major risks that are taken***." (Emphasis added.)

105. On January 29, 2008, Lehman filed its 2007 Form 10-K with the SEC, which was signed by defendants Fuld, Callan, Ainslie, Akers, Berlind, Cruishank, Evans, Gent, Hernandez, Kaufman and Macomber, and contained management certifications of Lehman's financial statements and internal controls over financial reporting by the CEO and CFO, as well as those certifications required by SOX, also by defendants Fuld and Callan. In the 2007 Form 10-K, Lehman reported record net revenue for the 2007 fiscal year of $19.257 billion, record net income of $4.192, record net income applicable to common stock of $4.125 billion, earnings per share ("EPS") of $7.63 and diluted EPS of $7.26. The 2007 Form 10-K showed that Lehman had a total exposure of $32.179 billion to its residential mortgage holdings, including $14.235 billion in whole loans, $16.709 billion in RMBSs and $1.235 billion in mortgage servicing.

D. Lehman Raises Billions in Capital While Refusing to Recognize Losses on Real Estate-Related Holdings

106. In 2008, Lehman, although consistently boasting of its liquidity and discipline in risk management and proficiency in hedging its mortgage book, went on a capital-raising binge, issuing millions of shares in February, April and June 2008 that ultimately raised approximately $12 billion. Throughout the capital raisings, Lehman and its top executives maintained that Lehman's liquidity and financial position was solid, and that the additional capital it sought to raise would enhance Lehman's purportedly already strong capital base.

107. On May 30, 2006, Lehman had filed a Form S-3 shelf registration statement with the SEC, which included a prospectus governing the future issuance of debt securities, warrants, purchase contracts, preferred stock, depositary shares, common stock and units (the May 30, 2006 shelf registration statement and the prospectus contained therein are together referred to as the "Registration Statement"). Defendants Fuld, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez, Kaufman, and Macomber each signed the Registration Statement.

108. The Registration Statement allowed Lehman to make issuances when it desired, hence it is often referred to as a "shelf registration." The Registration Statement incorporated Lehman's Annual Report on Form 10-K for the fiscal year ended November 30, 2005 filed with the SEC and stated:

> [M]anagement's assessment of the effectiveness of internal control over financial reporting as of November 30, 2005 included therein, have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their reports thereon, included therein, and incorporated by reference therein. Such consolidated financial statements and management's assessment are, and audited consolidated financial statements and management's assessment of internal control over financial reporting to be included in subsequently filed documents will be incorporated herein in reliance upon the reports of Ernst & Young LLP pertaining to such consolidated financial statements and management's assessments to the extent covered by consents filed with the Securities and Exchange Commission, given on the authority of such firm as experts in accounting and auditing.

109. Each Offering under the Registration Statement allowed the supplemental prospectus issued to incorporate more recent filings of Lehman with the SEC.

110. While Lehman raised new capital, it actually bought back shares and increased its quarterly dividend in early 2008. Dividends were paid every quarter until bankruptcy, in an attempt to convince investors that Lehman remained financially solid.

111. Lehman personnel had frequent and direct communication with the Division. Lehman was the Division's number one domestic trading relationship by brokerage volume and

equity commissions. As Lehman sought to raise capital in 2008, it went to its most important client relationships to solicit purchases. On February 4, 2008, Chris Albanese ("Albanese"), Senior Vice President, Fixed Income Sales and Lehman's sales representative for the Division, sent Clark the preliminary prospectus for a public offering of preferred shares, Series J, consisting of 1.9 million shares of 7.95% Convertible Preferred Stock, issued at $1,000 per share. At the time, the Division declined to participate in the February offering.

112. On the public announcement of this $1.9 billion preferred offering by Lehman on February 4, 2008, Lehman shares closed at $63.82 per share.

113. Speaking at a February 6, 2008 Credit Suisse Financial Services Forum ("February 6 Credit Suisse Forum"), defendant Callan commented on the reception to the $1.9 billion preferred stock offering and its impact on the Company's balance sheet:

> [We are] so very happy with the market reception to our name and our brand. Diversifying investors going to retail investors on a particular transaction. And a great way to grow the balance sheet, which we continue to see opportunities for, without putting more leverage onto the balance sheet. So that's a key operating principle for us in 2007, is not to create more leverage, but if anything, to de-lever slightly in the environment.
>
> On the liquidity side, our liquidity pool at the Holding Company is larger than it ever has been, at $35 billion. We look at unencumbered assets about $63 billion that we could always finance against.

114. Defendant Callan also claimed that the February 4 preferred share offering which raised $1.9 billion was part of Lehman normal capital-raising plan, stressing that "[i]t has no connection to any write-down experiences or expected write-down experiences," and that it should take "**care of our full-year needs**."

115. At the conference, defendant Callan also touted Lehman's "discipline around liquidity, risk management, capital and expenses" including during the second half of 2007,

which partially stemmed from Lehman's "active hedging of the residential mortgage book, which [Lehman] started in fiscal 2006."

116. Defendant Callan also acknowledged that Lehman's mortgage inventory was "the thing everybody's interested in," reporting that, as of the end of the 2007, Lehman had $37 billion in residential mortgages and $39 billion in commercial mortgages in a total mortgage book of $90 billion. Regarding Lehman's residential mortgage portfolio, Callan stated:

> Residential. On the Residential side, when we look at the $37 billion of assets, so that's after the deduction of the FAS 140 gross-up, the composition of that portfolio is a combination of whole loans being roughly 44%, prime whole loans being roughly half of that portfolio; and Europe being almost a third of that portfolio. So, just give you some perspective on what's in that $16 billion [in mortgages]. We've talked a lot about subprime. We reported 5.3 at the end of the quarter. It's a little bit down from there – 39% in the form of retained interest and substantially all of those retained in securities rated single A or better. And the remaining component in whole loans. **So, feeling pretty good about that portfolio.**

117. Turning to Lehman's commercial mortgage portfolio, defendant Callan stated, in relevant part: "Again, I want to give you some information on Commercial that we have in the past. $39 billion of Commercial mortgage exposure, in which the vast majority comes in the form of whole loans and 30-odd percent comes in the form of securities, which are substantially in the category AA rated or better." Regarding the significance of the CMBX as an indicator of Lehman's commercial mortgage portfolio, defendant Callan noted that the "CMBX actually bears very little relationship to the whole portfolio as we mark it. And that's just because it's one data point, but there are lots of other data points, including sales in the market bid list and actual transactions to look at."

118. Addressing concerns raised by analysts at the February 6 Credit Suisse Forum about Lehman's increased classification of assets as Level 3 assets, defendant Callan asserted that there was a traceability of assets moving from Level 2 to Level 3:

> But the majority of the assets that have moved into Level III are assets moving out of Level II. And it's merely a function that won't surprise you. The liquidity environment we're in, the ability to have good data points and inputs on pricing. And so other than a pretty small amount, this has really come from, particularly in the mortgage asset class – and you see the numbers doubled there, which is the most significant amount, have come from the movement of certain mortgage asset classes into that arena.

119. As a result of defendant Callan's comments at the February 6 Credit Suisse Forum, the price of Lehman common stock increased $2.30, or 3.95 percent, from its closing price of $58.18 on February 6, 2008, to close at $60.48 per share on February 7, 2008.

120. Following comments made by defendant Callan at the February 6 Credit Suisse Forum, Credit Suisse analyst Susan Roth Katzke published a report stating that "**[m]anagement's comments ought to increase confidence that such outperformance can continue**" and that Lehman has "**differentiated itself**" in terms of risk management expertise in 2007. (Emphasis added). With respect to Lehman's mortgage portfolio, Katzke further noted that "[w]hile there's clearly risk of near-term mark-downs[for Lehman's mortgage portfolio,] [m]anagement is more confident that this portfolio will prove money good over the long term." Katzke then reiterated her Outperform rating for Lehman.

121. In this time frame, at Albanese's request, Clark met in February with Albanese and Ivan Gruhl, another Lehman Senior Vice President, for Pension Solutions. The Lehman executives asked if the Division would be interested in investing in Lehman as the Division had done with Merrill Lynch and Citigroup. Clark indicated the Division would be interested under the right circumstances in investing in Lehman.

122. During the second week of March 2008, Bear Stearns imploded. On Friday, March 14, 2008, shares of Bear Stearns opened at $54.24, by the next trading day, Monday, March 17, its shares had closed at $4.81. Over the weekend, JPMorgan agreed to purchase Bear

Stearns at the bargain-basement price of $2 per share, later raised to $10, after the Federal Reserve Bank agreed to guarantee $29 billion of Bear Stearns's troubled assets.

123. On speculation that other investment banks might also collapse, on March 14, Lehman shares closed at $39.26 dropping from their prior day's close of $45.99 per share. On March 17, Lehman shares closed at $31.75, a 19% drop and a 4 1/2 year low.

124. On March 18, 2008, Lehman issued a press release filed with the SEC on Form 8-K announcing its financial results for the quarter ended February 29, 2008 ("March 18 Form 8-K"), reporting net revenues of $3.5 billion and net income of $489 million. "Net revenues in the first quarter of fiscal 2008 reflect negative mark to market adjustments of $1.8 billion, net of gains on certain risk mitigation strategies and certain debt liabilities." In the March 18, 2008 press release, defendant Fuld was quoted as follows: "In what remains a challenging operating environment, our results reflect the value of our continued commitment to building a diversified platform **and our focus on managing risk and maintaining a strong capital and liquidity position**. This strategy has allowed us to support our clients through these difficult and volatile markets, while continuing to build and strengthen our global franchise for our shareholders." (Emphasis added.)

125. On March 18, 2008, Lehman, after issuing the press release, held a conference call to discuss the first quarter results. During the earnings conference call, defendant Callan, speaking on behalf of the Company, stated that Lehman's "continued diligence around risk management, which includes the active involvement of [its] senior management team" and "risk management discipline allowed [it] to avoid any single outsize loss" during the quarter. Defendant Callan further addressed the Company's liquidity position, emphasizing that **"[w]e had disciplined liquidity and capital management, which we consider to be a core**

competency, and maintained liquidity to date, and ***we've executed close to two-third of our full-year capital plan at the end of the first quarter.***" Accordingly, defendant Callan concluded her introductory remarks "by noting that we don't expect that this extremely challenging period is going to end in the near term. However, we do believe we have the leadership, the experience, the risk management discipline, the capital strength, and certainly the liquidity to ride out the cycle."

126. Defendant Callan further discussed the distinction between impairment and mark-to-market adjustments the Company recorded during the quarter, stating:

> We look at the mark to market adjustments as more temporary in nature, as they reflect mark to market accounting related to the pricing of similar transactions in a liquidity constrained environment that we're living in and driven by many technical factors, which may not reflect intrinsic value.
>
> And I'd like to contrast that with write-offs, which are more permanent in nature and refer to impairment. So I know there's been a lot of dialogue in recent weeks about the whole mark to market accounting mechanism, but I just wanted to highlight that this is under the mark to marketing accounting framework and not necessarily reflective of permanent impairment of the assets.
>
> * * *
>
> So let me speak a moment about the composition of the net 1.8 write-down. Residential mortgage related positions accounted for 800 million, net. The 800 million net relates to 3 billion gross. **So I think it's fair to say we continue to do a very, very good job managing the risk on residential mortgages, an area that I think we're credited with a lot of expertise, a great franchise.**

127. Regarding Lehman's exposure to residential mortgages, defendant Callan stated: "Prime and alt-A make up 14.6 billion versus 12.7 at year end. Again, reflecting a fair amount of assets sold and bought opportunistically, and also includes a meaningful component of servicing which we added during the quarter, ***which really does reflect a very natural hedge for the mortgage asset class.***" Moreover, "for residential securities it was a pretty different story for

this quarter than last. ***We began to see a lot more transparency in the alt-A sector late in the quarter, allowing us to mark positions based on observable prices, much less use of models.***"

128. As for Lehman's commercial mortgage portfolio, defendant Callan stated, in relevant part:

> Again, questions on how we value the commercial portfolio, we look at a number of data points including activity in loans with similar property types and similar regions because there's a very regional element to this. We look at recent securitizations, we look at loan syndications, CMBS spreads and the CMBX Index. And in fairness, as opposed to last quarter, we have seen similar spread experiences in recent securitizations as a CMBX, so what was a divergence in the last quarter has really converged to be pretty identical pricing as securitization and CBMX.
>
> Delinquencies in commercial mortgages continue to be very low at approximately 40 basis points. Our research expectations that they would not exceed 70 in a difficult environment but however, **I will note that our valuations reflect how the market is pricing these positions, not fundamentals of the asset class, regardless of our view on their intrinsic value.**

129. Defendant Callan also indicated that Lehman was net short in subprime RMBSs, and was buying Alt-A RMBSs at very good prices. Specifically, defendant Callan stated:

> The activity really in purchase and sales took place in resis. Close to 2 billion between sales and purchases in that asset class, and really in the Alt-A space. We saw great opportunity in what happened with Alt-A pricing around the Peloton fund, execution transactions around that situation. So we were excited to have the ability to have some dry powder there and go get off the sale of some other assets, other agency related product, in order to buy what we thought was Alt-A at a very good price. We are very well hedged, I mean it's always a little challenging how you look at it, we would consider ourselves at this point net short in the residential asset class.

130. Bank of America Securities analyst Michael Hecht questioned defendant Callan about the Lehman's Level 3 assets, to which defendant Callan responded explaining the shifts from Level 2 to Level 3: "Yes, we did have some shifts across the buckets at the end of the quarter....[A]t the end of year, we were about 38.8 [billion] in total Level 3 assets. In terms of what happened in Level 3 asset changes this quarter, we had net payment, purchases, or sales of

1.8 billion, the net transfer in of 1.1 billion, so it's stuff that was really moved in or re-characterized from level 2. And then there was about 875 million of write-downs and that gives a balance of 38.682 as of February 29."

131. Lastly, defendant Callan expressly reiterated the comments she made after Lehman's $1.9 billion preferred stock issuance in early February, indicating that Lehman "***took care of [its] full year needs when it raised $1.9 billion through its offering of preferred stock in February.***"

132. The investment community clearly responded favorably to Lehman's first quarter results and defendant Callan's explanations. By the end of the day, March 18, Lehman rebounded over 46% to close at $46.49 per share.

133. An interview of defendant Callan conducted on March 18, 2008 by Maria Bartiromo of CNBC appeared in *Business Week* on March 31, 2008. Asked whether Lehman would follow Bear Stearns into a fire-sale, defendant Callan said "Categorically, no." Defendant Callan made the case that Bear Stearns had collapsed due to a liquidity situation unique to that company:

> MB: I have a hard time understanding how things could change so fast and furiously for Bear. Can you business really reverse course like that in a 48-hour period, or was that perhaps a situation unique to Bear?
>
> EC: I think that will be the lingering question about our industry and our business model—and it should be. Liquidity is the thing that will kill you in a moment. It won't necessarily be writedowns. We obviously saw huge writedowns taken by other members of Bear's peer group, and they raised capital and came back for another day. So I think there were a number of factors related to how Bear managed its liquidity **that were specific to that organization.**

(Emphasis added.)

134. As reported by *Business* Week, defendant Callan reiterated that Lehman had $38 billion in Level 3 assets. Defendant Callan also discussed the impact of the opening by the Federal Reserve of its credit facility to investment banks:

> MB: So does the Fed opening the window, do you think that prevents a Bear Stearns type of run that so many people talk about? And of course, when your colleagues go down in the business, your name always comes up.
>
> EC: **Yeah, I think it certainly takes the question of liquidity off the table.** I think that's the great news about what happened. I think what's the bad news is there's a real question about what's the optimal way to run this business model, and I think that's what people will grapple with over the next several months.

(Emphasis added.)

135. On March 30 or 31, 2008, Clark learned from Albanese that Lehman was issuing another convertible preferred offering. On March 31, 2008, Albanese sent Clark the preliminary prospectus for a public offering, consisting of 3 million shares of 7.25% Non-Cumulative Perpetual Convertible Preferred Stock Series P issued at $1000 per share, soliciting investment by the Division.

136. After declaring in February that it would not raise capital for the rest of the year, Lehman announced on March 31, 2008 that the issuance of the Series P Preferred Stock was in response to "investor interest" and to "bolster the Firm's capital and increase flexibility." Defendant Callan stated that "[g]iven the challenging environment and our previously stated view that it will likely continue the balance of the year, issuing convertible preferred is appropriate as it optimizes our funding and accelerates our plan to reduce leverage, and at the same time minimizes dilution to our shareholders...We also felt that this was the right time as there was a window of opportunity in the market, as we have received significant interest from several key institutional investors, who have been strong supporters of the Firm over time."

137. On March 31, 2008, Clark sent Albanese an e-mail indicating he would talk to him about the Series P Preferred Stock Offering. He was told by Albanese the following day that the deal had been priced and had closed the night before.

