11 CIV 0384

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK By ANDREW M. CUOMO, Attorney General of the State of New York,

Plaintiff,

v.

ERNST & YOUNG LLP,

Defendant.

11 Civ. ____

NOTICE OF REMOVAL

PLEASE TAKE NOTICE that Defendant Ernst & Young LLP ("EY"), pursuant to 28 U.S.C. §§ 1331 and 1441, and 15 U.S.C. § 78aa and 15 U.S.C. § 7202(b), hereby removes the above-captioned civil action from the Supreme Court of the State of New York, New York County, to the United States District Court for the Southern District of New York. EY appears for the purpose of removal only and for no other purpose and reserves all defenses and rights available to it, and states as follows:

1. On December 21, 2010, Plaintiff the People of the State of New York by Andrew M. Cuomo, the Attorney General of the State of New York (the "Attorney General"), filed this action in the Supreme Court of the State of New York, New York County, under Index No. 451586/2010. Also, on December 21, 2010, counsel for EY accepted service via email of the summons and complaint. Pursuant to Rule 81.1(b) of the Local Civil Rules of this District and 28 U.S.C. § 1446(a), a true and correct copy of all records and proceedings in the state court is attached hereto as Exhibit A.

2. This Notice is being timely filed under 28 U.S.C. § 1446(b), and this Court has jurisdiction over the parties.

3. Removal of this case is proper because there is federal-question jurisdiction over every cause of action in it, based on the express allegations of the Complaint. In particular, each cause of action is expressly predicated on (1) EY's alleged violation of the federal auditing standards promulgated by the Public Company Accounting Oversight Board ("PCAOB"), *see, e.g.*, Compl. ¶¶ 57, 67-70, and (2) EY's alleged false statements that it complied with those standards and that the financial statements of Lehman Brothers Holdings Inc. ("Lehman") complied with GAAP, *see, e.g.*, *id.* ¶¶ 58-61, 73, 77. All of the Attorney General's causes of action raise substantial federal issues that are necessary to their resolution, and therefore there is federal jurisdiction over all of them. *See Franchise Tax Bd. v. Const. Laborers Vacation Trust*, 463 U.S. 1, 8 (1983) (stating that federal district courts have original jurisdiction over actions in which the "plaintiff's right to relief necessarily depends on resolution of a substantial question of federal law"); *D'Alessio v. NYSE*, 258 F.3d 93, 100 (2d Cir. 2001) (finding substantial federal issue where state law claims required the court to construe "federal law governing securities trading on a national exchange and the NYSE's role, as defined under federal law, in enforcing and monitoring a member's compliance with those laws").

4. Moreover, there is exclusive federal jurisdiction over the Attorney General's claims pursuant to the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (the "Exchange Act") and the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 *et seq.* ("Sarbanes-Oxley"), which provide that there is exclusive federal jurisdiction over alleged violations of the federal auditing standards promulgated by the PCAOB and over actions brought to enforce those standards. *See* 15 U.S.C. §§ 78aa and 7202(b). Further, the Attorney General cannot establish the falsity of EY's statements regarding its audits and reviews of Lehman's financial statements without establishing EY's failure to comply with such standards, and additionally, EY's duty to issue

those statements (as well as the form and content of those statements) is prescribed by SEC and PCAOB rules under the Exchange Act. *See* 15 U.S.C. § 78m. Accordingly, EY's alleged false statements that it complied with federal auditing standards and that Lehman's financial statements complied with GAAP likewise are subject to the exclusive jurisdiction of the federal courts under the Exchange Act and Sarbanes-Oxley.

5. The Attorney General's claim that Lehman's public filings with the SEC omitted required information, *see, e.g.*, Compl. ¶¶ 32-35, 39, 62-64, 66, presents a related substantial federal question because that claim necessarily involves the construction and application of SEC standards governing the preparation of financial statements and Management's Discussion & Analysis. *See, e.g.*, *Gobble v. Hellman*, No. 02-0076, 2002 WL 34430286, at *3 (N.D. Ohio Mar. 26, 2002) (stating that interpreting SEC rules and regulations "is a matter of substantial federal concern" sufficient to support removal to federal court).

6. There is federal jurisdiction over all of the Attorney General's claims. However, federal-question jurisdiction over one claim is all that is needed to support removal. *Broder v. Cablevision Systems Corp.*, 418 F.3d 187, 195 (2d Cir. 2005) ("A single claim over which federal-question jurisdiction exists is sufficient to allow removal."). For any claims not independently subject to jurisdiction under 28 U.S.C. § 1331, 15 U.S.C. § 78aa or 15 U.S.C. § 7202(b), supplemental jurisdiction lies under 28 U.S.C. § 1367 because all claims in this case form part of the same case or controversy.