138. In fact, in the interim, Lehman had changed the terms from the preliminary prospectus and increased the size of the Series P Offering from $3 billion to $4 billion. On April 1, 2008, defendant Callan was quoted as commenting on the increase in the size of the Offering as follows: "[t]he significant oversubscription for this deal demonstrates the confidence that investors have in Lehman Brothers. **The success of the transaction is also reflective of the strength of the business model, the capital base and liquidity profile of the Firm as we continue to successfully weather challenging environments**." (Emphasis added.) Upon this disclosure, Lehman's stock rose 18 percent, increasing by $6.70 to $44.34 per share.

139. Clark and other members of the Division were invited by Lehman to participate in a conference call with defendant Callan on April 1, 2008. Defendant Callan reiterated her public comments of the oversubscription for the deal and stated that out of the $4 billion Offering, $3 billion was purchased by four large shareholders of Lehman. Defendant Callan also said that the CEO of General Electric Company, Jeffrey Immelt, had personally contacted defendant Fuld to participate in the Offering. She further indicated that the remaining $1 billion was distributed to various market participants.

140. Lehman executives solicited Plaintiff directly to participate in the April offering and arranged for Plaintiff to obtain 2000 shares of the 7.25% Non-Cumulative Perpetual Convertible Preferred Stock Series P Offering on April 1, 2008 at a cost of $2 million. The Offering was pursuant to a prospectus supplement dated April 1, 2008 ("April 1 Prospectus Supplement"), with LBI as the underwriter. The April 1 Prospectus Supplement incorporated by

reference Lehman's 2007 Form 10-K and a series of current reports on Form 8-K filed with the SEC and dated between December 13, 2007 and April 1, 2008, including the March 18 Form 8-K.

141. On April 8, 2008, Lehman filed its First Quarter 2008 Form 10-Q, which was signed by defendant Callan, and included management's certifications of the Company's interim financial statements and internal controls over financial reporting, as well as those certifications required pursuant to SOX, which were signed by defendants Fuld and Callan. The First Quarter 2008 Form 10-Q also contained statements concerning the Company's risk management and management's evaluation and the effectiveness of the Company's internal disclosure controls.

142. The First Quarter 2008 Form 10-Q contained a review opinion on the Company's interim financial statements. Defendant E&Y noted that it had conducted a review of the consolidated financial statements for the quarter and stated "**we are not aware of any material modifications that should be made**." (Emphasis added).

143. In the First Quarter 2008 Form 10-Q, the Company reported net revenues of $3.507 billion, net income of $489 million, net income applicable to common stock of $465 million, EPS of $0.84 and diluted EPS of $0.81. Lehman also disclosed total assets of $786.035 billion and financial instruments and inventory positions owned of $326.658 billion. Of the $326.658 billion in financial instruments and inventory positions owned, Lehman disclosed that $84.609 billion related to mortgages and asset-backed positions.

144. In the First Quarter 2008 Form 10-Q, Lehman reported a breakdown of its subprime and Alt-A/prime mortgage-related positions. Specifically, Lehman reported a $4.017 billion exposure to the subprime market, consisting of $1.295 billion in residential subprime whole loans, $2.692 billion in retained interests in subprime-backed securitizations, and $30

million in other subprime exposure. Regarding its exposure to non-subprime loans, Lehman reported Alt-A/prime mortgage holdings of $14.6 billion, including $3.7 billion in whole loans, $9.2 billion in retained interests in Alt-A/prime-backed securitizations and $1.7 billion in other subprime exposure. Its subprime exposure had decreased to $4.017 billion from $5.276 billion as of November 30, 2007 while its Alt-A/prime holdings had increased to $14.6 billion from $12.7 billion as of November 30, 2007.

145. The Company also reported making value adjustments of negative gross $4.7 billion and negative net $1.8 billion to its real estate and mortgage-related positions. Specifically, the Company made value adjustments of negative gross $3.0 billion and negative net $0.8 billion to its residential mortgage-related positions and negative gross $1.1 billion and negative net $.7 billion to its commercial mortgage-related positions.

146. On April 15, 2008, speaking at the Lehman annual shareholder meeting, defendant Fuld told investors that the "**worst of the credit crisis is behind us**," but that the environment "will remain challenging."

147. In early June 2008, Lehman common stock was trading in the mid to low thirties, having fallen from the mid forties in May. Lehman sought to do another capital raise. On June 5, 2008, Lehman executives asked that the Division sign a confidentiality agreement and refrain from trading for a few days until the confidential information it wished to impart related to the Offering and its earnings was disclosed by Lehman publicly. The Division agreed to do so, and received confidential information as to the Offering and Lehman's second quarter earnings that would be subsequently released to the market on June 9, 2008. Lehman executives offered to let Clark and other members of the Division speak with defendant Callan. Clark was told by Lehman executives that Lehman was looking to raise $5 billion in a common share

issuance with no preferred component. On June 5, 2008, a conference call was held between defendant Callan and other Lehman executives and several individuals from the Division.

148. The rationale for the Offering imparted by Lehman executives on the call was that "we don't need to do this offering, but we're getting beaten up with the press over Lehman's liquidity position and want to shore up capital to take the issue off the table." According to defendant Callan, Lehman had evaluated the issue of shareholder dilution, but felt that "taking the insolvency issue off the table" warranted the issuance of the new common stock. Defendant Callan indicated that the second quarter numbers were still moving and that the numbers could be off one or two percent on the announcement, but decisions had been made to announce to the Street basically the numbers Lehman disclosed to the Division during the call: Lehman was going to report an unexpectedly large loss of $2.8 billion whereas the Street was only expecting a $500 million loss. Defendant Callan stated that Lehman had chosen to aggressively write-down assets to convey management's confidence in the transparency of its balance sheet.

149. When asked by Clark: "How do you know that the market values are fair and reflective of the true market?," defendant Callan replied that Lehman has prudent risk management practices and individual processes to value Lehman's assets, and that the sales of similar assets were comparable to where they were marked. Defendant Callan also said that if Lehman's rating was downgraded, Lehman would be exposed, at most, to a requirement to post an additional $500 million in collateral. The theme conveyed by defendant Callan to the Division was that Lehman was de-leveraging and de-risking Lehman's balance sheet as a way to reduce Lehman's risk profile. A list of statistics was provided to the Division's representatives on the call as to the reductions made in the quarter in the overall size of Lehman's balance sheet as follows:

Commercial – took down from $36 billion to $25 billion
Residential – took down from $31 billion to $25 billion
High yield - took down from $17.7 billion to $11.7 billion
Contingent leverage - buyout paper down to $0.5 billion
High yield inventory - took down from $31 billion to $23 billion
Overall balance sheet - took down from $790 to $655 billion
Net balance sheet - down from $395 to $330 billion
Leverage ratio gross balance sheet 24x, net balance sheet 12.1x.

150. Defendant Callan also noted affirmatively that Lehman had been successful in liquidating some of Lehman's Archstone bridge loan position, and had exited all parts of the mortgage origination business.

151. Defendant Callan also affirmed that Lehman's liquidity pool had increased to $45 billion, up from $34 billion in the first quarter of 2008. Defendant Callan also said the Company had "tested" the Federal Reserve discount window seven times, but would not be tapping it in the future. The Company was also engaging in discussions with sovereign funds to invest. This call lasted approximately one hour.

152. On Friday morning, June 6, 2008, after the June 5 evening call Clark and others had with Callan, the Division was told by Matthew Johnson ("Johnson") of Lehman that Lehman was adding a preferred offering component because of the strong demand by investors. Lehman was asking investors though to put in an order both for common and preferred. Requests would then be granted on a pro rata basis. The intimation was: "If you only asked for preferred, you would not get as much preferred as you requested," preference would be given to investors who placed orders for both the common and preferred shares.

153. The Division had a final call with Johnson on the same day at approximately 5:00 p.m.. Clark asked Johnson how the order book was going on the deal, and Johnson told him that it is "well over-subscribed," indicating that investor demand for the deal was strong.

154. As set forth, Lehman executives solicited Plaintiff directly to participate in the Offerings of common stock at $28 per share and preferred shares, Series Q, consisting of 2 million shares of 8.75% Non-Cumulative Mandatory Convertible Preferred Stock, issued at $1,000 per share. The total common stock Offering was $4 billion. The total preferred share Offering was $2 billion with $60 million paid to the Company's broker/dealer subsidiary, LBI, as an underwriting discount. Both types of shares were offered pursuant to a prospectus supplement dated June 9, 2008 ("June 9 Prospectus Supplement"), and were delivered by LBI on June 12, 2008.

155. The June 9 Prospectus Supplement also incorporated the quarterly report on First Quarter 2008 Form 10-Q and a series of current SEC Reports on Form 8-K dated between December 13, 2007 and June 9, 2008.

156. On June 9, 2008, Lehman reported its preliminary 2008 second quarter results in a press release filed with the SEC on a Form 8-K ("June 9, 2008 Earnings Results Form 8-K"), reporting that it expected net loss of $2.8 billion, or $5.14 per share, on negative net revenues of $0.7 billion, compared with $5.5 billion in net revenues for the second quarter of 2007. Lehman also reported that for the first half of 2008 it expected to report a net loss of approximately $2.3 billion, or $4.33 per diluted common share. Lehman further announced a gross write-down of $2.4 billion in its residential mortgage-related holdings and $1.0 billion in its commercial-related holdings, which, in actually, totaled $1.3 billion due to commercial "hedges" that had increased Lehman's loss by $400 million.

157. That day, Lehman also announced that it had closed on the $4.0 billion public offering of 143 million shares of common stock at $28.00 per share and the $2.0 billion offering

of the 8.75% Non-Cumulative Mandatory Convertible Preferred Stock, Series Q ("June 9, 2008 Offerings Form 8-K").

158. On the conference call held in conjunction with the press releases on earnings and the Offerings on June 9, defendant Callan confidently proclaimed, despite Lehman's lackluster results and increasingly high net gross leverage, that "***[w]e do not intend to lower our leverage ratios…To be clear, we do not expect to use proceeds of this equity raise to further decrease leverage, but rather to take advantage of future market opportunities…we stand extremely well capitalized to take advantage of these new opportunities.***"

159. Defendant Callan specifically addressed markdowns in Lehman's exposure to Archstone and SunCal as follows:

> I would like to stop for a moment and comment on the many questions we have received about two investments; Archstone is the first. Archstone is a company which owns a very diversified portfolio of high quality apartment assets, the underlying fundamentals of which continued to improve. For example, it had first quarter '08 same-store revenue growth of 5%. Notwithstanding that performance in recognition of the change in real estate market valuation metrics we have taken a significant mark on that position. The current mark reflects a projected mid-teens internal rate of return on net capital. As a matter of Lehman policy and consistent with industry practice, we do not disclose specific marks. Similarly our SunCal exposure, which resides in both our fixed income and third-party managed funds area represents approximately 1.6 billion of unlevered direct Lehman exposure. The exposure has been marked to reflect an approximate 15% unleveraged internal rate of return. That mark takes into account recent similar large transactions that have occurred in relevant markets. For example, of the total exposure, approximately 250 million is in the Inland Empire with an adjusted basis of approximately 20,000 per lot.

160. In discussing other mark-to-market adjustments taken by Lehman for the quarter, defendant Callan defended Lehman's accounting practices and again touted its hedging of risk, stating: "It has been suggested we have not been sufficiently aggressive in marking our inventory. ***In fact, I believe our successful hedging performance over the past year has muted the magnitude of our gross markdowns***." Defendant Callan emphasized the proactiveness of

Lehman's write-downs and the positive impact of its hedging: "To give you the cumulative size of gross losses we have taken on these asset classes since the beginning of fiscal 07, most of which occurred in the past 12 months, in residential mortgages and other asset backed securities we have taken over $11 billion of aggregate write-downs. In commercial mortgages and real estate held for sale we have taken approximately $3.5 billion of gross write-downs. In acquisition finance we have written down almost $2 billion of assets." Accordingly, "[i]n total we have taken approximately $17 billion in gross mark to market adjustments since the beginning of last year, offset by hedging benefits of approximately $7.5 billion."

161. Analysts also asked defendant Callan a series of questions relating to the sales in the asset classes and write-downs. For example, Merrill Lynch's Guy Moszkowski asked: "Can you respond maybe to critics who are going to say that the $130 billion of asset sales must be the absolute easiest assets to sell? Can you give us some flavor for some of the more difficult asset class reductions; and whether they are in line with those overall percentages; and the extent to which you might have therefore bitten the bullet with some of those more difficult asset classes and then reflected those prices across the remainder of the book?" In response, defendant Callan noted that "in terms of the residential book and what we sold there, the vast majority of what we sold was in the form of whole loans, not the securities portion," while "the story on the commercial side is very similar," as "[v]irtually everything that we sold on the commercial side was in the whole loan category."

162. Deutsche Bank analyst Mike Mayo asked the same question that Clark had raised with defendant Callan, "[h]ow do we know that you have taken enough write-downs in your real estate book?" Defendant Callan replied confidently: "I think in terms of the confidence level on write-downs, you know it is the following two points. One is that the aggregate number is very

large that we have taken since Q3 predictably last year. So that gives me confidence in the actual accumulated loss across those portfolios, resi[dential] and commercial." Additionally, "I think you [know that] the other piece though that is very, very important is we were probably the most active seller of assets in the market this quarter across all these asset classes. As I talked about earlier we weren't selling AAAs. We were selling the entire capital structure and we were selling risk assets." Thus Callan concluded, "I think unquestionably our price visibility we got from these transactions was tremendous. So much more activity for us certainly than we did last quarter. So I think the confidence level about the remaining inventory can only be higher than it was given all that sales activity, the visibility, the number of clients we dealt with, and the resultant impact of our remaining inventory."

163. Defendant Callan further tried to allay any misgivings about Lehman's liquidity and its ability to repay counterparties on credit default swaps and lenders in general, asserting: "I don't think there is any question on the part of any of our counterparties or lenders that they will be repaid by Lehman Brothers. I think there is a good debate that's being had about the investment banking sector, its return profile as we move forward in a lower leveraged environment. ***But we are not having any conversation with counterparties or lenders about whether they feel confident extending funds and credit to us***." (Emphasis added).

164. Following defendant Callan's comments on the conference call and the announcement of the common share Offering at $28 per share, the price of Lehman shares fell $2.81, or 8.7 percent, from its closing price of $32.29 on June 6, 2008, to close at $29.48 on June 9, 2008, on heavy trading volume of 168 million shares.

E. Lehman Collapses and Files for Bankruptcy

165. Following the June 9 close, Lehman's stock price continued to drop, and never again recovered above the June 9, 2008 close of $29.48.

166. Lehman's alleged attempt at transparency regarding its real estate-related holdings was questioned. As *Bloomberg News* reported on June 10, 2008, David Einhorn ("Einhorn"), president and co-founder of hedge fund Greenlight Capital, Inc., questioned the smallness of the write-downs, stating:

> There are signs already from the press release that the company has more to go, particularly in the commercial mortgage backed securities areas, where they only wrote down $700 million gross. It's unclear to me why the writedown would be so small.
>
> The burden is on them [Lehman] to be much more forthcoming and transparent in their disclosures and discussion and analysis of their high-risk assets.
>
> This confirms a lot of things we've been saying. The credit market did not really deteriorate between February and May. Most of these losses are losses that were probably evident quarters ago.

167. On June 12, 2008, Lehman issued a press release that CFO Callan and COO Gregory would be stepping down and replaced by Lowitt as CFO and McDade as COO.

168. A week later on June 16, 2008, after filing its results for the second quarter, Lehman held another conference call. Defendant Fuld stated: "I am the one who ultimately signs off and am comfortable with our valuations at the end of the second quarter." In particular, defendant Fuld explained:

> Years ago we made a decision to build out the best-in-class commercial and residential mortgage origination and distribution platforms. We created significant revenues and net income over those years that funded many of the Firm's investments that have diversified our core franchise today. We made active decisions to deploy our capital. **Some of which in hindsight were poor choices, because we really did not react quickly enough to the eroding environment.** For example, we accumulated positions in leveraged loans that we believed we could syndicate and clearly not all of those got sold. Together, the

> accumulation of all these positions ultimately led to our decision this past quarter to aggressively delever.

(Emphasis added). But most importantly, he reassured investors: **"our capital and liquidity positions have never been stronger."**

169. The newly appointed CFO, defendant Lowitt, reiterated the point on the June 16 call: "In conclusion I reviewed with you the strength we continue to see in our client franchise and **our strong capital and liquid position**."

170. On July 10, 2008, Lehman filed its Second Quarter 2008 Form 10-Q signed by Lowitt which showed that its Level 3 assets fell in the second quarter of 2008 to $41.3 billion from $42 billion at year end 2007 – a mere .7 billion – and total assets dropped by 8%. Lehman shares closed at $14.43 per share, a 16.6% drop from the prior trading day close of $17.30 per share.

171. Throughout the Summer, rumors swirled that Lehman was attempting to sell itself, get investments from sovereign funds, spinoff its real estate portfolio and sell its IMD.