7. The Attorney General's allegations involve nearly identical facts and very similar legal issues to the numerous Lehman cases consolidated as part of the multi-district proceeding pending before the Honorable Lewis A. Kaplan under the caption, *In re Lehman Brothers Securities & ERISA Litigation*, No. 09-MD-2017 (LAK) (S.D.N.Y.). In the interests of judicial

efficiency, EY will file, in addition to this Notice of Removal, a request pursuant to Local Rule 1.6 that this action be assigned to the Honorable Lewis A. Kaplan, as related to *In re Lehman Brothers Securities & ERISA Litigation*, No. 09-MD-2017 (LAK) (S.D.N.Y.).

8. EY will promptly serve a copy of the Notice of Removal on the Attorney General and file with the Clerk of the Supreme Court of the State of New York, New York County, a Notice of Filing of Notice of Removal pursuant to 28 U.S.C. § 1446(d).

9. This Notice of Removal is signed pursuant to Fed. R. Civ. P. 11.

WHEREFORE, EY removes this action in its entirety from the Supreme Court of the State of New York, New York County to the United States District Court for the Southern District of New York.

Dated: New York, New York
January 19, 2011

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Exhibit A

FILED: NEW YORK COUNTY CLERK 12/21/2010 INDEX NO. 451586/2010
NYSCEF DOC. NO. 1 RECEIVED NYSCEF: 12/21/2010

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK
By ANDREW M. CUOMO, Attorney General of the State of New York,

Plaintiff,

- against -

ERNST & YOUNG LLP,

Defendant.

Index No.

SUMMONS

Plaintiff designated New York County as the place of Trial

TO THE ABOVE-NAMED DEFENDANT:

YOU ARE HEREBY SUMMONED to answer in this action and serve a copy of your answer, or if the complaint is not served with the summons to serve a notice of appearance, on the Plaintiff's attorney within twenty (20) days after the service of the summons, exclusive of the day of service. If the summons is not personally served upon you, or if the summons is served upon you outside of the State of New York, then your answer or notice of appearance must be served within thirty (30) days. In case of your failure to appear or answer, judgment will be taken against you by default, for the relief demanded in the complaint.

Dated: December 21, 2010
New York, New York

ANDREW M. CUOMO
Attorney General of the State of New York

MARIA T. VULLO
Executive Deputy Attorney General for Economic Justice

By: _____
MARIA T. VULLO

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK By ANDREW M. CUOMO, Attorney General of the State of New York, Plaintiff, - against - ERNST & YOUNG LLP, Defendant.	Index No. **COMPLAINT**

Plaintiff, the People of the State of New York, by Andrew M. Cuomo, Attorney General of the State of New York (the "Attorney General"), alleges upon information and belief the following against Ernst & Young LLP ("Defendant," or "E&Y").

PRELIMINARY STATEMENT

1. E&Y substantially assisted Lehman Brothers Holdings Inc. ("Lehman," or the "Company"), now bankrupt, to engage in a massive accounting fraud, involving the surreptitious removal of tens of billions of dollars of securities from Lehman's balance sheet in order to create a false impression of Lehman's liquidity, thereby defrauding the investing public. Called "Repo 105," these transactions, hatched in 2001, allowed Lehman to park tens of billions of dollars of highly liquid fixed income securities with European banks for the sole purpose of reducing Lehman's balance sheet leverage, and painting a false picture of an important financial metric for investors, stock analysts, lenders, and others involved with Lehman. The Repo 105 transactions involved nothing other than the transfer by Lehman of investment grade securities in return for

cash, which Lehman then used to pay down liabilities, with the binding understanding that Lehman would repurchase the same securities from the banks within a short time, often just a few days, in return for improved balance sheet "metrics." E&Y not only approved but consistently supported Lehman's Repo 105 policy, and advised Lehman that it could take advantage of a technical accounting rule, known as FAS 140, to treat these Repo 105 transactions, which in reality were short-term financings, as "sales," enabling Lehman to remove the securities from inventory on its financial statements until they were repurchased. As E&Y also knew, at no time did Lehman disclose, either in its financial statements or otherwise, that it was transferring tens of billions of dollars in fixed income securities to foreign banks, on a temporary basis, often at the very end of Lehman's fiscal quarters, with the obligation to quickly repurchase the securities.

2. These Repo 105 transactions had no independent business purpose and were designed solely to enable Lehman to manage the company's financial balance sheet "metrics." In fact, a number of senior financial executives at Lehman warned management that the transactions were improper. Nevertheless, Lehman used the transactions aggressively, and issued financial statements, audited, reviewed, and approved by E&Y, that concealed the transactions and created a highly misleading picture of Lehman's true leverage. Not only were the transactions concealed, but Lehman's financial statements affirmatively, and falsely, stated that the only securities subject to repurchase ("repo") agreements were "collateralized agreements and financings" (*i.e.*, loans), even though, as E&Y well knew, Lehman was treating the transfer of tens of billions of dollars of securities in Repo 105 transactions as "sales," not "loans." Rather than expose this fraud as auditors must, E&Y expressly "approved" this practice

in 2001, and, year after year thereafter, E&Y gave clean opinions on Lehman's financial statements even though the statements concealed the massive Repo 105 transactions.

3. Moreover, at a time when disclosure was most warranted, when Lehman was facing severe liquidity problems in 2007 and 2008, and its leverage was too high in the view of the financial community on which Lehman depended for capital, the fraud grew even larger. By 2007, analysts and other market participants called upon Lehman and other investment banks to reduce their leverage. Lehman responded by frantically accelerating the use of Repo 105 transactions, which gave the false impression of reduced leverage. At the end of each quarter from 2007 until Lehman's collapse in September 2008, Lehman used the Repo 105 transactions to transfer up to $50 billion of fixed income securities for the sole purpose of reducing reported leverage.

4. Thus, as the financial crisis deepened in 2007 and 2008 and Lehman's liquidity problems intensified, E&Y was aware that Lehman was dramatically increasing the Repo 105 transactions in a desperate effort to stave off collapse. At a time when it was critical for investors to make informed decisions as to whether to keep or buy Lehman stock, E&Y assisted Lehman in defrauding the public about the Company's deteriorating financial condition, particularly its leverage. The Repo 105 transactions concealed the full extent of Lehman's liquidity problem by mitigating the adverse impact its increasingly "sticky"/illiquid inventory – comprised mostly of leveraged loans and residential and commercial real estate positions – was having on the Company's publicly reported leverage. This risk ultimately materialized when Lehman declared bankruptcy in September 2008, due to liquidity problems.

5. E&Y knew every significant aspect of Lehman's Repo 105 transactions, and knew that the Lehman financial statements violated Generally Accepted Accounting Principles

("GAAP"), which require that such statements (a) not be misleading, (b) fairly disclose the Company's financial position, and (c) not omit material information necessary to fairly present the financial position. As the public auditor for Lehman, E&Y had the absolute obligation to ensure that Lehman's financial statements complied with GAAP and did not mislead the public. Instead of fulfilling this obligation, E&Y gave a clean opinion each year, erroneously stating that Lehman's financial statements complied with GAAP. E&Y sat by silently while Lehman deceived the public by concealing the Repo 105 transactions and misrepresenting the Company's leverage. By doing so, E&Y directly facilitated a major accounting fraud, and helped Lehman mislead the public as to its true financial condition. E&Y, which reaped over $150 million in fees from Lehman, must be held accountable for its role in this fraud.

JURISDICTION AND VENUE

6. The Attorney General has an interest in the economic health and well-being of investors who reside or transact business within the State of New York, and E&Y's conduct has injured these interests. Accordingly, the State of New York brings this action in its sovereign and quasi-sovereign capacity pursuant to Executive Law §§ 63(1) and 63(12) and General Business Law §§ 352 *et seq.* (the "Martin Act").

7. Pursuant to Executive Law § 63(12), the Attorney General is authorized to bring an action for restitution, damages, and other relief in connection with repeated fraudulent or illegal acts or persistent fraud or illegality in the carrying on of any business.

8. Pursuant to the Martin Act, the Attorney General is authorized to bring an action for restitution, damages, and other relief in connection with fraudulent practices regarding the purchase, sale, promotion, exchange, negotiation or distribution within or from this State of securities.

9. Defendant's actions originated from New York, where Defendant resides and conducts business. Numerous New York investors, as well as the interests of the State of New York, were harmed substantially by Defendant's conduct.

PARTIES

10. Plaintiff Andrew Cuomo is the Attorney General of the State of New York and brings this action on behalf of the People of the State of New York and, in particular, to fulfill the Attorney General's role to protect the integrity of the securities markets.