172. On July 15, 2008, the *New York Post* reported that defendant Fuld was considering ways to take Lehman private. Lehman closed at $12.99.

173. On July 18, 2008, Moodys cut its ratings on Lehman to reflect its expectations of more mark to market losses on Lehman's residential and commercial mortgage portfolios. Noting Lehman's proactive efforts at bolstering capital and de-leveraging its balance sheet, Moody's said "Despite these notable risk reductions, Lehman's mortgage exposures and concentrations remain high and have weighed heavily on the firm's operating results and market confidence."

174. On July 25, 2008, CNBC reported that Lehman was considering a sale of at least part of its IMD.

175. On August 10, 2008, *The New York Times* reported Lehman was preparing to cut 1,500 jobs.

176. On August 22, 2008, Reuters reported that state-owned KDB spokesman told it: "We are studying a number of options and are open to all possibilities, which include (buying) Lehman." Lehman closed at $14.41 per share that day.

177. On September 2, reports indicated KDB was considering buying a 25% stake.

178. On September 6, 2008, Lehman announced Jeremy Isaacs ("Isaacs"), London-based Head of European and Asian Operations, was leaving the Company. In recent years, the European and Asian Operations had become a major contributor to Lehman's revenues – contributing nearly half.

179. On September 9, 2008, KDB announced it had ended talks with Lehman. Lehman's shares fell by 30% to $7.79 per share from a prior day close of $14.15.

180. On September 10, 2008, Lehman held an earnings guidance call on short notice, a week prior to its scheduled call. Lehman reported a $3.9 billion loss, as well as another $7.8 billion in gross write-downs including $7 billion on its residential and commercial real estate holdings. On the call, defendant Fuld stated that the "decisions announced today will best protect the core client franchise, and create a very clean, liquid balance sheet." The plans presented included exiting commercial real estate and spinning off the unit, reducing residential and leveraged loan exposures, and raising capital by selling an equity stake in Lehman's IMD. On the call, defendant Lowitt seconded defendant Fuld's positive outlook, asserting: "I'll now provide an update on our liquidity position which **remains very strong**. We have maintained our strong liquidity and capital profiles even in this difficult environments and the potential sale of IMD further improves our capital position." Defendant Lowitt noted further: "Even under the

scenario of limited debt issuing capacity in 2009 we anticipate the core Lehman will have ample cash capital to sustain its business opportunities."

181. On the conference call, Mike Mayo, a Deutsche Bank AG bank analyst, asked whether Lehman would need to raise $4 billion to inject more capital in the Company, prompting defendant Lowitt to respond: "We don't feel that we need to raise that extra amount," since "[o]our capital position at the moment is strong." Regarding the $7 billion write-downs in residential and commercial mortgages, defendant Lowitt admitted that "[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 and did not affect the performance of our hedges. **Unfortunately, there is no correct hedge for Alt-A assets as there is in subprime with ABX.**"

182. On the September 10 conference call, defendant Lowitt, the CFO, said the firm's recent sales of real estate assets had been "**in and around our marks.**"

183. Following the conference call on September 10, 2008, Lehman executives worked feverishly to sell the bank or at least parts of its commercial holdings to various banks, including Goldman Sachs, Credit Suisse, Barclays, and Bank of America, all of whom ultimately spurned Lehman's overtures. In conjunction with management's attempts to sell Lehman, various Wall Street executives reviewed Lehman's troubled real estate portfolio. As reported in *The Wall Street Journal* on October 6, 2008, the executives almost universally concluded that Lehman's $32.6 billion in commercial real estate holdings were overvalued by as much as 35 percent. Media reports also indicated that defendant Walsh faced hostile questions regarding Lehman's valuations of its commercial assets.

184. On Friday, September 11, 2008, Lehman shares closed at $3.03.

185. On September 13, Federal Reserve officials met with Wall Street executives and the SEC to discuss the future of Lehman.

186. On September 14, Lehman's talks with Bank of America and Barclays collapsed after the Federal Reserve said it would not guarantee Lehman's liabilities.

187. Federal Reserve Chairman Ben Bernanke, who testified before Congress on October 15, 2008, stated that the government could not lend money to Lehman – and thereby prevent its bankruptcy – because the Company lacked sufficient collateral. Likewise, Treasury Secretary Henry Paulson ("Paulson") corroborated Chairman Bernanke's evaluation, asserting in an interview with *The New York Times* on October 23, 2008, that the **value of Lehman's assets created "a huge hole" on its balance sheet**. (Emphasis added.)

188. Unable to sell itself or even part of itself to another bank, on September 15, 2008, Lehman filed for bankruptcy protection in the Southern District of New York. The filing specifically did not include the Lehman broker-dealer subsidiary, LBI. On Friday, September 19, 2008, LBI was forced into dissolution by SIPC, also in the Southern District of New York.

189. On September 16, 2008, Barclays agreed to buy the bulk of Lehman's North American assets for $1.54 billion. Of the portfolio of assets that Barclays acquired from Lehman, less than 5% were regarded as real estate-related. Barclays also bought Lehman's global headquarters at 745 Seventh Avenue in New York and two data centers in New Jersey for $1.5 billion.

190. Following the bankruptcy of Lehman, government prosecutors have subpoenaed Lehman executives including defendants Fuld and Callan. Lehman is reportedly the subject of at least three federal criminal investigations. The U.S. Attorney's Office in Manhattan is reportedly

investigating whether Lehman executives marked the firm's commercial real estate properties accurately on its balance sheet. One subpoena has gone to defendant Walsh. The U.S. Attorney's Office in Brooklyn is reportedly investigating Lehman's sale of auction rate securities, as well as the conference call held by management on September 10, five days before the bankruptcy filing. Defendant Lowitt has received a subpoena. The U.S. Attorney's Office in New Jersey is believed to be investigating disclosures surrounding the sale of securities by Lehman in June 2008, including specifically to, among others, Plaintiff which statements and omissions are the subject of this litigation.

191. The FBI is reportedly investigating whether Lehman pressured rating agencies to award top ratings to securities it issued in return for higher fees or the promise of more work. The FBI investigation is also understood to be looking at whether senior executives intentionally misled investors about Lehman's health.

F. Accounting and Auditing Responsibilities of Both Lehman Defendants and Ernst & Young

1. The Lehman Defendants' Violations of GAAP

192. Neither Lehman, nor LBI, nor the Defendants, conducted a reasonable investigation of the financial statements contained in the April 1 and June 9 Prospectus Supplements to the Registration Statement or the documents incorporated therein, and did not possess reasonable grounds for believing that the statements in those documents were true and not misleading.

193. The Officer Defendants, by virtue of their executive positions with the Company, each had key roles in controlling the Company's management, and each were involved in its day-to-day operations, including its financial reporting and accounting functions. All held top management positions within the Company and thereby controlled the Company individually

and collectively, and were actively involved in convincing Plaintiff to invest directly in the Company.

194. The Officer Defendants and defendant Walsh were responsible for the valuation of Lehman's real estate portfolio on its balance sheet and the Officer Defendants should have investigated and insisted that such valuations were done properly. The Lehman Defendants recognized that the subprime crisis was spreading in late 2007 and 2008 to other types of mortgages – Alt-A and commercial real estate mortgages and commercial real estate directly, but failed to recognize impairments in its real estate-related assets or to appropriately mark to market such assets in accordance with GAAP. The Lehman Defendants also improperly failed to recognize that such exposure was not directly hedgeable. As defendant Lowitt later admitted in September 2008, the Alt-A mortgages were not hedgeable.

195. As its peers were continuing to take write-downs in 2008, Lehman only decreased its real estate portfolio by a little over 2.5% in the first quarter of 2008, from $110 billion to $107.2 billion.

196. During the Summer of 2008, the Officer Defendants and defendant Walsh worked hard to package Lehman's $32 billion commercial real estate portfolio into a spinoff entity. Investors did not bite, because the actual value of the commercial real estate portfolio was overstated.

197. The supposed valuation of the commercial real estate portfolio at $32 billion drew other Wall Street firms to ask exceedingly hostile questions of defendant Walsh in Lehman's final days in September 2008.

198. Some former Lehman employees and observers have laid the blame for Lehman's demise at defendant Walsh's feet, including, most recently, defendant Callan, who told *Fortune*

magazine on October 13, 2008 that "the commercial real estate portfolio really was the albatross of the firm." Critics in the real estate industry have criticized defendant Walsh, and his boss, defendant Fuld, for what they describe as a concentration of too much power, too much autonomy, and too much risk-taking in too few hands. As to defendant Walsh: "He's very calculating and political and was able to ingratiate himself with Dick Fuld and had incredible autonomy and was able to do things in the firm that no one else was able to do," said a former Lehman employee. "There were reportedly capital committees and processes under way that everyone else had to go through, and defendant Walsh didn't have to go through them." Defendant Walsh pushed through the Archstone deal with little oversight. Indeed, up until mid-2007, defendant Walsh shared responsibility for Lehman's commercial real estate operations with longtime Lehman executives like Ray Mikulich, Michael Mazzei and Robert Lieber who were more experienced with real estate downturns. Once they left, former Lehman employees say the risk-taking and bad bets increased, that defendant Walsh consulted fewer about his decisions, and held his cards even closer to his chest. The firm, according to one developer, became known as the lender of last resort, willing to loan money to just about anyone at increased interest rates. Others active in commercial real estate lending criticized defendant Walsh for forgetting that real estate, unlike fuel and wheat, is not a simple commodity. "[Lehman real estate lenders] were totally spreadsheet-oriented, analysis-oriented, with no understanding of the industry," said a top commercial real estate mortgage broker about Lehman. "They were buying buildings they never even visited," and basing loans on returns that were not sustainable in a changing real estate market.

199. Lehman Defendants failed to recognize and timely communicate to investors the financially precarious nature of its commercial real estate holdings, such as its stake in

Archstone, its $2 billion investment in deals with SunCal, its partnering with others to invest in billion-dollar office complexes in Arlington, Virginia and Austin, Texas, its investments in, and financing of, projects in Florida, in excess of $2 billion and multiple projects around the world. By the end of fiscal 2007, Lehman had more than $38.9 billion in commercial whole loans and securities on its book and real estate held for sale of $21.9 billion.

200. As described previously, in the 2007 Form 10-K, Lehman revealed significant exposure to the mortgage markets, reporting holdings of $89.106 billion in mortgage and asset-backed securities, including $37.44 billion in residential and asset-backed securities and $38.938 billion in commercial real estate holdings. Lehman also reported a $5.276 billion exposure to subprime residential mortgages, $3.226 billion related to whole loans, $1.995 billion related to retained interests in securitizations and $55 million to other subprime exposure.

201. The 2007 Form 10-K showed an increased categorization of certain mortgage-related securities as Level 3 assets from the prior year. Over 28 percent of Lehman's mortgage-related securities were categorized as Level 3. In general, under the Generally Accepted Accounting Principles ("GAAP"), Fair Value Measurements 157 ("FAS 157"), assets are assessed at three different levels, Levels 1, 2 and 3. The value of Level 1 assets is readily ascertainable, meaning that their "inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date." The value of Level 2 assets is mostly ascertainable, meaning that their "inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly." Finally, the value of Level 3 assets is difficult to obtain, since these assets do not rely on observable inputs – i.e. inputs from sources independent of the reporting entity – but unobservable inputs, which are the reporting entity's own assumptions about the

assumptions market participants would use, meaning that they are valued at the discretion of management based on internal modeling. *See e.g.* FAS 157, ¶¶22-30.

202. Specifically, FAS 157, ¶30 states:

> In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. ***However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.***

(Emphasis added).

203. Thus, Level 1 inputs are unadjusted, whereas Level 2 and Level 3 inputs may require adjustments to measure fair value appropriately. Regarding Level 2 inputs, FAS 157 provides that the adjustments are based on factors specific to the asset and may include factors such as the condition of the asset and the volume and level of activity in the markets within which the inputs are observed. FAS 157, ¶ 29. Conversely, the adjustments for Level 3 inputs *must* include assumptions about risk and the inputs *must* be adjusted for risk ("A measurement (for example 'mark-to-model' measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.") FAS 157, ¶ 25, n. 15.

204. Under GAAP, financial instruments and other inventory must be reported at fair value. "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FAS 157, ¶5. Moreover, "the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price.)." FAS 157, ¶7. FAS 157 indicates that fair value is measured using valuation techniques that are

appropriate in the circumstances and for which sufficient data are available and segregates the inputs, or assumptions, used in the valuation techniques into two categories – observable inputs, which are inputs from sources independent of the reporting entity (i.e. stock market), and unobservable inputs, which are the reporting entity's own assumptions about the assumptions market participants would use. FAS 157, ¶21.

205. Lehman's Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") provided that:

> The Company has categorized its financial instruments measured at fair value into a three-level classification in accordance with SFAS 157. Fair value measurements of financial instruments that use quoted prices in active markets for identical assets or liabilities are generally categorized as level 1, and fair value measurements of financial instruments that have no direct observable levels are generally categorized as Level 3.
>
> * * *
>
> Level 2 – Inputs (other than quoted prices included in Level I) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

206. Lehman, under FAS 157, was obligated to properly assess all of its assets at the correct market value, no matter how obscure, opaque or illiquid the market is for the asset in question, and to properly classify an asset using the correct valuation techniques, by measuring the fair market value using one of the three broad levels for valuating assets.

207. In its 2007 Form 10-K, Lehman classified 28.3 percent of its assets – roughly $25.194 billion of its total $89.106 billion in mortgage- and asset-backed securities – as Level 3, with that number stabilizing at 28.1 percent and 28.4 percent of its assets after the first and second quarters of 2008, respectively.

208. Lehman's classification of these assets as Level 3 in the 2007 Form 10-K must be measured against comments made by certain Officer Defendants acknowledging significant pricing visibility for these mortgage and asset-backed securities. As described above, on December 13, 2007, defendant O'Meara, during the year-end earnings conference call, had indicated that there was good price visibility into the mortgage-backed securities:

> They're certainly in there and significant. Alt-A across the capital structure. Each of these in terms of how these market values are established, there are at the top of the capital structure, particularly in AAA in both prime and subprime, there is market discovery. So there are transactions being executed in the AAA space. As you move down the capital structure, there aren't transactions being executed, maybe there are some, but it's not as visible and not as much information on it and so the way to model them out is you have to default to the information that is visible which is the index trading around ABX in the different parts of the capital structure for ABX and so those inputs or that information around ABX is used to price out the cash products in the bottom parts of the capital structure. ***But there are some trades being done. We've got good visibility into them.***

(Emphasis added).

209. As described above, on February 6, 2008, defendant Callan reiterated the same sort of thing with regard to commercial mortgage securitizations: "The interesting thing about the Commercial mortgage market is there's still an active B piece in [the] mez[zanine] class buyer base. So, there's an active risk-taking buyer base that hasn't changed; pension funds, insurance funds, who always do their old fashioned good real estate due diligence. So in virtually all the cases, we can sell off what we consider the risk classes of these deals."

210. On March 18, 2008, defendant Callan again remarked on the pricing transparency of some of Lehman's mortgage-related securities: "[W]e began to see a lot more transparency in the Alt-A sector late in the quarter, allowing us to mark positions based on observable prices, much less use of models," explaining further that "[p]eople are familiar with the developments around the Peloton fund and really create a lot of market transparency. And this included loans

as well as securities across the cap structure. In Europe there's a more liquid derivative market evolving, which is providing us a better basis to value those positions."

211. On June 9, 2008, defendant Callan reiterated that Lehman's SunCal exposure had been marked to take into account "recent similar large transactions that occurred in similar markets."

212. On June 16, 2008, defendant Fuld made the same type of representations, noting in a conference call with investors that Lehman "had the benefit of much greater price visibility, due to the number of assets that were sold, especially in the commercial and residential mortgage area." Likewise, defendant Lowitt said on the same call that "[a]lthough certain sectors of the markets are currently distressed, there has been recent sales activity in many asset classes, allowing us to benchmark prices. The strong flows we've seen over the past quarter have given us very good transparency in the marks we have against our remaining positions." Moreover, Lowitt stressed that residential mortgage asset sales of approximately $11 billion and purchases of $6 billion during the quarter, including allegedly risky loan types such as Alt-A and subprime mortgages, gave Lehman "good transparency in our pricing."

213. These statements suggest that there was significant pricing transparency for those securities that Lehman did not classify as Level 3.

214. In fact, the values reflected on Lehman's financial statements at year-end 2007, first quarter 2008 and second quarter 2008 for many of the assets categorized as Levels 1 and 2 assets lacked significant price transparency, were overstated and were not appropriately adjusted for risk.

215. Instead of recognizing the impairments to Level 2 and Level 3 assets and the writing the values down, the Lehman Defendants allowed the Company's balance sheet to be materially misstated and become a "black hole."

216. Indeed, despite the continued turmoil in the residential and commercial mortgage markets, Lehman took a total write-down of only $1.5 billion on its mortgage and asset-backed holdings in the fourth quarter of 2007, $4.3 billion in the first quarter of 2008 and $3.7 billion in the second quarter of 2008.