11. Defendant E&Y is a limited liability partnership headquartered in New York and is one of the largest accounting firms in the United States and, indeed, the world. For the relevant period, 2001 through September 2008, E&Y acted as auditor for Lehman, and also rendered significant accounting, tax and advisory services. Lehman was one of E&Y's biggest clients, with numerous E&Y accountants working on a given audit. In return, E&Y received over $150 million in compensation for the period 2001, when Lehman began Repo 105 transactions, through Lehman's bankruptcy in September 2008. As one witness stated, E&Y's "primary responsibility ... [wa]s to perform ... audit procedures to ensure that the financial statements [we]re not materially misstated. And if during the course of those procedures [E&Y] c[a]me across a risk that there might be something that could be perceived negatively by the public that the company is doing, then ... [E&Y] would ask more questions...." E&Y also reviewed Lehman's quarterly disclosure documents, reviewing the Form 10-Qs to certify that "nothing [had] c[o]me to [E&Y's] attention that ... material modification is needed for the financial statements in accordance with GAAP."

FACTUAL ALLEGATIONS

I. Background

12. "Repo transactions" are financing arrangements pursuant to which a financial institution uses securities as collateral for short term loans, with an agreement to repurchase the same (or equivalent) securities at a later date. These transactions are recorded on the books as financings, meaning that the company keeps the securities as part of its inventory, while recording the receipt of cash from the loan and a concurrent obligation to repay the loan as a liability.

13. For many years Lehman engaged in such repo transactions, which it accounted for as financings, by recording the assets (the proceeds of the loans) and the liabilities (the obligation to repay the loans). Leverage is the ratio of assets to equity (assets minus liabilities). In addition, Lehman calculated its "net leverage" ratio by dividing net assets by tangible equity capital. Lehman defined "net assets" – the numerator for its net leverage ratio – as total assets less: (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements; and (iii) identifiable intangible assets and goodwill. For the denominator, Lehman included stockholders' equity and junior subordinated notes in "tangible equity capital," but excluded identifiable intangible assets and goodwill. Since Lehman used the proceeds from ordinary repo transactions to pay down other liabilities, when properly categorized as financings, these transitions caused no net change in either assets or liabilities, and hence no effect on either the Company's leverage or net leverage ratio.

14. In early 2000, the Financial Accounting Standards Board ("FASB") issued FAS 140, regarding the transfer of corporate assets. Under FAS 140, certain transfers of securities in connection with financings may – but need not be – treated not as loans, but as "sales." In order

to do so, the company must give up all control of the securities, in Lehman's case by obtaining a "True Sale" legal opinion. In addition, the company must take a "haircut," whereby it receives only 95% (or less) of the value of the securities it transfers, thereby (theoretically) putting the company in a position where it may not be able to reacquire the securities, because of the shortfall between the value of the securities and the amount of cash the company received. FAS 140 says nothing about a company's independent obligation of disclosure.

15. In 2001, Lehman, assisted by E&Y, decided to take advantage of FAS 140 by treating certain short-term financing transactions as "sales," in order to remove the securities used as collateral for the loans, from Lehman's balance sheet on a temporary basis, even though such an arrangement was economically disadvantageous to Lehman (because of the large "haircut" needed). Lehman decided to do this solely to create the misleading appearance that its leverage was being reduced by the removal of assets from the balance sheet and the paying down of liabilities. Lehman and E&Y also affirmatively decided not to disclose the impact of Repo 105 transactions on Lehman's financial statements – and in particular the obligation to repurchase – to the investing public. Lehman had no legitimate business reason to enter into such transactions, and could have obtained sufficient financing through less costly means, including the use of ordinary repo transactions. Its only reason for doing Repo 105 transactions was to reduce leverage without disclosing such transactions to investors.

II. E&Y Approved Lehman's Repo 105 Policy Designed to "Manage Balance Sheet Metrics"

16. In 2001, Lehman adopted an internal Accounting Policy Statement ("the Policy") that enunciated Lehman's intention to use Repo 105 transactions. Before issuing the Policy, senior Lehman personnel, including Kristine Smith, discussed the proposed Policy with Kevin

Reilly, the E&Y "engagement partner" in charge of E&Y's relationship with Lehman, and with E&Y partners William Schlich and Matthew Kurzweil. In their discussions, E&Y specifically "approved" the Policy. As Reilly testified, "I would have communicated that we believed that their conclusions were acceptable under the accounting literature." Q. "Ernst & Young approved the policy that they had adopted vis-à-vis Repo 105 transactions, correct?" A. "I concluded it was acceptable, yes."