217. GAAP are those principles recognized by the accounting profession as the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time. GAAP principles are the official standards accepted by the SEC and promulgated in part by the American Institute of Certified Public Accountants ("AICPA"). GAAP consists of a hierarchy of authoritative literature. The highest priority is comprised of Financial Accounting Standards Board ("FASB") of Financial Accounting Standards ("FAS"), followed by FASB Interpretations ("FIN"), Accounting Principles Board Opinions ("APB"), Accounting Research Bulletins ("ARB"), and AICPA Statements of Position ("SOP"). GAAP provides other authoritative pronouncements including, among others, the FASB Concept Statements ("FASCON").

218. As a publicly traded company, Lehman is responsible and required to maintain books and records in sufficient detail to reflect the transactions and assets of the Company and therefore prepare financial statements in accordance with GAAP. Specifically, the Securities and Exchange Act of 1934, 15 U.S.C. §78 m(b)(2) (the "Exchange Act"), requires public companies to:

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that –

i. transactions are executed in accordance with management's general or specific authorization;

ii. transactions are recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (ii) to maintain accountability for assets;

iii. access to assets is permitted only in accordance with management's general or specific authorization; and

iv. the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences

219. 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 footnotes or other disclosures. 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. §210.10-01(a)).

220. As set forth in the AIPCA Auditing Standards ("AU"), the responsibility for preparing for preparing the financial statements in conformity with GAAP rests with a company's management, as adopted by the PCAOB on April 16, 2003. Specifically, AU 110.03 establishes:

> The financial statements are management's responsibility...Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, authorize, record, process, and report transactions (as well as events and conditions)

> consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management...Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility.

221. The Company's assets with exposure to real estate and mortgage-related investments were materially overstated and its liabilities were materially understated as reported in its 2007 Form 10-K, First Quarter 2008 Form 10-Q, and its June 9, 2008 Earnings Results Form 8-K. As a result, the Company's net earnings were materially overstated and its losses were materially understated as reported in the Company's financial statements on or before the date of the Offerings. Additionally, the Company lacked adequate disclosure controls and procedures, and internal control over financial reporting, despite repeated certifications signed by certain Lehman Defendants and other statements to the contrary at the end of 2007 and during the first two quarters of 2008.

222. GAAP outlines fundamental principles, such as FASCON, detail various requirements or principles that must be set forth in financial statements. The Company's relevant financial statements presented its financial position and results of operations in a matter which, among other things, violated the following fundamental accounting principles:

(a) 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 (FASCON 1, ¶ 34);

(b) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims of those resources, and the effects of transactions, events, and circumstances that change resources and claims to those resources (FASCON 1, ¶ 40);

(c) The principle that financial reporting should provide information about an enterprise's financial performance during a period. Specifically, "[i]nvestors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investments and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on past enterprise performance." (FASCON 1, ¶ 42);

(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. "To the extent that management offers securities of the enterprise to the public, it voluntary accepts wider responsibilities for accountability to prospective investors and to the public in general." (FASCON 1, ¶ 50);

(e) The principle that financial reporting should be reliable and represent what it purports to represent. That information should be reliable as well as relevant is a notion that is central to accounting (FASCON 2, ¶¶ 58-59);

(f) The principle of completeness, which means nothing material is left out of the information that may be necessary is a notion that is central to accounting (FASCON 2, ¶ 79);

(g) The principle that financial reporting should be verifiable and provide a significant degree of assurance that accounting measures represent what they purport to represent (FASCON 2, ¶ 81); 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 (FASCON 2, ¶¶ 95, 96).

223. Likewise, GAAP requires certain disclosures to prevent financial statements from being false and misleading. Specifically, FAS No. 5 states as follows, in relevant part:

> After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset was not insured at the date of the financial statements. On the one hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or filing of bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements....**Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss**

> **contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements...**

FAS 5, ¶¶10-11 (Emphasis added).

224. As alleged above, the Lehman Defendants disregarded the inherent credit risk and the market factors indicating the true value of Lehman's real estate and mortgage-related investments and the resulting significant declines of the Company's real estate and mortgage-related investments by the date of the Offerings, when issuing its financial results for 2007 and the first and second quarters of 2008. As such, disclosure of the material decline in the fair value and related losses on the Company's real estate and mortgage-related investments, because of the significance to the financial statements, was necessary to prevent these financial statements from being misleading. Moreover, in addition to failing to recognize the losses on its real estate and mortgage-related investments, the Company's financial statements for 2007 and the first and second quarters of 2008 did not properly disclose such losses which were, at a minimum, reasonably possible, in violation of GAAP (FAS 5). FAS 5 ¶ 3b defines reasonably possible as the chance of the future event or events occurring is more than remote but less than likely. This failure to properly disclose reasonably possible losses misled the Division as to Lehman's true financial position and results of operations. Lehman Defendants were well aware that the real estate market was experiencing significant negative market stress in December 2007 and January 2008 when Lehman Defendants were preparing the 2007 Form 10-K.

225. FAS 107, as amended by FAS 133, further requires disclosure of all significant concentrations of credit risk arising from all financial instruments, including the following:

a. **Information about the (shared)** activity, region, or **economic characteristic that identifies the concentration;**

b. **The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contract** and the collateral or other security, if any, for the amount due to be of no value to the entity;

c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments;

d. The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk.

FAS 107, as amended by FAS 133, ¶15A (Emphasis added).

226. Lehman's disclosures in the 2007 Form 10-K under FAS 107 were not correct. Lehman failed to break out its concentrations of risks with regard to residential real estate securitizations grouping all mortgage types together whether subprime, Alt-A or prime.

227. Additionally, SOP No. 94-6, *Disclosure of Certain Risks and Uncertainties* ("SOP 94-6") also requires disclosures to be made in financial statements about the risks and uncertainties existing as of the date of those statements regarding the following: "(a) Nature of operations; (b) Use of estimates in preparations of financial statements; (c) **Certain significant estimates**; and (d) Current vulnerability due to certain concentrations." SOP 94-6, ¶8 (Emphasis added).

228. Additionally, APB No. 28, *Interim Financial Reporting* ("APB 28") states:

Contingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date should be disclosed in interim

> reports in the same manner required for annual reports. Such disclosures should be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial. APB 28 ,¶22 (footnote omitted).

229. Lehman also failed to account for the fact that its exposure to its Alt-A securitizations was not able to be fully or adequately hedged as was admitted on September 10, 2008 by defendant Lowitt.

230. In addition to the requirements of GAAP, Regulation S-K requires the Company to include certain disclosures in the MD&A section of the Company's filing with the SEC. Regulation S-K states as follows, in relevant part:

> 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 income from continuing operations. (17 C.F.R. §229.303(a)(3)(ii)).
>
> 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 or of future financial conditions. (17 C.F.R. §229.303(a)).

231. The Company's MD&A, filed with the SEC as of the Company's 2007 Form 10-K filed January 29, 2008, and Forms 10-Q filed April 8, 2008 and July 10, 2008, in violation of Regulation S-K, did not adequately disclose the material decline in the fair value and related losses on the Company's real estate and mortgage-related assets indicating the reported financial information was not indicative of the Company's future financial position or results of operations.

232. Internal control over financial reporting is defined in Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS2"), as follows, in relevant part:

> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, 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** and 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 to 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 of the financial statements.

This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. *See* Exchange Act Rules 13a-15(f) and 15(d)-15(f) (AS 2, ¶7) (Emphasis added).

233. Exchange Act Rules 13a-14 and 15d-14 require the Company's principal executive officer and principal officer to quarterly and annually certify the effectiveness (or deficiencies in the effectiveness, as applicable) of the Company's disclosure controls and procedures as of as assessment within 90 days prior to the filing date of the report. Further, the Company is required to annually report on the effectiveness of its internal control over financial reporting. AS 2 states, in relevant part:

> A company is subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer") is required to include in its annual report a report of

> management on the company's internal control over financial reporting...The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective....

234. In the Company's 2007 Form 10-K for the year ended November 30, 2007, and Forms 10-Q filed April 8, 2008 and July 10, 2008, the Lehman Defendants caused the Company to not adequately disclose the ineffectiveness of the Company's controls and procedures, and internal control over financial reporting. In particular, the Company's disclosure controls and procedures, and internal control over financial reporting were not effective, as the Lehman Defendants caused the Company to issue the relevant financial statements that were materially misstated with respect to the valuation and disclosure of the Company's loss exposure due to concentration. As a result of the Company's failure to maintain effective disclosure controls and procedures and internal control over financial reporting, the Lehman Defendants were not only able to delay recognizing material losses on its real estate and mortgage-related assets, but also failed to properly disclose the extent of the Company's loss exposure in violation of GAAP. The Company's true financial condition and results of operations were further masked by the Lehman Defendants' false reassurances that the Company had an effective risk management process and adequate hedging.

a. **False Statements**

i. **2007 Form 10-K**

235. On January 29, 2008 Lehman filed its 2007 Form 10-K with the SEC, which was signed by Defendants Fuld, Callan, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez, Kaufman and Macomber, and contained management's certifications of the Company's financial statements and internal controls over financial reporting, as well as those

certifications required by SOX. The 2007 Form 10-K also contained statements concerning the Company's risk management and management's evaluation and the effectiveness of the Company's internal disclosure controls.

236. In the 2007 Form 10-K, Lehman reported record net revenue for the 2007 fiscal year of $19.257 billion, record net income of $4.192, record net income applicable to common stock of $4.125 billion, EPS of $7.63 and diluted EPS of $7.26. The 2007 Form 10-K reported total assets for the 2007 fiscal year of $691.063 billion, financial instruments and inventory positions owned of $313.129 billion, of which the Company stated that $89.106 billion related to mortgages and asset-backed positions, including $37.44 billion in residential and asset-backed securities, up about $10 billion from the previous year, and $38.938 billion in commercial real estate holdings, up more than $14 billion from the previous year. Lehman also reported a $5.276 billion exposure to subprime residential mortgages, and stated that $3.226 billion of this exposure related to whole loans, while $1.995 billion related to retained interests in securitizations and $55 million to other subprime exposure. The Company further reported $11.3 billion in retained interests in securitizations, including retaining $7.1 billion in investment grade interests in residential mortgage securitizations, $1.6 billion in non-investment grade interests in residential mortgage securitizations, $2.4 billion in investment grade interests in commercial mortgage securitizations and $26 million in non-investment grade interests in commercial mortgage securitizations.

237. The 2007 Form 10-K also discussed Lehman's Level 3 assets as follows:

> During the 2007 fiscal year, our Level III assets increased, ending the year at 13% of Financial instruments and other inventory positions owned, measured at fair value with our derivatives on a net basis. The increase in Level III assets resulted largely from the reclassification of approximately $11.4 billion of mortgage and asset-backed securities, including approximately $5.3 billion in U.S. subprime residential mortgage-related assets, previously categorized as Level II assets into

> the Level III category. This reclassification generally occurred in the second half of 2007, reflecting the reduction of liquidity in the capital markets that resulted in a decrease in the observability of market prices. Approximately half of the residential mortgage-related assets that were classified as Level III at the end of the 2007 fiscal year were whole loan mortgages. In particular, the decline in global trading activity impacted our ability to directly correlate assumptions in valuation models used in pricing mortgage-related assets, including those for cumulative loss rates and changes in underlying collateral values to current market activity. Additionally and during the fiscal year, the increase of assets characterized as Level III was also attributable to the acquisition of private equity and other principal investment assets, funded lending commitments that had not been fully syndicated at the end of the fiscal year as well as certain commercial mortgage-backed security positions.

238. The 2007 Form 10-K specifically broke down Lehman's $89.106 billion mortgage exposure in Level 1, Level 2 and Level 3 assets, reporting $240 million in Level 1, $63.672 billion in Level 2, and $25.194 billion in Level 3 assets. Regarding the losses attributable to Lehman's Level 3 assets, the 2007 Form 10-K stated:

> Net revenues (both realized and unrealized) for Level III financial instruments are a component of Principal transactions in the Consolidated Statement of Income. Net realized gains associated with Level III financial instruments were approximately $1.3 billion for the fiscal year ended November 30, 3007. The net unrealized loss on Level III non-derivative financial instruments was approximately $2.5 billion for the fiscal ended November 30, 2007, primarily consisting of unrealized losses from mortgage and asset-backed positions. The net unrealized gain on Level III derivative financial instruments was approximately $1.6 billion for the fiscal year ended November 30, 2007, primarily consisting of unrealized gains from equity and interest rate-related derivative positions. Level III financial instruments may be economically hedged with financial instruments not classified as Level III; therefore, gains or losses associated with Level III financial instruments offset by gains or losses associated with financial with financial instruments classified in other levels of the fair value hierarchy.

239. With respect to its Level 3 asset value during fiscal year 2007, Lehman reported $6.914 billion in net payments, purchases and sales, $11.373 billion in net transfers into Level 3, $995 million in realized gains and $2.663 billion in unrealized losses.

240. For the reasons set forth in ¶¶ 189 to 234, the foregoing statements in ¶¶ 235 to 239 contained untrue statements of material fact and omitted to state material facts. Specifically, Lehman Defendants failed to disclose Lehman's exposure to losses associated with Lehman's real estate and mortgage-related positions and failed to adequately write-down such assets to reflect their true value in the fiscal 2007 year. Moreover, Defendants failed to disclose that certain real estate and mortgage-related assets, including Alt-A mortgages and securitizations and commercial real estate investments, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses.

ii. <u>1Q08 Financial Results and First Quarter 2008 Form 10-Q</u>

241. Lehman's March 18 Form 8-K reported, *inter alia*, net income of $489 million, or $0.81 EPS, for the quarter along with net revenues of $3.5 billion, reflecting "negative mark to market adjustments of $1.8 billion, net gains on certain risk mitigation strategies and certain debt liabilities." Lehman further reported capital markets net revenues of $41.7 billion in the first quarter, a decrease of 54 percent from the first quarter of 2007, and Fixed Income Capital Markets net revenues of $262 million, a decrease of 88 percent from $2.2 billion in the first quarter of fiscal 2007.

242. On April 8, 2008, Lehman filed its First Quarter 2008 Form 10-Q, which was signed by defendant Callan, and included management's certifications of the Company's interim financial statements and internal controls over financial reporting, as well as those certifications required pursuant to SOX, which were substantially similar to those set forth in the 2007 10-K, and were signed by defendants Fuld and Callan. The First Quarter 2008 Form 10-Q also contained statements concerning the Company's risk management and management's evaluation

and the effectiveness of the Company's internal disclosure controls, which were substantially similar to those set forth in the 2007 Form 10-K.

243. In the First Quarter 2008 Form 10-Q, the Company reported net revenues of $3.507 billion, net income of $489 million, net income applicable to common stock of $465 million, EPS of $0.84 and diluted EPS of $0.81. Lehman also disclosed total assets of $786.035 billion and financial instruments and inventory positions owned of $326.658 billion. Of the $326.658 billion in financial instruments and inventory positions owned, Lehman disclosed that $84.609 billion related to mortgages and asset-backed positions.

244. In the First Quarter 2008 Form 10-Q, Lehman reported a breakdown of its subprime and Alt-A/Prime mortgage-related positions. Specifically, Lehman reported a $4.017 billion exposure to the subprime market, consisting of $1.295 billion in residential subprime whole loans, $2.692 billion in retained interests in subprime-backed securitizations, and $30 million in other subprime exposure. Regarding its exposure to non-subprime loans, Lehman reported Alt-A/Prime mortgage holdings of $14.6 billion, including $3.7 billion in whole loans, a $9.2 billion in retained interests in Alt-A/Prime-backed securitizations and $1.7 billion in other subprime exposure.

245. The Company also reported making value adjustments of negative gross $4.7 billion and negative net $1.8 billion to its real estate and mortgage-related positions. Specifically, the Company made value adjustments of negative gross $3.0 billion and negative net $0.8 billion to its residential mortgage-related positions, and negative gross $1.1 billion and negative net $.7 billion to its commercial mortgage-related positions.

246. The First Quarter 2008 Form 10-Q further reported that Lehman classified $270 million of its $84.6 billion in mortgage and asset-backed securities as Level 1 assets, $60.527

billion as Level 2 assets, and $23.812 billion as Level 3 assets. The Company also reported that the quarterly change in its Level 3 assets resulted from $46 million in net payments, purchases and sales, $519 million in net transfers out of Level 3, $83 million in realized gains and $750 million in unrealized losses, and net gains (unrealized/realized) of $228 million.