17. E&Y understood that the Repo 105 transactions were, as Reilly described it, designed to "manage balance sheet metrics." As reflected in an August 19, 2001 memo from Smith to Reilly, Schlich, and Kurzweil, entitled "Rules of Road – Repo Recharacterizations (Repo 105)," the Repo 105 transactions gave Lehman "the ability to recharacterize reverse repo and repo trades (meeting the criteria specified below) as inventory trades [and] will allow for an increased ability to net down Lehman's balance sheet for matched book positions since such financial transactions once classified as inventory would then be subject to netting under cusip netting rules."

18. In October 2002, Smith again discussed the Repo 105 transactions with Reilly, Schlich and Kurzweil, at a time when Lehman was considering expanding the transactions to include a related "Repo 107" structure. At that time, Lehman provided E&Y with a memorandum reaffirming that the Repo 105 transactions were being done for the blatant purpose of "reducing the balance sheet as firm inventory." Subsequently, Lehman expanded into "Repo 108" transactions, which utilized equities, rather than fixed income securities, with a minimum of eight percent overcollateralization (as used herein, the term "Repo 105" refers to both Repo 105 and Repo 108 transactions).

III. Lehman Could Not Obtain A True Sale Opinion In the United States

19. In order to use FAS 140, and categorize the transfers as "sales," Lehman policy required a legal opinion that the transfers complied with certain legal criteria relating to transfer of control of the securities. As the policy acknowledged, however, Lehman, a United States taxpayer and reporter, "generally cannot obtain a true sale opinion under U.S. law," and, therefore, Lehman decided to look to foreign jurisdictions for the Repo 105 transactions.

20. In March 2001, Lehman approached Linklaters, a United Kingdom law firm, to seek an opinion under English law. Linklaters issued an opinion addressed to "LBIE," a United Kingdom affiliate of Lehman, which, by the letter's terms, was intended solely for LBIE's benefit. The letter set forth certain circumstances under which, in Linklaters' opinion, LBIE could engage in transactions that, under FAS 140, could be categorized as "sales." However, the letter expressly stated that such transactions had to be based in the United Kingdom, subject to English law, and had to involve securities that were "sited" in the United Kingdom.

21. Lehman used the Linklaters opinion repeatedly to engage in billions of dollars worth of highly questionable transactions without disclosing the truth in its financial statements. Lehman did so despite knowing – as E&Y knew – that the Linklaters letter placed limits on the use of Repo 105 transactions. In an October 3, 2002 e-mail to E&Y, for example, Smith attached her August 2001 "Rules of Road – Repo Recharacterizations (Repo 105)" memo that stated:

> ...Linklaters has issued a True Sale opinion covering repo transactions documented under a GMRA agreement under English Law. Therefore this policy is expected to cover Reverse Repo and Repo Trades executed in London under a GMRA agreement, provided also that the customer resides in a jurisdiction covered under English Law as noted on attached Rules of the Road Document.

22. Armed with the Linklaters letter, beginning in or about November 2001, Lehman engaged in Repo 105 transactions by transferring fixed income securities to banks in the United Kingdom in return for short term loans of cash. Typically, Lehman would transfer fixed income securities with a fair market value of, for example, $105 million or more, in return for cash of $100 million or less, which was generally used to pay down liabilities. Lehman then recorded the transaction as a "sale" although, pursuant to standard contractual agreements with the banks, Lehman was obligated, within a few days or weeks, to repurchase the securities for the cash it had received, $100 million, thereby restoring Lehman to the same position it was in earlier, but after paying a premium.

23. Smith, who reviewed the Linklaters letter, understood that it applied only to transactions between LBIE and counterparties based in the United Kingdom, using fixed income securities. However, Lehman's Repo 105 transactions expanded to include the transfer of billions of dollars of American fixed income government securities. Contrary to the later professed ignorance by Schlich, E&Y's engagement partner, of this expansion to include securities not based in the United Kingdom – and therefore clearly outside the scope of Linklaters' letter – Smith and Martin Kelly, who replaced Erin Callan as Lehman's Global Financial Controller on December 1, 2007 and remained in that position until September 2008, testified that they specifically informed Schlich of the use of American-based securities in Repo 105 transactions.

IV. Lehman Dramatically Increases Its Use of Repo 105 Transactions in 2007-2008

24. Although Lehman regularly effectuated Repo 105 transactions after 2001, in mid-2007 Lehman scurried to obtain greater amounts of Repo 105 relief to improve its reported leverage ratio. At that time, deleveraging by selling real estate and mortgage-related assets was

problematic, because many of Lehman's positions in such assets were illiquid and could not be sold without incurring substantial losses. Selling illiquid assets at discounted prices would have had a negative impact on Lehman's earnings, and would have led to a loss of market confidence in the valuations Lehman ascribed to its remaining assets. As a February 10, 2007 Lehman document, titled "Proposed Repo 105/108 Target Increase for 2007" recognized, "Repo 105 offers a low cost way to offset the balance sheet and leverage impact of current market conditions." Further, "[e]xiting large CMBS positions in Real Estate and sub prime loans in Mortgages before quarter end would incur large losses due to the steep discounts that they would have to be offered at and carry substantial reputation risk in the market. . . . A Repo 105 increase would help avoid this without negatively impacting our leverage ratios." The message was clear: increase the use of Repo 105 transactions solely to impact balance sheet metrics.

25. In 2002, Lehman had informed E&Y that the Company intended to limit the use of Repo 105 transactions to some $20-$30 billion. Lehman communicated this limit on January 16, 2002, when Smith e-mailed Reilly and Schlich, stating: "Business has $20B soft limit on Repo 105." However, as Lehman's financial condition worsened, pressures mounted to increase the internal limits on Repo 105 transactions and, in February 2007, the Chief Financial Officer of Lehman's Fixed Income Division ("FID"), Joseph Gentile, recommended to Lehman's Global Financial Controller, Ed Grieb, that Lehman increase the limit by $3 billion.

26. Within months, Lehman's use of Repo 105s exceeded even that increased limit. For the close of Lehman's third quarter in August 2007, the Repo 105 usage was $36.4 billion, and, at the close of Lehman's fiscal year on November 30, 2007, the transactions were in the amount of $38.63 billion. By the close of Lehman's first quarter 2008, the Repo 105 quarter-end usage had leaped to $49.1 billion, and, at the close of the second quarter of 2008, $50.38 billion.

Thus, Lehman's use of the Repo 105 transactions more than doubled in the span of five reporting periods, from approximately $24 billion for the fourth fiscal quarter of 2006 (November 2006) to $50.38 billion for the second quarter of 2008 (May 2008).

27. Internal Lehman correspondence illustrates the frantic use of Repo 105 transactions near the close of quarterly financial reporting periods:

- **FY'07**: On November 26, 2007, four days prior to the close of the fiscal year, one employee in FID was searching for ways to meet his balance sheet target and wrote to his colleague in FID: "Can you imagine what this would be like without 105?"

- **1Q'08**: On February 28, 2008, when FID's balance sheet was above target in the days leading up to the close of the first quarter, a senior financial officer within that division warned that the division was "looking at selling what ever we can and also doing some more repo 105." Similarly, the head of the Liquid Markets group within FID wrote the same day regarding the group's balance sheet: "We have a desperate situation and I need another 2 billion from you, either through Repo 105 or outright sales. Cost is irrelevant, we need to do it." Also that day, a member of LBIE's Secured Financing Desk wrote to John Feraca, who ran Lehman's Secured Funding Desk, which was responsible for executing ordinary repo and Repo 105 transactions: "Just took a call from FID mgmt - seems they're up on net b/s by 3 bln unanticipated & are a little excited w Q end. I am looking to do an additional repo 105 with Mizuho. . . ."

- **2Q'08**: On May 21, 2008, ten days from the close of Lehman's second quarter, Kaushik Amin, the head of the Liquid Markets group within FID, wrote to another Lehman employee: "Let's max out on the Repo 105 for your stuff and see where end up"; when Amin asked another employee for an update on the balance sheet management, he replied: "[A]nything that moves is getting 105'd." In an e-mail to a Lehman employee that same day, Amin wrote: "Do as much as you can in Repo 105. Can you find Repo 105 capacity among Japanese counterparties to take US Agencies?"

- **3Q'08**: On August 20, 2008, as the close of Lehman's third quarter was approaching, Amin asked Andrew Morton, the head of FID, for additional Repo 105 authority in order to make balance sheet targets. Responding to Morton's question, "[c]an you keep going on bal sheet[?]" Amin stated: "I am squeezing hard. But, the challenge is that liquidity is poor given the European holidays. Most of our tough balance sheet is inflation and Agencies, which is extremely illiquid. I think we should relax the Repo 105 constraints a bit. Instead of $20 Bln, we should take it up to say $25 Bln."