247. For the reasons set forth in ¶¶ 189 to 234, the foregoing statements in ¶¶ 241 to 246 contained untrue statement of material facts and omitted to state material facts. The Lehman Defendants failed to disclose Lehman's exposure to losses associated with Lehman's real estate and mortgage-related positions and failed to adequately write-down such assets to reflect their true value in the first quarter of 2008. Moreover, the Lehman Defendants failed to disclose that certain mortgage-related assets, including Alt-A mortgages and securitizations and its commercial real estate investments, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses.

iii. 2Q08 Financial Results

248. Lehman's June 9, 2008 Earnings Results Form 8-K reported, *inter alia*, a net loss of $2.8 billion or a net loss of $5.14 per share, on negative net revenues of $0.7 billion, compared with $5.5 billion in net revenues for the second quarter of 2007. Lehman also reported that for the first half of 2008 it expected to report a net loss of approximately $2.3 billion, or $4.33 per diluted common share. Lehman further announced a gross write-down of $2.4 billion in its residential mortgage-related holdings and $1.0 billion in its commercial mortgage-related holdings, which, in actually, totaled $1.3 billion due to commercial "hedges" that had increased Lehman's loss by $400 million.

249. On July 10, 2008, Lehman filed its Second Quarter 2008 Form 10-Q, which was signed by defendant Lowitt, and included management's certifications of the Company's interim

financial statements and internal controls over financial reporting, as well as those certifications required pursuant to SOX, which were substantially similar to those set forth in the 2007 Form 10-K and were signed by defendants Fuld and Lowitt. The Second Quarter 2008 Form 10-Q also contained statements concerning the Company's risk management and management's evaluation and the effectiveness of the Company's internal disclosure controls, which were substantially similar to those set forth in the 2007 Form 10-K.

250. In the Second Quarter 2008 Form 10-Q, the Company reported a net loss of $2.774 billion, or a net loss of $5.14 per share, on negative net revenues of $0.668 billion. Lehman also disclosed total assets of $639.432 billion and financial instruments and inventory positions owned of $269.409 billion. Of the $269.409 billion in financial instruments and inventory positions owned, Lehman disclosed that $72.461 billion related to mortgages and asset-backed positions.

251. In the Second Quarter 2008 Form 10-Q, the Company reported having $24.9 billion in residential mortgages, including $15 billion in securities, $8.3 billion in whole loans and $1.6 billion in mortgage servicing and other exposure, and $29.4 in commercial mortgages, including $19.9 billion in whole loans and $9.5 billion in securities and other exposure. The Company also reported of making value adjustments of negative gross $3.6 billion and negative net $3.7 billion to its real estate and mortgage-related positions. Specifically, the Company made value adjustments of negative gross $2.4 billion and negative net $2.0 billion to its residential mortgage-related positions, and negative gross $.9 billion and negative net $1.3 billion to its commercial mortgage-related positions. For the first six months of 2008, Lehman reported of making value adjustments of negative gross $8.3 billion and negative net $5.5 billion to its real estate and mortgage-related positions.

252. The Second Quarter 2008 Form 10-Q reported a breakdown of its subprime and Alt-A/Prime mortgage-related positions, including reported a $2.775 billion exposure to the subprime market, consisting of $1.048 billion in residential subprime whole loans, $1.686 billion in retained interests in subprime-backed securitizations, and $21 million in other subprime exposure. Regarding its exposure to non-subprime loans, Lehman reported Alt-A/Prime mortgage holdings of $10.2 billion, including $2.1 billion in whole loans, a $6.5 billion in retained interests in Alt-A/Prime-backed securitizations and $1.2 billion in other subprime exposure.

253. The Second Quarter 2008 Form 10-Q further reported that Lehman classified $347 million of its $72.461 billion in mortgage and asset-backed securities as Level 1 assets, $51.517 billion as Level 2 assets, and $20.597 billion as Level 3 assets.

254. For the reasons described in ¶¶ 189 to 234, the foregoing statements in ¶¶ 248 to 253 contained untrue statements of material facts and omitted to state material facts. Specifically, the Lehman Defendants failed to disclose Lehman's exposure to losses associated with Lehman's real estate and mortgage-related positions, particularly in its commercial real estate portfolio, and failed to adequately write-down such assets to reflect their true value in the second quarter of 2008. Moreover, the Lehman Defendants failed to disclose that certain real estate and mortgage-related assets, including Alt-A mortgages and securitizations and commercial real estate investments, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses.

255. The April 1 Prospectus Supplement and June 9 Prospectus Supplement incorporated the 2007 Form 10-K, stating:

> The consolidated financial statements and financial statement schedule of Lehman Brothers Holdings Inc. appearing in Lehman Brother Holdings Inc.'s Annual

> Report (Form 10-K) for the year ended November 30, 2007, and of the effectiveness of internal control over financial reporting as of November 30, 2007 included therein have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their reports thereon, included therein, and incorporated by referenced herein. Such consolidated financial statements are incorporated herein by reference in reliance upon the reports of Ernst & Young LLP pertaining to such consolidated financial statements given on authority of such firm as experts in accounting and auditing.

256. The 2007 Form 10-K and the First Quarter 2008 Form 10-Q contained material misstatements as to the value of Lehman's Level 2 and 3 assets and other misstatements as discussed above. For example, Note 4 to Lehman's consolidated financial statements for the year ending November 30, 2007, included in its 2007 Form 10-K, stated that the net value of its Level 3 assets at November 30, 2007 was $38.9 billion. Note 4 to Lehman's consolidated financial statements for the quarter ended February 29, 2008 in the First Quarter 2008 Form 10-Q stated that the net value of its Level 3 assets had risen to $40.3 billion. These statements were untrue and contained omissions of material fact because they failed to disclose the true value of Lehman's assets which were substantially less than represented.

257. Lehman Defendants made material misstatements of Lehman's asset values (and thus risk) in the 2007 Form 10-K and the First Quarter 2008 Form 10-Q, causing Plaintiff substantial damages.

2. Ernst & Young's Violations of GAAP

258. E&Y served as Lehman's outside auditor for decades, and was retained by Lehman to conduct quarterly reviews of its interim financial results and to conduct the annual audit of Lehman's fiscal results for the fiscal years ending in 2005, 2006 and 2007, among others. In its position as Lehman's outside auditor, E&Y was responsible for conducting audits on Lehman's financial statements and issuing audit reports, knowing that they would be used and

relied upon by prospective and existing investors of Lehman, as well as analysts, in evaluating the purchase and holding of Lehman securities.

259. By virtue of its long history with Lehman, and Defendant Goldfarb's history as a former partner with E&Y and a member of Lehman's Executive Committee, E&Y was intimately involved with Lehman's business model, its employees, its products, and its increasing exposure by virtue of its real estate and mortgage-security holdings. Moreover, in the course of its audit work, including its audit planning procedures for the audit of fiscal year 2007, E&Y was required to audit management's assessment of the effectiveness of Lehman's internal controls over financial reporting, especially paying attention to real estate asset valuations and risk exposure, as a result of the deterioration in the subprime market and real estate securitizations.

260. In addition, E&Y, as part of its standard procedures with public companies it audits, would have reviewed Lehman's quarterly press releases, which announced Lehman's performance, financial condition, asset valuations and revenues. E&Y reviewed drafts of Lehman's filings with the SEC prior to filing, and also attended and made presentations at Board and Audit Committee meetings, where E&Y discussed the results of its examination of Lehman's financial statements. For its services, E&Y received significant compensation from Lehman.

261. For the fiscal year 2007, Lehman provided unqualified and "clean" audit opinions included in Lehman's 10-K for 2007, confirming that E&Y had conducted its audit in accordance with Generally Accepting Accounting Standards ("GAAS") and that based on its audit, Lehman's financial statements fairly represented the Company's position for the fiscal year 2007, in accordance with GAAP.

262. The central purpose of an audit is to obtain an opinion that the financial statements fairly present, in all material respects, the financial position of the company in conformity with GAAP. AU 110.01. The auditor has the affirmative duty to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether by error or fraud. AU 110.02.

263. To obtain such reasonable assurance, the independent auditor has to perform specific procedures call for by GAAS, and, after performing such procedures, determine if anything has come to their attention that would lead them to believe that the financial statements were not fairly presented in accordance with GAAP. AU 722.09. Indeed, the audit process requires professional skepticism in order to properly test management's representations so that the auditor actually has a reasonable basis on which to form an opinion regarding the financial statements. AU 332.02.

264. An auditor must consider both audit risk and materiality in (1) planning the audit and designing audit procedures, and (2) in evaluating the results of the audit in relation to the financial statements as a whole. AU 312.12. The auditor must plan the audit to obtain reasonable assurance of detecting material misstatements that it believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. AU 312.20.

265. In performing audit work, an auditor must perform such work in conformity with GAAP, as well as the standard of care established by the American Institute of Certified Public Accountant or AICPA, which includes the GAAS' Ten Professional Standards of care:

General Standards

1. The audit must be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

Standards of Field Work

4. The work is to be adequately planned and assistants, if any, are to be properly supervised.

5. A sufficient understanding of internal controls is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

6. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

7. The report shall state whether the financial statements are presented in accordance with Generally Accepted Accounting Principles.

8. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

9. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

10. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect than an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

266. Based upon its annual audit and quarterly reviews, E&Y failed to obtain sufficient competent evidential matter in violation of GAAP. This allowed Lehman to improperly account for and disclose the true financial condition and exposure of its real estate-related securities,

including RMBSs and CMBSs, nonprime mortgage holdings, including subprime mortgages and Alt-A mortgages, and its commercial real estate holdings. E&Y further allowed Lehman to improperly account for and inadequately disclose Lehman's deteriorating financial condition, which contradicted the unqualified audit report and interim reviews on Lehman's financial statements, which report and reviews were meant to be distributed to the market and to Lehman's shareholders, including Plaintiff. E&Y's reports incorporated by Lehman to promote Lehman's issuance and sale of securities to the market, including Plaintiff, were issued in violation of E&Y's professional standards and duties.

267. During its inspection of E&Y from April 2007 to December 2007, the PCAOB identified several cases among E&Y's audit clients in which it appeared that E&Y had not obtained sufficient competent evidential matter to support its audit opinion. The PCAOB reported publicly the details of such deficiencies since it considered the deficiencies to have reached the level of high significance. The PCAOB report however does not publicly disclose information about the identity of E&Y's audit client, but does outline the degree of significance on an audit-by-audit basis. With regard to one issuer whose business model paralleled that of Lehman, the PCAOB report noted as follows:

> In this audit, [E&Y] failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –
>
> - The issuer originates, acquires, and sells mortgage loans. The issuer sells whole pools of mortgage loans with certain recourse provisions, related to borrower defaults, which may require the issuer to repurchase loans from the buyers. During the year under audit, the issuer had repurchased 600 percent more whole pool mortgage loans than in the previous year. [E&Y] failed to perform substantive procedures to test whether the repurchases of whole pool mortgage loans had been made in accordance with the terms of the related mortgage loan sales agreements, in order to determine whether the accounting treatment related to these loans was appropriate.

- The issuer provided financing to certain non-affiliated entities, which used the financing to originate mortgage loans. In certain cases, the issuer then purchased these mortgage loans. There was no evidence in the audit documentation, and no persuasive other evidence, that [E&Y] had evaluated whether these non-affiliated entities were variable interest entities, as defined by Financial Accounting Standards Board Interpretation No. ("FIN") 46(R), *Consolidation of Variable Interest Entities* ("FIN 46(R)") that were required to be consolidated.

- There was no evidence in the audit documentation, and no persuasive other evidence, that [E&Y] had traced to source documents or otherwise tested certain key inputs to the calculations used to estimate the allowance for loan losses, including the inputs related to non-performing loans. Further, [E&Y]'s work papers included multiple, inconsistent amounts for non-performing loans.

  After the inspection field work, [E&Y] and the issuer determined that each of these amounts was incorrect. The issuer later corrected, in a subsequent filing, delinquency information that had been included in its Form 10-K.

268. On information and belief, E&Y did not obtain sufficient competent material to support its audit opinion of Lehman, particularly for the value of assets Lehman categorized as Level 2 and Level 3 and its estimates on future losses.

269. Specifically, E&Y violated the following principles of GAAP and GAAS, including, among others:

A. GAAS General Standard No. 3, which requires the auditor to exercise due professional case in the performance of the audit and preparation of the audit report;

B. GAAS Reporting Standard No. 1, which requires the audit report to state whether the financial statements are presented in accordance with GAAP;

C. GAAS Field Standard No. 1, and the standards set forth in AU sections 310, 320, 327 and others, by failing to adequately plan its audit and properly supervise the work of assistants so as to establish and carry out procedures reasonably designed to search for and detect the existence of errors and irregularities which would have a material effect upon the financial statements; and

D. AU section 316, which requires the auditor to plan and perform its examination of the financial statements with professional skepticism. In particular, in Lehman's case, there were numerous audit red flags and risk factors that alerted E&Y to the potential of misstatements, and E&Y failed to expand its audit procedures and perform effective audit testing to obtain more reliable, persuasive audit evidence of such significant factors and audit red flags.

270. With regard to its quarterly reviews of Lehman's financial results, E&Y violated AU section 722.18, which states: "If, in performing a review of interim financial information, the accountant becomes aware of information that leads him or her to question whether the interim financial institution to be reported conforms with generally accepted accounting principles, the accountant should make additional inquires or employ other procedures he or she considers appropriate to provide the limited assurance for a review engagement." In view of all the previously described risk factors and audit red flags at Lehman, E&Y should have made additional inquiries, including further communications with Lehman's Audit Committee and the Board, in view of the various risk factors known to it at the time of its April 8, 2008 review, namely:

1. the contagion of the subprime mortgage crisis to all real estate markets;

2. the absence of comparable market data to value real estate-related assets;

3. the implosion of Bear Stearns;

4. the closure of Lehman's residential real estate origination business;

5. the hedging activity of Lehman;

6. Lehman's purchases or Alt-A securitizations in the first quarter of 2008; and

7. the continued activity of Lehman's commercial real estate investment and lending.

271. E&Y was also responsible to conduct additional procedures subsequent to the issuance of its audit report for the year ended November 30, 2007 through the date of the consent for the inclusion of such audit report in the April and June Offering Materials. According to AU Section 771.10, the "auditor should extend his procedures with respect to subsequent events from the date of his audit report up to the effective date" to prove that "he has made a reasonable investigation." A reasonable investigation is defined at AU Section 711.03 as "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

272. The procedures to be performed, according to AU Section 711.10 and AU Section 560.12, include, among other procedures, reading interim financial statements and comparing the interim statements to the audited statements in the consent, inquiry of officers and executives having responsibility for financial and accounting matters whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry or whether any events occurred that have a material effect on the audited statements.

273. According to AU Section 711.12, if the auditor "discovers . . . subsequent events that require adjustments or disclosure" or "becomes aware that facts may have existed at the date of his report," the auditor, according to AU Section 561.06, "should advise his client to make appropriate disclosure of the newly discovered facts and their impact of the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements." According to AU Section 711.12, it further states that "the auditor should also consider . . . withholding his consent." E&Y did not withhold its consent.

G. Causes of Action Under the Securities Act

COUNT I

Violations of Section 11 of the Securities Act Against Securities Act Defendants and E&Y

274. Plaintiff repeats and realleges each and every allegation of paragraphs 1 through 273 as if fully set forth herein. This claim is asserted under Section 11 of the Securities Act against all Defendants. For the purposes of this claim, Plaintiff asserts only strict liability and negligence claims and expressly disclaims any claim of fraud or intentional misconduct.

275. Plaintiff purchased Lehman securities issued pursuant to the Registration Statement, the April 1 Prospectus Supplement and the June 9 Prospectus Supplement ("Prospectuses"). The Registration Statement and the documents incorporated by the Prospectuses were signed by or on behalf of Fuld, Callan, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez, Kaufman and Macomber ("Securities Act Defendants").

276. The Registration Statement and Prospectuses, each of which incorporated certain public disclosures by reference, were inaccurate and misleading, contained untrue statements of material facts and/or omitted to state material facts necessary to make the statements made therein not misleading, as set forth above. The matters detailed above would have been material to a reasonable person reviewing the Registration Statement, the Prospectuses and the financial statements incorporated therein.

277. Lehman and LBI were sellers, offerors, and/or solicitors of the sales to Plaintiff.

278. Lehman was the registrant for the Registration Statement and Prospectuses. LBI was the underwriter for the Offerings as described in the Prospectuses.

279. Though direct claims against Lehman at this time are barred by the bankruptcy code, Lehman, as the issuer of the securities sold to Plaintiff would otherwise be strictly liable to

Plaintiff for the material misstatements and omissions alleged above. Similarly, because LBI is being dissolved pursuant to the SIPC, it is not a named defendant, but LBI, as the solicitor of the securities sold to Plaintiff, would otherwise be strictly liable to Plaintiff for the material misstatements and omissions alleged above.

280. The Securities Act Defendants were officers and directors of Lehman, the issuer of the securities within the meaning of Section 11(a)(3) of the Securities Act. All signed the Registration Statement and the false documents incorporated therein either personally or through an attorney-in-fact, and all were officers and directors of Lehman during the relevant period.