28. This frenzied use of Repo 105 transactions alarmed several Lehman officials, as reflected by the following internal emails:

- In a March 19, 2008 e-mail to Bart McDade, Lehman's former Head of Equities (2005–2008) and President and Chief Operating Officer (June–September 2008), a Lehman employee warned that "RUNNING A FIRM WIDE BALANCE SHEET OF 15.3 X LEVG IS NOT GOING TO BE A SUSTAINABLE BUSINESS MODEL FOR THE FIRM."

- In an April 2008 e-mail asking if he was familiar with the use of Repo 105 transactions to reduce net balance sheet, McDade replied: "I am very aware . . . it is another drug we r on."

- In a July 2008 e-mail to another Lehman employee, a senior member of Lehman's Finance Group, Michael McGarvey, said he considered Lehman's Repo 105 program to be balance sheet "window-dressing" that was "based on legal technicalities."

29. Kelly became familiar with Lehman's use of Repo 105 transactions soon after he became Financial Controller. Kelly testified that upon learning about the matter, he raised with E&Y and specifically the lead auditor Schlich, several concerns he had about the transactions, including: (a) the reliance on Linklaters' "True Sale" opinion, coupled with Lehman's inability to obtain a United States legal opinion, (b) Repo 105 transactions that utilized American securities transferred to LBIE, (c) the spike in Repo 105 transactions at the end of each quarter, (d) the fact that the accounting justification for treating the transactions as "sales" was "form-driven" and "legalistic," and (e) the fact that none of Lehman's peer financial institutions appeared to be using such transactions.

30. In April 2008, FID sought Kelly's permission to expand the Repo 105 program to include Australian securities, and consistent with his concerns about the Repo 105 transactions, Kelly responded: "[Repo 105] Program has some risk to it. Reluctance to expand to new regions/geographies." The requested expansion was denied.

31. In mid-2008, Lehman's senior management sought to reduce the use of Repo 105 transactions by the beginning of the fourth quarter 2008. When management conveyed this intention, however, it was met with protests from business units that had grown dependent on the

transactions. Thus, upon learning that Lehman's Global Product Controller, Gerard Reilly, had proposed a $25 billion cap on Repo 105 transactions for the third quarter of 2008, Andrew Morton, the head of FID, replied, "rates business cannot survive at these levels, ie reducing r105 by 20." Similarly, in July 2008, an employee in FID's Liquid Markets Division complained that, given the planned reduction in FID's Repo 105 transactions for the third quarter of 2008, and curtailment of Repo 105 usage for the fourth quarter, "there are not many places we can reallocate balance sheet from if Repo 105 is gone for the inflation book."

V. E&Y Approved Lehman's Financial Statements That Concealed the Repo 105 Transactions

32. Under FAS 140, Lehman's obligation to repurchase the fixed income securities for less than their fair market value, and the banks' corresponding obligation to sell them back at such prices, was treated as a "derivative" by Lehman, the derivative's value being measured by the difference between the fair market value of the security to be reacquired and the (lesser) amounts Lehman would pay to reacquire them. Lehman hid these "derivatives" as part of a much larger group of derivatives in footnotes to its financial statements which lumped the value of the Repo 105 "derivatives" in with derivatives of a more traditional nature. This aggregation made it impossible for readers of the financial statements to know that Lehman had engaged in Repo 105 transactions.

33. Worse still, as E&Y also knew, Lehman's financial statements did not disclose that Lehman had the obligation to repurchase tens of billions of dollars in securities that had been temporarily transferred to counterparties in the Repo 105 transactions. Smith testified that she and several other senior Lehman officials made a conscious decision in 2001, at the outset of the program, not to disclose the Repo 105 transactions on the absurd theory that it was unnecessary

because the following type of catchall statements would be included in the Management Discussion and Analysis ("MD&A") portions of Lehman's Forms 10-Ks: "[D]ue to the nature of our client flow activities and based on our business outlook, the overall size of our balance sheet will fluctuate from time to time and, at specific points in time, may be higher than the year-end or quarter-end amounts." This alleged characterization of what became $50 billion in Repo 105 transactions per quarter as merely "balance sheet fluctuations" that did not require disclosure was totally ridiculous, and clearly not a justification for the fraudulent non-disclosure of the transactions. Moreover, even this supposedly cautionary statement was omitted from Lehman's 2007 Form 10-K.