281. The Securities Act Defendants were responsible for ensuring the true and accurate contents of the Registration Statement and Prospectuses, prior to their dissemination.

282. The Securities Act Defendants acted negligently and without reasonable care regarding the accuracy of the information contained in the Registration Statement and Prospectuses (including the public disclosures incorporated by reference therein), and lacked reasonable grounds to believe that such information was accurate and failed to state all material facts necessary to make the statements made therein not misleading.

283. The Securities Act Defendants owed Plaintiff the duty to make a reasonable and diligent investigation of the statements contained in the Registration Statement and Prospectuses at the time they became effective, to ensure that they 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. In the exercise of reasonable care, the Securities Act Defendants knew or should have known of the material misstatements and omissions contained in the Registration Statement and Prospectuses.

284. Defendant E&Y audited the Lehman financial statements that were incorporated by reference in the Registration Statement and Prospectuses.

285. E&Y's audit opinion in the 2007 Form 10-K, which was incorporated by reference in the Registration Statement and Prospectuses, incorrectly stated that E&Y's audits were performed in accordance with GAAS and that Lehman's financial statements were fairly presented in accordance with GAAP.

286. E&Y consented to being named as having prepared or reviewed the financial statements in the materially false and misleading Registration Statement and Prospectuses filed by Lehman, registering securities acquired by Plaintiff, and as such is liable to the Plaintiff for damages. E&Y should have known of the material misstatements and omissions contained in the Registration Statement and Prospectuses.

287. Plaintiff did not know or in the exercise of due diligence could not have known of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses.

288. Plaintiff has sustained damages as a result of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses for which it is entitled to compensation.

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

290. Accordingly, Securities Act Defendants are liable under Section 11 of the Securities Act.

COUNT II

Violations of Section 12(a)(2) of the Securities Act Against Defendant Fuld and Defendant Callan

291. Plaintiff repeats and realleges each and every allegation of paragraphs 1 through 290 as if fully set forth herein. This claim is asserted under Section 12(a)(2) of the Securities Act against defendants Fuld and Callan. For the purposes of this claim, Plaintiff asserts only strict liability and negligence claims and expressly disclaims any claim of fraud or intentional misconduct.

292. Plaintiff purchased Lehman securities issued pursuant to the Registration Statement and Prospectuses, the oral communications by defendant Callan and the offered communications with defendant Fuld.

293. Defendant Fuld and defendant Callan were sellers, officers and/or solicitors of sales of the Offerings pursuant to the Registration Statement and pursuant to the Prospectus Supplements issued in connection with each Offering.

294. The Prospectuses contained untrue statements of material fact and omitted other material facts necessary to make the statements not misleading, and failed to disclose material facts as set forth above. Further, defendant Callan solicited directly the purchase of the Offerings by the Plaintiff with oral communications that were false. Defendant Fuld falsely stated to investors that "the worst of the credit crisis is behind us" at Lehman's annual shareholder meeting on April 18, 2008.

295. Defendant Fuld and defendant Callan are solicitors within the meaning of the Securities Act because they solicited the purchase of the Lehman Offerings by Plaintiff motivated by the desire to serve their own financial interest and the financial interest of Lehman.

Defendant Callan, in conjunction with Lehman and LBI, used the means and instrumentalities of interstate commerce, including the telephone and the United States mail.

296. The matters detailed above would have been material to a reasonable person reviewing the Registration Statements, the Prospectuses and the financial statements incorporated therein, and in hearing the oral communications.

297. Defendant Fuld and defendant Callan were responsible for the contents and dissemination of the Registration Statement and Prospectuses and their oral statements and are liable under Section 12(a)(2) of the Securities Act for any material misrepresentations or omissions contained therein. Defendant Fuld and defendant Callan did not make a reasonable investigation and did not possess reasonable grounds for believing that their oral statements to Plaintiff and the statements contained in the Registration Statement and Prospectuses were true, did not omit any material fact, and were not materially misleading. Further, defendant Fuld and/or defendant Callan did not possess reasonable grounds for believing the oral communications made to Plaintiff as part of the solicitation to purchase the Offerings.

298. Defendant Fuld and defendant Callan owed Plaintiff the duty to make a reasonable and diligent investigation of the statements contained in the Registration Statement and Prospectuses at the time they became effective, to ensure that they 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. In addition, both owed Plaintiff a duty to make sure any oral communications for purposes of solicitation were not misleading. In the exercise of reasonable care, defendant Fuld and defendant Callan knew or should have known of material misstatements and omissions contained in the Registration Statement and Prospectuses.

299. Plaintiff did not know or in the exercise of due diligence could not have known of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses including the public disclosures incorporated by reference therein, nor in the oral communications of defendant Fuld and/or defendant Callan.

300. Plaintiff has sustained damages as a result of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses and in the oral communications for which it is entitled to compensation.

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

302. Accordingly, defendant Fuld and defendant Callan are liable under Section 12(a)(2) of the Securities Act.

COUNT III

Violations of Section 15 of the Securities Act Against the Officer Defendants and Walsh

303. Plaintiff repeats and realleges each and every allegation of paragraphs 1 through 302 as if fully forth herein. Plaintiff expressly disclaims any allegation of intentional or reckless misconduct.

304. The Officer Defendants and Walsh each acted as a controlling person of Lehman and LBI within the meaning of Section 15 of the Securities Act as alleged herein. By virtue of their high-level positions, and their ownership and contractual rights, participation in and/or awareness of Lehman's operations and/or intimate knowledge of the statements filed by Lehman with the SEC and disseminated to the investing public, the Officer Defendants and Walsh had the power to influence and control and did influence and control, directly or indirectly, the decision-making of Lehman, including the content and dissemination of the false and misleading

statements of material facts and omissions. The Officer Defendants and Walsh were provided with or had unlimited access to copies of the Company's financial statements, reports, press releases, public filings and other statements alleged by Plaintiff to be misleading prior to the time that these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected.

305. Further, the Officer Defendants and Walsh were officers of Lehman and had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, are presumed to have had the power to control or influence the particular transactions and statements giving rise to the securities violations as alleged herein, and exercised that control as alleged herein.

306. As alleged above, non-parties Lehman and LBI violated Sections 11 and 12 of the Securities Act by the acts and omissions as alleged in this complaint. By virtue of their positions as controlling persons of Lehman and LBI, the Officer Defendants and Walsh are therefore liable pursuant to Section 15 of the Securities Act to the Plaintiff.

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

308. Accordingly, the Officer Defendants and Walsh are liable under Section 15 of the Securities Act. As a direct and proximate result of the Office Defendants' and Walsh's conduct, Plaintiff has suffered damages, in an amount to be determined at trial.

V. ADDITIONAL FACTUAL ALLEGATIONS REGARDING CAUSES OF ACTION UNDER STATE LAW CLAIMS

309. Defendants, besides making a series of misstatements concerning Lehman's exposure to outsized losses from its massive real estate and mortgage portfolio, also committed acts displaying its intentional and fraudulent efforts to conceal Lehman's liquidity problems and to benefit themselves.

310. In her conversations with Plaintiff, defendant Callan expressly misrepresented to Plaintiff several items concerning Lehman's liquidity when successfully convincing the Division in April and June 2008 to purchase approximately $182 million worth of Lehman shares, claiming that the Company would only be exposed to a $500 million collateral call if there was a rating downgrade and that Lehman would not be using the Federal Reserve credit facility. Further, defendant Callan also falsely represented that Lehman had exited all parts of the mortgage origination area, and had been successful in reducing its exposure to Archstone and was well hedged. Defendant Callan failed to disclose that Lehman's exposure on Archstone remained above $2 billion and that major areas of its mortgage-related portfolio could not be hedged. Defendant Callan failed to disclose that Lehman intended to conceal its liquidity requirements by borrowing through its European operations, and would indeed continue to access the Federal Reserve credit facility. Defendant Callan and the other Lehman Defendants' major concern was continuing their high compensation and senior executive positions which is why they knowingly or recklessly made these false statements.

A. Knowledge of Lehman Executives Concerning the Liquidity Misrepresentations

311. Internally, Lehman executives were aware of, yet recklessly ignored, Lehman's precarious financial predicament and liquidity vulnerabilities, but made misstatements and omitted material facts in the statements made to the investing public and the State.

312. For example, an internal January 2008 presentation indicated that "[v]ery few of the top financial issuers have been able to escape damage from the subprime fallout," and warned that since "a small number of investors account for a large portion of demand [for Lehman issues], liquidity can disappear quite fast."

313. In early 2008, Lehman deployed its capital by raising its dividend 13% on January 29 and buying back its stock in the market, actions geared towards bolstering the Company's stock price and not the Company's liquidity.

314. If anything at this time, Lehman executives seemed more interested in punishing short sellers, like David Einhorn of the hedge fund Greenlight Capital, Inc., than dealing with Lehman's financial situation. In particular, when Lehman's year-end 2007 results were reported, Einhorn accused Lehman of overstating its record profits by, among other things, impermissibly marking up the value of electric generating plants in India by roughly $400 million to $600, booking $600 million of profit due to the ***decline*** in the market value of Lehman's own debt obligations (which as Congressman John Tierney of Massachusetts dryly noted is "like the profit that you make when your home is foreclosed for a value that is lower than your mortgage") and impermissibly doubling the value ascribed to certain mortgage servicing rights.

315. Defendant Fuld shocked his own employees in fact when at an internal Lehman investment banking conference in London in February 2008 he threatened: "When I find a short-seller, I want to tear his heart out and eat it before his eyes while he's still alive."

316. The short seller Einhorn became an obsession for defendant Fuld and other Lehman executives, side-tracking them from dealing with the Company's faltering financial position, not just its declining share price. In a May 26, 2008 email from defendant Goldfarb to defendants Fuld and Gregory, Goldfarb reported that a possible deal with KDB would provide several billion dollars worth of new capital to Lehman. Defendant Goldfarb suggested that the capital be used to buy back Lehman's shares: "It feels like this could be real. If we did raise $5 billion, I like the idea of aggressively going into market and spending 2 [billion] of the 5 buying back lots of stock (and hurting Einhorn bad!!)" That same day, Defendant Fuld responded to Goldfarb by stating emphatically, "I agree with all of it."

317. Following the demise of Bear Stearns on March 16, defendant Fuld finally focused on raising capital, and Lehman's April 1 Offering, in which the Division participated, represented for onlookers a signal that the firm continued to have access to capital and the confidence of investors.

318. At a dinner at the Treasury Department on April 11, 2008, defendant Fuld chatted with Treasury Secretary Paulson. According to an e-mail produced to the House Committee, defendant Fuld came away with the impression, as he wrote in an e-mail to defendant Russo, Lehman's Treasurer, that night, that we "have a huge brand with Treasury" and that Paulson "loved our capital raise."

319. Paulson would subsequently complain, after Lehman's demise, that he could not get defendant Fuld "off the dime" in finding a buyer for Lehman. According to Treasury statements, Paulson spoke to defendant Fuld quite often between April and September in 2008 pushing him to sell. Defendant Fuld refused to consider this option, ultimately causing the demise of Lehman.

320. Following the collapse of Bear Stearns in March, it was seen as disloyal to Fuld, among Lehman executives, to discuss the possibility of a sale of Lehman.

321. According to Andrew Gowers ("Gowers"), Lehman's Head of Corporation Communications in London, defendant Fuld, with his command and control style of leadership, was a walking stereotype – "the aggressive and domineering corporate chief who rules by fear, his closest underlings promoted above all for loyalty, his executives inculcated with the belief that to challenge his word was to breach his trust."

322. At the time of the April and June Offerings, the Lehman executives were fully aware of Lehman's worsening liquidity position and the need for action. An internal talking point memorandum from June 2008 addressing the record $2.8 billion quarterly loss announced June 9, 2008 that was produced on behalf of defendant Fuld to the House Committee asked, "Why did we allow ourselves to be so exposed?" The reasons cited for Lehman's exposure included that, "[c]onditions clearly [were] not sustainable. Saw warning signs. Did not move early, fast enough. Not enough discipline in our capital allocation." The firm had remained in "illiquid asset [origination] too much/too long" and behaved "too much like investors, not traders." Yet despite having multiple direct communications with representatives of Plaintiff at this time specifically concerning the Offerings and Lehman's financial status, neither defendant Callan nor any other Officer Defendant disclosed to Plaintiff the internal memorandum or any of its contents.

323. According to Gowers, defendant Callan initiated internal discussions as to how to present the $2.8 billion loss in the first quarter of 2008 in June. The idea arrived at by the Officer Defendants was to combine the announcement of the loss with the announcement of a capital raise:

> The worry, even then, was that it could be of a magnitude to cause a run on the bank. There was, of course, no way to spin it. The numbers would be atrocious. Lehman would simultaneously have to shore up confidence by raising fresh capital from increasingly wary investors.

This highly material fact also was, of course, not disclosed to the Division, and the capital Lehman raised in the June Offering proved wholly insufficient.

324. According to Gowers, defendant Fuld refused to admit how deeply in trouble Lehman was. Defendant Fuld rejected the idea that he take the lead, not defendant Callan, in talking to investment analysts and others on the June 9 earnings guidance conference call as was suggested to him.

325. After the *Wall Street Journal* revealed on June 8, 2008 that Lehman was in discussions about raising new capital, including with the Division, defendant Fuld ordered that no Lehman employee anywhere in the world should talk to any *Journal* reporter. Fuld was more concerned about containing leaks and retaining control than in being transparent with regard to Lehman's financial condition and the value of its assets.

326. On information and belief, the leak did come from within Lehman itself as defendant Fuld suspected, since Lehman executives were concerned that the June Offerings would not be fully subscribed on Monday and used the *Wall Street Journal* over the weekend to leak information about the Division's investment to act as a stalking horse for other investors. Johnson had misled Clark on June 6 when he said the June Offerings were "over-subscribed."

327. Following the first ever earnings loss announcement on June 9, on June 11, 2008, defendant Fuld had lunch with several of Lehman's senior investment bankers in his private dining room. Hugh Skip Magee, the Global Head of Investment Banking, had requested the meeting. The Lehman investment bankers wanted a change in leadership. One of the Lehman investment bankers indicated that the Board is going to be under pressure "to deliver a head" to

the Street. The investment bankers wanted defendant Fuld to fire defendant Gregory and defendant Callan. They indicated to defendant Fuld that either he (Fuld) would have to resign, or that he (Fuld) would have to fire or demote Callan and Gregory. Defendant Fuld accepted their demand in hopes of silencing Lehman's critics.

328. On June 12, *only three days* after the announcement of the second quarter loss, Lehman demoted defendants Callan and Gregory. Defendant Callan was a key participant in the Lehman's direct solicitation of Plaintiff to invest in the Offerings.

329. The selection of McDade to replace Gregory had significant ramifications. According to other Lehman executives, McDade had been jockeying for Fuld's own job. Among the consequences of the appointment of McDade was an ugly standoff at the very top of the firm over strategy and control. When it came to making crucial decisions that could have saved the firm, senior Lehman management became paralyzed. Isaacs, the London-based Head of European and Asian Operations, wanted the job and handed in his resignation on the day of McDade's appointment on June 12. Isaacs was responsible for half of Lehman's revenues and wanted equivalent recognition and power. Tellingly, his departure from Lehman was not announced until September 6, 2008. Defendant Fuld had determined not to reveal Isaacs' departure to the market, fearing a negative reaction, especially given the European and Asian operations recent and essential contributions to revenue as a result of Isaacs' leadership.

330. The fissure that already had existed between Lehman's New York operations and the very profitable London operations widened, and when the bankruptcy was filed, only the North American part of the Company filed, leaving the European and Asian operations in a lurch with no funding.

331. According to Treasury Secretary Paulson, after "Lehman announced bad earnings around the middle of June," the Federal Reserve "***told Fuld that if he didn't have a solution by the time he announced his third-quarter earnings, there would be a serious problem***...We pressed him to get a buyer." (Emphasis added).

332. During the Summer of 2008, Lehman, not wanting to be seen using the Federal Reserve credit facility so often, borrowed extensively from the European Central Bank through Lehman's Frankfurt operation. It is estimated that Lehman borrowed between $5 and $9 billion from the European Central Bank. This was not disclosed to the market and was directly opposite to what defendant Callan had told the Division about Lehman not using or needing the Federal Reserve credit facility and what other Lehman executives were saying about the Company's purportedly strong liquidity.

333. In addition, Lehman also reportedly did access the Federal Reserve credit facility in the Summer and borrowed needed cash by using new, highly rated securities backed by illiquid and unsaleable leveraged buyout loans as collateral. Such abuses of the system has recently led the Federal Reserve to change its rules for access to its credit facility.

334. Discussions within the firm included spinning off the bad real estate assets, selling the important IMD, finding a strategic investor to shore up confidence, and the obvious solution, to sell the whole Company.

335. According to Gowers, there were two problems with the obvious solution of selling the Company: "Dick Fuld and Bart McDade."

336. According to Gowers, "Lehman Brothers had been Fuld's life for 42 years. He had no desire to become part of a larger conglomerate or take orders from elsewhere. And he had a very clear view of what the firm was worth – a lot more than the market indicated."

337. According to Gowers, "As for McDade, he had his own reasons to find a sale of the firm less than appealing. It might extinguish his hopes of ousting Fuld and landing the top job for himself." According to another former executive: "Bart was completely fixated on controlling the firm at all costs. He thought it was only a matter of time before he could oust Fuld and take the prize."

338. According to Gowers, as the Summer wore on and Lehman's position weakened, the circle of interested investors shrank to one: KDB. According to Lehman insiders, the talks initiated by Isaacs' international team in Asia with KDB were serious.

339. As it would be for Barclays and Bank of America in September, the problem in the deal with KDB lay in the tens of billions of dollars of commercial real estate assets sitting on Lehman's balance sheet which had current and future losses. Before KDB would seal the deal, KDB wanted comfort that the toxic assets would be spun off into a separate capitalized entity limiting KDB's exposure. Lehman management was unable to meet the demand and shortly before Labor Day, the Koreans pulled out, furiously accusing McDade in particular of acting in bad faith. McDade produced to KDB new data about commercial real estate losses in late August. Supporters of Isaacs accused McDade of doing this to stop Isaacs from winning the kudos of saving Lehman, and with it the possibility of being appointed to defendant Fuld's job as CEO.

340. On September 9, 2008, the news surfaced in the market that KDB had ended discussions with Lehman. Lehman's stock plunged 45%, its largest daily percentage decline ever.

341. JPMorgan was Lehman's clearing bank, acting as the financial middleman between Lehman and its clients. As such, JPMorgan knew more about Lehman's financial

predicament than most outsiders, and it did not like what it saw. JPMorgan demanded $5 billion in additional collateral – liquid securities to cover lending positions that JPMorgan's clients had with Lehman.

342. On September 9, Steven Black, co-CEO of JPMorgan's Investment Bank, phoned Fuld. He told the Lehman CEO that in order to protect itself and its clients, JPMorgan needed an additional $5 billion in collateral. This $5 billion in additional collateral was over and above the $5 billion JPMorgan had demanded five days earlier on September 4, which had yet to be paid. Defendant Fuld managed to persuade Black to settle for $3 billion right away, leaving the prior $5 billion request unresolved.

343. This $10 billion capital call was well beyond the $500 million exposure that defendant Callan had disclosed to the Division.

344. Meanwhile, Lehman executives arranged a conference call for September 10 to announce earnings ahead of schedule and to disclose plans for a restructuring. That evening, investment bankers who were meeting with Lehman, counseled Lehman executives against holding the conference call, warning that there were too many open questions about the Company's finances. Top Lehman executives discussed the need to raise between $3 billion and $5 billion to shore up capital by early 2009. Documents that discussed this need for more capital were circulated to senior Lehman executives. This need for capital was not disclosed to the market.

345. Early the next morning, September 10, Lehman went ahead and hosted the conference call for investors anyway. The Company announced that it expected its largest quarterly loss ever, $3.9 billion, driven largely by declines in real estate valuations. Defendant Fuld said the firm intended to sell a majority stake in its IMD, spin off its commercial real estate

division and cut its dividend. Lehman executives, however, did not say anything about the need to raise capital. Mike Mayo, a Deutsche Bank AG bank analyst, asked whether Lehman would need to raise $4 billion as part of the plan, according to the transcript of the conference call. Lehman's CFO, defendant Lowitt, replied: "We don't feel that we need to raise that extra amount." At another point, defendant Lowitt said: "Our capital position at the moment is strong."

346. By the following day, September 11, the price of Lehman's credit default swaps, the cost to protect against losses on $10 million of its debt for five years had soared to $800,000 a year from $219,000 at the end of May 2008. Clients began getting concerned. None of them wanted to have money tied up with Lehman if it filed for bankruptcy protection. Christian Lawless, a Senior Vice President in Lehman's European Mortgage Operation, says he fielded numerous calls from investors seeking to pull out assets. "You guys are financial professionals," he recalls telling some skittish clients: "Our balance sheet is better than ever."

347. In early September, GLG Partners, a large London hedge fund in which Lehman held a stake, had grown increasingly concerned. In a series of calls, defendant Fuld and other Lehman executives assured GLG Partners that Lehman would survive.

348. On information and belief, many similar calls were made by Lehman executives assuring them that Lehman was in good shape and would survive.

349. JPMorgan as the clearing bank for Lehman was particularly concerned. Jane Byers Russo, Head of JPMorgan's Broker Unit, phoned Lehman's Treasurer, Paolo Tonuci, to tell him Lehman would have to turn over the $5 billion in collateral that JPMorgan had asked for days earlier. Fulfilling the request temporarily froze Lehman's computerized trading system. It immediately left the firm without sufficient capital to fund its trading and other operations.

Federal officials worked at Lehman's headquarters with its executives to determine which of its assets were not already pledged to other lenders and could be used as collateral for a federal loan. Lehman borrowed roughly $30 billion from the Federal Reserve on an overnight basis, paying it back by Saturday.

350. Over the weekend following the close of the market on September 12, Lehman hoped to strike a deal to sell itself to Bank of America or Barclays. Neither Barclays nor Bank of America, however, was interested in buying Lehman's commercial real estate operation. The Federal Reserve asked executives from a group of firms including Goldman Sachs Group, Inc. and Credit Suisse to value Lehman's massive commercial real estate portfolio and to consider investing several billion dollars each to buy it. The executives questioned defendant Walsh, then Lehman's Global Head of Commercial Real Estate. They wanted to know why Lehman had not more aggressively marked down, or cut in value its $32.6 billion commercial real estate holdings. Executives looking at Lehman's books were surprised by Lehman's high valuations on its real estate assets. Two Wall Street executives who reviewed Lehman real estate documents say they believe the firm's real estate valuations were roughly 35% higher than they should be. Some of its European real estate loans raised particular concern. According to a Lehman document reviewed by the *Wall Street Journal,* Lehman marked some European securities backed by real estate loans at 97.9% of par value, or nearly 98¢ on the dollar. Lehman valued similar U.S. assets at 56¢ on the dollar. While the European market for such securities had been slightly better than the U.S. market, it had also been hammered by the credit crisis. Further, Lehman executives knew for example that one of their CMBS, Windermere XII, had received a very poor market reception and was certainly not worth anywhere near 98¢ on the dollar. In

September 2008, Lehman received from Cushman & Wakefield an appraisal which decreased the overall value of the Coeur Defense project by nearly 20% from its original purchase price.

351. Yet, Lehman executives continued to falsely represent that Lehman's real estate portfolio was properly valued. On the September 10 conference call, defendant Lowitt, the CFO, said the firm's recent sales of real estate assets had been "in and around our marks."

352. By Sunday, September 14, 2008, Lehman had run out of options. Neither Barclays, nor Bank of America, would commit to a deal unless the government agreed to guarantee it. Shortly after midnight on September 15, Lehman sought Chapter 11 bankruptcy protection.

353. On September 15, Lehman's broker dealer arm, LBI, which had not itself sought bankruptcy protection, borrowed $45.5 billion from the Federal Reserve credit facility.

354. That same day, Barclays re-started talks with Lehman. The following day, September 16, Barclays agreed to buy the bulk of Lehman's North American business for $1.54 billion. Of the portfolio of assets that Barclays acquired from Lehman, less than 5% were regarded as mortgage-related. Barclays also bought Lehman's global headquarters at 745 Seventh Avenue in New York and two data centers in New Jersey for $1.5 billion.

355. The following week, LBI was placed into liquidation under SIPA.

B. Knowledge of Lehman Executives Concerning Risk Management And Hedging Misrepresentations

356. Defendant Fuld recognized the risk that would confront Lehman in 2008 when he spoke privately at a luncheon at the World Economic Forum in Davos in January 2007 to other attendees at his table, according to Gowers. Defendant Fuld was worried that: "This could be the year when the markets crack. Trouble might come from the U.S. housing market, from the excesses of leverage finance, from spiraling oil prices or a combination of all three." According

to defendant Fuld, Lehman, true to its tradition of strong risk management and fleet-footed investment decisions had become more cautious and defendant Fuld indicated Lehman "had taken a bit of money off the table." This was in fact untrue. As detailed above, Lehman increased its exposure to leverage finance and real estate in 2007.

357. As defendant Fuld was privately mussing about his worries concerning risk, defendant Gregory in 2007 was actively urging divisional managers at Lehman to place even more aggressive bets in the mortgage and commercial real estate asset markets.

358. Those who raised concerns over the Company's risk management and exposure to mortgage-related investments were replaced. For example, as both Michael Gelband ("Gelband"), head of Lehman's Fixed Income Division, and Madelyn Antoncic ("Antoncic"), Lehman's Chief Risk Officer, were "pushed aside" after they "urged caution" with respect to Lehman's mortgage positions. Gelband left Lehman's Fixed Income Division in May 2007 to become head of Global Markets after he "balked at taking more risk." In September 2007, Lehman removed Antoncic as Chief Risk Officer and reassigned her to a government relations positions within the Company.

359. After Gelband departed, the position of Head of Lehman's Fixed Income Division became a revolving door. Gelband's successor, Roger Nagioff, quit in the beginning of 2008, after realizing he could not understand Lehman's mortgage-related positions, and was replaced by Andrew Morton, who was fired at the end of August 2008.

360. Internal Lehman documents from as early as 2006 discussed how a meltdown in the commercial mortgage market would follow a meltdown in the residential mortgage market. With the subprime mortgage meltdown in mid-2007, Lehman's executives were aware of the danger to the commercial mortgage and CMBS markets by mid-2007.

361. As Lehman's peer bank competitors began recognizing losses on mortgage-related securities by the Fall of 2007, Lehman both internally and externally touted that they were better positioned due to the Company's success in hedging. On November 14, 2007, during the Merrill Lynch Banking and Financial Services Conference (the "Merrill Banking Conference"), defendant Lowitt stated, regarding Lehman's ability to hedge the mortgage markets, "[w]e've had ***success in our hedging and so we don't believe that there will be any requirement for substantial markdowns and certainly no requirement for us to announce anything. We're very comfortable with where we are with regard to that.***"

362. Lehman's supposed hedging prowess and stellar financial results continued to impress analysts. In a November 15, 2007 report issued by the research firm Punk Ziegel & Company following defendant Lowitt's statements at the Merrill Banking Conference, analyst Richard Bove stated:

> **Unlike numbers of its competitors, Lehman suggested that there will not be a meaningful mark down. In fact, the company suggested that it was short many of the offending securities. This would mean that Lehman could make money where others are losing.**
>
> * * *
>
> **However, Lehman went beyond these assertions suggesting that it had no major losses in the impacted areas for the industry. The company argued that its business is benefiting from the problems surfacing elsewhere. In essence, as customers move their accounts away from impacted firms, Lehman along with Goldman Sachs (GS/233.31/Market perform) is getting the business.**

Internally, defendant Fuld and Lehman executives congratulated themselves on Lehman's clever hedging strategies.

363. On December 13, 2007, Lehman, after issuing a press release announcing its third quarter results, held a conference call to discuss the foregoing results. On the call, commenting

on the Company's strong financial results, defendant O'Meara stated, "it reflects the strength of our management culture in terms of managing our overall risk appetite, seeking appropriate risk reward dynamics and exercising diligence around risk mitigation" and "reinforces the importance of our disciplined liquidity and capital management framework which sets up to operate our business through periods of market stress."

> In terms of our mortgage inventory at year end, this totaled $91 billion, reflecting in part the decline in securitization activity over the period. Of this, $12 billion reflects those amounts we have sold to third parties but have to gross up under FAS 140 and we are not at risk for. The remaining $79 billion is roughly evenly split between residential mortgage-related inventory and commercial mortgage-related inventory. Within the residential mortgage piece, our subprime balance sheet exposure amounted to $5.3 billion, compared to $6.3 billion last quarter.
>
> This $5.3 billion subprime breaks down as follows. 3.2 of whole loans, 1.9 of investment grade securities, and about $160 million of non investment grade securities and residuals. In addition, we had approximately $1 billion of ABS-CDOs on the balance sheet at quarter end. And after consideration of hedges, we remain modestly net short in the ABS-CDO asset class...**In terms of other exposures, we have largely mitigated our risk.**

364. Defendant Russo, Lehman's Vice Chairman, was quoted in a Bloomberg TV interview as saying: "Dick Fuld is very conscious of risk. He has created a culture that has enabled us to do fine." However, internally, executives at Lehman realized the precarious nature of the Company's risk position. Indeed, a January 2008 internal presentation made by Eric Felder, a Lehman executive, acknowledged that the mortgage crisis was having a severe impact on the Company's operations and liquidity position, as slides accompanying Felder's presentation stated that "[v]ery few of the top financial issuers have been able to escape damage from the subprime fallout." The presentation further presciently warned that, because "a small number of investors account for a large portion of demand [for Lehman issues], liquidity can disappear quite fast."

C. Compensation Was Awarded Despite Losses

365. The Lehman Defendants' fraudulent conduct was motivated by simple greed. Between 2004 and 2007, Lehman paid out a staggering $16 billion in bonuses to employees. Historically, Lehman's compensation ratio hovered around 50% of net revenues. The bonuses continued at the same dollar level even when the Company declared losses in 2008. Defendant Fuld received over $260 million in compensation during these years.

366. For 2007, in the midst of declines in the mortgage and mortgage-securitizations markets, Lehman, upon reporting record earnings, paid out in total compensation over $9.5 billion – 9.5 percent more than the previous year – to its employees. For the year, defendant O'Meara received total compensation of $9,492,857, defendant Gregory received total compensation of $34 million, including restricted stock of $29 million, and defendant Lowitt received total compensation of $9.49 million, while defendant Fuld received an astounding $40 million in total compensation.

367. In fact, compensation for senior Lehman executives was so outlandish that in June 2008 managers at Lehman's money management subsidiary, Neuberger Berman ("Neuberger"), suggested that Fuld and other Defendants should forgo bonuses for 2008, thereby significantly reducing expenses and sending the message to both employees and investors that management is not shirking accountability for their recent lackluster performance. In early June of 2008, senior executives at Neuberger, sent an e-mail to Defendant Fuld and his Executive Committee as follows: "As long term employees and former partners of Neuberger Berman, we feel compelled to express our views on several matters to members of Lehman's Executive Committee." Lehman has made "management mistakes," and "a substantial portion of the problems at Lehman are structural rather than merely cyclical in nature." The e-mail recommended two

actions: "top management should forego bonuses this year. This would serve a dual purpose. Firstly, it would represent a significant expense reduction. Secondly, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance." The second action recommended by the e-mail was "do a partial spinout of [Neuberger]. A partial spinout could be an attractive source of capital for Lehman at a time when the company needs capital." Yet, instead of welcoming Neuberger's sensible suggestion, within fifteen minutes of receipt of the e-mail, George W. Walker, Lehman's Global Head of Investment Management, responded: "Sorry team. I am not sure of what is in the water at 605 Third Avenue today. The compensation issue she raises is hardly worth the EC's [Executive Committee's] time now. I am embarrassed and I apologize." Defendant Fuld further replied: "They are only people who think about their own pockets."

368. Lehman paid out $2.3 billion in bonuses for the second quarter of 2008, even though revenues were a negative $700 million. This was up 27.7% from $1.8 billion paid out in the second quarter of 2007 when revenues were positive.

369. In July 2008, Lehman employees received an unscheduled equity award to enable them to benefit from the plunge in Lehman shares to $27.

370. On September 11, 2008, a memorandum written by the Compensation Committee proposed giving two senior employees additional compensation despite the fact they had been fired. The memorandum proposed giving Andrew Morton, the former Global Head of Fixed Income, a $2 million cash payment and Benoit Savoret, the former Chief Operating Officer of Europe and the Middle East, a $16 million cash payment.

371. The payment of such large amounts of compensation was inappropriate given the circumstances of Lehman's then-existing financial condition.

D. The Board, the Director Defendants, Negligently and Recklessly Rubber Stamped the Actions of the Officer Defendants and Walsh

372. The supine Board that defendant Fuld hand-picked provided no backstop to Lehman's executives' zealous approach to the Company's risk profile, real estate portfolio and their own compensation. The Director Defendants were considered inattentive, elderly and woefully short on relevant structured finance expertise. Many of them were professional directors, but without any financial background. The composition of the Board according to a recent filing in the Lehman bankruptcy allowed defendant "Fuld to marginalize the Directors, who tolerated an absence of checks and balances at Lehman."

373. Due to his long tenure and ubiquity at Lehman, defendant Fuld has been able to consolidate his power to a remarkable degree. Defendant Fuld was both the Chairman of the Board and the CEO, a combination that is becoming more and more unusual as trends in corporate governance have counseled for separating the positions, and the leader of Lehman's two-person Board executive committee. The Board executive committee was responsible for making important decisions between Board meetings of the Director Defendants. While the Board executive committee met a reported 16 times in 2007, the full Board met only 8 times. The other executive committee member responsible was John Macomber, who had served as a Director for 14 years and largely deferred to defendant Fuld.

374. The Director Defendants acted as a rubber stamp for the actions of Lehman's senior management. There was little turn-over on the Board. By the date of Lehman's collapse, more than half of the Director Defendants had served for 12 or more years. Service as a Director of Lehman was lucrative. In 2007 alone, Director Defendants received collective compensation of more than $3.2 million in cash and common shares from Lehman.

375. The Director Defendants acted complacently in 2007 as Lehman continued to provide billion of dollars in subprime loans, even though the United States housing market was tanking and many banks were closing their subprime operations. After the Bear Stearns hedge funds collapsed in 2007, the Director Defendants neither inquired about nor acted on concerns and investor questions regarding Lehman's subprime exposure or the contagion to Lehman's other real estate assets. Their lack of concern is exemplified by the fact that the Finance and Risk Committee of the Board met only twice in 2007. Similarly, they provided no restrictions on Lehman's executives in the first quarter of 2008 with regard to Lehman's real estate expenses. Even after Lehman announced its first-ever quarterly loss in the second quarter of 2008, the Director Defendants did nothing to examine the Company's financial position or to alter its course.

376. Lehman Defendants, including the Director Defendants, knew or disregarded before September 10, 2008 that the Company would fail if a merger or government bailout did not occur, yet no one counseled for a sale of the Company. Indeed, as of September 10, 2008, the Company's only alternatives to avoid bankruptcy were either: (i) a possible business combination with Barclays or Bank of America; or (ii) a government bailout. Neither occurred.

E. Causes of Action Under State Law

COUNT IV

Violations of Section 14(a) of the New Jersey Uniform Securities Law Against All Defendants (N.J.S.A. 49:3-71(a))

377. Plaintiff repeats and realleges each and every allegation of paragraphs 1 through 376 as if fully set forth herein. This claim is asserted under Section 14(a) of the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq. (the "NJ Securities Law") against the Defendants.

378. Plaintiff purchased Lehman securities issued pursuant to the Registration Statement, Prospectuses and statements made by Lehman Defendants. The Registration Statements and the Prospectuses were signed by or on behalf of the Securities Act Defendants, and contained financial statements of Lehman audited and reviewed by E&Y.

379. The Registration Statement and Prospectuses, each of which incorporated certain public disclosures by reference, at the time they were issued and became effective, were inaccurate and misleading, contained untrue statements of material fact and/or omitted to state material facts necessary to make the statements made therein not misleading, as set forth above. The matters detailed above would have been material to a reasonable person reviewing the Registration Statements, the Prospectuses and the financial statements incorporated therein.

380. The Defendants were responsible for the contents and dissemination of the Registration Statement and Prospectuses and are liable under Section 14(a) of the NJ Securities Law for any material misrepresentations or omissions contained therein. Defendants did not make a reasonable investigation and did not possess reasonable grounds for believing that the statements contained in the Registration Statement and Prospectuses were true, did not omit any material fact, and were not materially misleading.

381. The Defendants owed Plaintiff the duty to make a reasonable and diligent investigation of the statements contained in the Registration Statement and Prospectuses at the time they became effective, to ensure that they 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 no misleading. In the exercise of reasonable care, the Defendants knew or should have known of material misstatements and omissions contained in the Registration Statement and Prospectuses.

382. In addition, Lehman Defendants engaged in direct contact with Plaintiff that operated as a fraud and deceit upon the Division to induce it to buy the Offerings.

383. Plaintiff did not know or in the exercise of due diligence could not have known of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses including the public disclosures incorporated by reference therein.

384. Plaintiff has sustained damages as a result of the misstatements and omissions of material fact contained in the Registration Statement and Prospectuses and in the statements made by the Lehman Defendants for which Plaintiff is entitled to compensation.

COUNT V

Negligent Misrepresentation Against All Defendants

385. Plaintiff realleges and reasserts each of the foregoing paragraphs 1 through 384 as if fully set forth herein.

386. This Count is brought against all Defendants.

387. In order to induce Plaintiff to invest in the Offerings, Defendants negligently made numerous affirmative misrepresentations and negligently withheld material facts to Plaintiff, including those contained in press releases, public statements, public filings, the Registration Statement, the Prospectuses and other disclosures made by Defendants, all as described above.

388. The Defendants made numerous false and misleading statements involving facts and/or omitted to state to the Plaintiff facts necessary to make the statements which they made not misleading relating to the financial condition of Lehman. The defendants' statements and omissions were negligent, material and made with knowledge of their materially false and misleading character, or with negligent indifference to their truth or falsity, with the intention

and expectation that the Division would rely on them or, in the case of omissions, were ignorant of them in purchasing and/or holding Lehman securities.

389. The Defendants' negligent misrepresentations and omissions are set forth more fully elsewhere in this complaint, and include, without limitation, the following:

a. that Lehman's financial results were free of material misstatement and "fairly present" the Company's financial results;

b. that Lehman's accounting practices conformed to GAAP and SEC regulations;

c. that Lehman's risk management was effective and Lehman's exposures were well-hedged;

d. that Lehman timely and properly took appropriate charges to write down the value of certain of its assets, including its mortgage-backed assets and its commercial real estate holdings;

e. that Lehman's liquidity position was strong;

f. that Lehman would not use or need to use the Federal Reserve credit facilities to support its liquidity;

g. that Lehman's Level 2 and Level 3 assets were appropriately valued; and

h. that Lehman would only be exposed to a $500 million collateral call if there was a rating downgrade of the Company.

390. Specifically, Lehman Defendants negligently failed to disclose Lehman's exposure to losses from its real estate-related investments and its failure to write down its real estate and mortgage-related assets to reflect their true fair value. Moreover, Lehman Defendants negligently failed to disclose that certain mortgage-related assets, including Alt-A mortgages and

securitizations and real estate holdings, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses.

391. E&Y negligently consented to the reissuance and incorporation of its unqualified audit report on Lehman's financial statements contained in the 2007 Form 10-K in the Prospectuses and to the incorporation of its reviews of Lehman's second quarter of 2008 financial statement, and Lehman's financial results for the second quarter of 2008, which they knew and intended would be read and relied upon by investors in the Offerings, like Plaintiff, and which were in fact read and relied upon Plaintiff in making its investment decisions.

392. Such affirmative misrepresentations and omissions of material fact were made negligently by Defendants with the purpose to induce Plaintiff to purchase the Offerings.

393. Plaintiff reasonably relied on these negligent affirmative misrepresentations and negligent omissions of material fact, including E&Y's consent to reissue E&Y's unqualified audit opinion and E&Y's review of Lehman's 2008 first quarter financial statements and Lehman's financial results for the second quarter of 2008, in investing in and holding Lehman securities.

394. But for the negligent affirmative misrepresentations and omissions of material facts of defendants, Plaintiff would not have purchased the Offerings.

395. As a direct and proximate result of Defendant's misrepresentations and omissions of material fact, Plaintiff has suffered economic losses in an amount to be determined at trial.

COUNT VI

Fraud Against the Officer Defendants

396. Plaintiff repeats and realleges each of the foregoing paragraphs 1 through 395 as if fully set forth herein except those allegations alleging that the Officer Defendants acted only negligently.

397. This Count is brought against the Officer Defendants.

398. Officer Defendants made material misrepresentations and omissions to Plaintiff that were false and misleading, including those contained in press releases, public statements, financial statements, registration statements, prospectuses and other disclosures made by Officer Defendants, all described above.

399. The Officer Defendants made numerous false and misleading statements involving facts and/or omitted to state to the Plaintiff facts necessary to make the statements which they made not misleading relating to the financial condition of Lehman. The Officer Defendants' statements and omissions were fraudulent, material and made with knowledge of their materially false and misleading character, or with reckless indifference to their truth or falsity, with the intention and expectation that the Division would rely on them or, in the case of omissions, were ignorant of them in purchasing and/or holding Lehman securities.

400. The Officer Defendants' fraudulent misrepresentations are set forth more fully elsewhere in this complaint, and include, without limitation, the following:

a. that Lehman's financial results were free of material misstatement and "fairly present" the Company's financial results;

b. that Lehman's accounting practices conformed to GAAP and SEC regulations;

c. that Lehman's risk management was effective and Lehman's exposures were well-hedged;

d. that Lehman timely and properly took appropriate charges to write down the value of certain of its assets, including its mortgage-related assets and commercial estate holdings;

e. that Lehman's liquidity position was strong;

f. that Lehman would not use or need to use the Federal Reserve credit facilities to support its liquidity;

g. that Lehman's Level 2 and Level 3 assets were appropriately valued; and

h. that Lehman would only be exposed to a $500 million collateral call if there was a rating downgrade of the Company.

401. The Officer Defendants failed to disclose Lehman's exposure to losses from its real estate investments and its failure to write down real estate and mortgage-related assets to reflect their true fair value. Moreover, the Officer Defendants failed to disclose that certain mortgage-related assets, including Alt-A mortgages and securitizations and real estate holdings, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses.

402. The Officer Defendants had reason to expect that the Division would rely on Officer Defendants' fraudulent misrepresentations and material omissions. Moreover, Officer Defendants knew or should have known that it was the regular practice of the State's Division to monitor and review the kinds of sources in which Officer Defendants' fraudulent misrepresentations and material omissions were contained, and knew that their private conversations with the Division would be considered material to its investment decisions.

403. The Division did in fact rely on the Officer Defendants' fraudulent misrepresentations and material omissions in making its decisions to acquire and hold Lehman securities, and the State's reliance was reasonable. Unlike many investors who rely on third parties to manage their investments, the Division employs its own investment analysts, whose standard practice was to monitor and take into account, and who did monitor and take into account, pertinent materials including, but not limited to, Company SEC filings, corporate financial statements and reports, press releases, and other communications originating from Lehman. The Division reasonably relied on those materials, and on the misrepresentations and the fraudulent and misleading statements contained therein, in its decisions to acquire and hold Lehman securities, as well as the direct statements to the Division made by the Officer Defendants.

404. By reason of the Division's reasonable reliance on Defendants' fraudulent misrepresentations and omissions, and as a proximate result thereof, the Division has suffered pecuniary harm in an amount to be proven at trial, and the Officer Defendants are liable to the Division, jointly and severally, for all damages sustained by the Division.

COUNT VII

Aiding and Abetting Fraud Against All Defendants

405. Plaintiff realleges and reasserts each of the foregoing paragraphs 1 through 404 as if fully set forth herein except those allegations alleging that any of the Defendants acted only negligently.

406. This Count is brought against all the Lehman Defendants and E&Y.

407. All Defendants including E&Y aided and abetted the Officer Defendants in committing fraud upon Plaintiff by their active participation, aid, encouragement, and/or ratification of the fraud alleged in this complaint, for their own benefit.

408. Specifically, the Lehman Defendants aided and abetted the fraud of the Officer Defendants by failing to disclose Lehman's exposure to losses from its real estate-related investments and its failure to write down real estate investments and mortgage-related assets to reflect their true fair value. Moreover, Defendants failed to disclose that certain mortgage-related assets, including Alt-A mortgages and securitizations and real estate holdings, could not be effectively hedged to mitigate losses, and that Lehman's hedging activities exposed investors to additional losses. Additionally, E&Y aided and abetted the fraud by issuing an unqualified audit opinion on Lehman's financial statements in 2007 and reviewing the quarterly financial results for the first and second quarter of 2008, which they knew and intended would be read and relied upon by prospective and existing investors in Lehman securities, like the State, and which were in fact read and relied upon by the Division in making its investment decisions.

409. The acts of the Lehman Defendants and E&Y constitute the active participation, aid, encouragement, or ratification of the committing of fraud by the Officer Defendants upon the State of New Jersey, all as alleged above.

410. The Lehman Defendants' participation, aid, encouragement and/or ratification of the committing of fraud by the Officer Defendants upon Plaintiff was done for their benefit, to protect their compensation as officers and directors, and to facilitate and protect the payment of hundreds of billions of dollars in bonuses and total compensation as officers.

411. E&Y's participation, aid, encouragement and/or ratification of the common plan or design to commit fraud upon Plaintiff and the investing public was done for its benefit, which

included, among other things, securing substantial compensation totaling in the millions of dollars from accounting and auditing services its provided to Lehman.

412. By virtue of Defendants' conduct in aiding and abetting the fraud, Plaintiff has suffered economic harm in an amount to be proven at trial and the Lehman Defendants and E&Y are liable to the Division, jointly and severally, for all damages sustained by the Division.

COUNT VIII

Breach Of Fiduciary Duty Against All Lehman Defendants

413. Plaintiff realleges and reasserts each of the foregoing paragraphs 1 through 412 as if fully set forth herein.

414. This Count is brought against all Lehman Defendants who were officers and/or directors of Lehman and controlled LBI.

415. The Lehman Defendants, as officers and/or directors of Lehman, owed fiduciary duties to Plaintiff as holders of Lehman securities and as brokerage clients. These defendants further owed fiduciary obligations to Plaintiff as they sought to induce and did induce Plaintiff to purchase and hold the Lehman securities.

416. These Lehman Defendants owed Plaintiff a fiduciary duty to accurately and timely disclose the truth concerning the Company's actual financial performance and results. Lehman Defendants owed this duty by virtue of their status and positions as senior officials and/or directors of Lehman; their transactions in Lehman shares; their statements about the Company; and because of their superior knowledge, information and experience concerning the Company's affairs.

417. Plaintiff reasonably reposed trust and confidence in the integrity and fidelity of the Lehman Defendants' statements and conduct and, in the exercise of due diligence, could not have ascertained the truth until after Lehman filed bankruptcy.

418. As fiduciaries, these Lehman Defendants owed Lehman's shareholders duties of loyalty, good faith, due care and fair dealing, including but not limited to the following: to refrain from misleading the Division regarding the value of Lehman's assets, to refrain from doing any act injurious to the Division, to disclose all material, non-public information, to refrain from doing any injurious act to Plaintiff, or which would deprive Plaintiff of any profit or advantage, and to not elevate their own financial interests ahead of the interests of the Division and other Lehman investors.

419. These Lehman Defendants had insider knowledge of adverse non-public information regarding Lehman's financial condition and risk profile. Lehman Defendants concealed this adverse non-public information from the Plaintiff. In addition, several Officer Defendants and Walsh affirmatively misrepresented Lehman's financial condition and risk profile.

420. These Lehman Defendants violated their fiduciary duties to Plaintiff by virtue of the wrongs alleged in this complaint, and by placing their own financial interests ahead of those of Plaintiff.

421. As a direct and proximate result of Lehman Defendants' breaches of their fiduciary duties, the Division acquired and held Lehman securities at artificially inflated prices and was damaged thereby.

VI. PRAYER FOR RELIEF

WHEREFORE, Plaintiff The State of New Jersey, Department of Treasury, Division of Investment, prays for the following relief:

(a) Entering judgment against each of the Defendants, jointly and severally;

(b) Ordering Defendants, jointly and severally, to pay Plaintiff's compensatory, consequential, incidental and punitive damages to the full extent legally available, in an amount to be determined at trial;

(c) Awarding Plaintiff pre-judgment and post-judgment interest, as well as costs and reasonable attorneys' fees, expert witness fees and other costs as and to the extent permitted by law; and

(d) Awarding Plaintiff all such other and different relief as the Court deems just and proper.

VII. DEMAND FOR JURY TRIAL

Plaintiff demands a trial by jury on all issues so triable.

Dated: March 17, 2009

COHN LIFLAND PEARLMAN HERRMANN & KNOPF LLP

By: ______________________

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CERTIFICATION PURSUANT TO RULE 4:5-1

The undersigned hereby certifies that the within matter in controversy is not the subject of any pending or contemplated action or arbitration proceeding other than *Operative Plasterers and Cement Masons International Assn. Local 262 Annuity Fund v. Richard Fuld, Jr., et al.*, S.D.N.Y. 08-cv-5523 (LAK); *Capital Services Real Estate Ltd. v. Lehman Brothers Real Estate Partners, LP*, S.D.N.Y. 08-cv-9030; *Maria DeSousa v. Lehman Brothers Holdings, Inc., et al.*, S.D.N.Y. 08-cv-6626; *Monique Miller Fong v. Lehman Brothers Holdings, Inc., et al.*, S.D.N.Y. 08-cv-6282; *JoAnne Buzzo v. Lehman Brothers Holdings, Inc., et al.*, S.D.N.Y. 08-cv-6245; and *Alex Rinehart v. Lehman Brothers Holdings, Inc., et al.*, S.D.N.Y. 08-cv-5598, and such other actions that may be hereinafter instituted, and, subject to further discovery, knows of no additional parties who should be joined in this action.

I certify that the foregoing statements made by me are true. I am aware that if any of the foregoing statements made by me are willfully false, I am subject to punishment.

JEFFREY W. HERRMANN