34. In order to conceal the Repo 105 transactions from the public, Lehman made materially false and misleading statements in its annual disclosures (Forms 10-K) for the years 2001 to 2007. A detailed breakdown of Lehman's assets and liabilities in the "Consolidated Statement of Financial Condition" failed to document any Repo 105 transactions, in categories described as "short-term financing," "payables," or "commitments and contingencies." Nor did the explanatory notes to the consolidated financial statements disclose the Repo 105 transactions. Indeed, one arguably relevant note, "Note 1 Summary of Significant Accounting Policies," included a discussion of "Repurchase and Resale Agreements" within a category of "Secured Financing Activities," but did not mention Repo 105. And Lehman's Form 10-K for 2007 not only omitted any discussion of the Repo 105 transactions, but it affirmatively made the following misrepresentation that all repurchase and resale arguments secured borrowings by Lehman were accounted for as financings, rather than as sales:

> Collateralized Lending Agreements and Financings
>
> Treated as collateralized agreements and financings for financial reporting purposes are the following:

> *Repurchase and resale agreements*. Securities purchased under agreements to resell and securities sold under agreements to repurchase are collateralized primarily by government and government agency securities and are carried net by counterparty, when permitted, at the amounts at which the securities subsequently will be resold or repurchased plus accrued interest. We take possession of securities purchased under agreements to resell. The fair value of the underlying positions is compared daily with the related receivable or payable balances, including accrued interest. We require counterparties to deposit additional collateral or return collateral pledged, as necessary, to ensure the fair value of the underlying collateral remains sufficient.
>
> ....
>
> *Other secured borrowings*. Other secured borrowings principally reflect transfers accounted for as financings rather than sales under SFAS 140. Additionally, [o]ther secured borrowings includes non-recourse financings of entities that we have consolidated because we are the primary beneficiaries of such entities. (emphasis added)

As Schlich testified, the description of "repurchase and resale agreements" did not include Repo 105 transactions, which were treated as "sales" rather than as "financings," nor did the section labeled "[o]ther secured borrowings."

35. Lehman also omitted any mention of Repo 105 in the MD&A section of its periodic financial reports, which discussed various aspects of the Company's business. For instance, a chart accompanying the MD&A section in the 2007 Form 10-K, titled "Fair Value of OTC Derivative Contracts by Maturity," did not include any mention of Repo 105. In Schlich's words, "a reader of th[is] chart would have no way of knowing what dollar sum, if any, is attributable to a forward contract portion of the [Repo 105] transaction." E&Y routinely reviewed the statements made in the MD&A as part of its work for Lehman. As Schlich explained, "...for the MD[&]A ... the expectation and requirement is for us to read it and make sure it's not materially inconsistent with the audited financial statements." Yet, E&Y never questioned the omission of the Repo 105 transactions from the MD&A or any other part of the public filings. As noted above, although the Repo 105 transactions were not disclosed in the

Forms 10-K, or the quarterly filings, E&Y gave clean opinions as to each 10-K and never questioned Lehman's quarterly reports which E&Y reviewed.

VI. Lehman's Financial Statements Misstated Its Leverage

36. In the MD&As, Lehman described the importance of leverage as follows: "The relationship of assets to equity is one measure of a company's capital adequacy. Generally, this leverage ratio is computed by dividing assets by stockholders' equity. We believe that a more meaningful, comparative ratio for companies in the securities industry is net leverage, which is the result of net assets divided by tangible equity capital."

37. From late 2007 through the second quarter 2008, Lehman publicly reported a net leverage ratio that was substantially lower than it would have been if Lehman had used ordinary repo transactions, instead of Repo 105 transactions. Moreover, the "reduction" in the net leverage that Lehman trumpeted was only temporary and wholly illusory. Pursuant to the terms of the Repo 105 contracts, shortly after Lehman's fiscal quarters ended, the Company would repay the Repo 105 counterparties and the securities would be restored to Lehman's balance sheet.

38. The reduction in reported net leverage that Lehman accomplished through the use of Repo 105 was "material" under the standards used by both Lehman and E&Y. E&Y itself defined "materiality" with respect to the process for reopening or adjusting a closed balance sheet, as "any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)." The effect of the Repo 105 transactions on Lehman's leverage clearly fell within this definition.

39. By overstating the reduction in its net leverage, Lehman painted a misleading picture of the Company's financial health, exceeding the materiality threshold of a change in net

leverage of 0.1 by engaging in Repo 105 transactions. Lehman's net leverage was artificially reduced as follows:

- **FY'07**: The 2007 10-K reported that Lehman's net leverage ratio was 16.1, which was materially misleading because it failed to take into account $38.634 billion in Repo 105 assets that were temporarily removed from Lehman's balance sheet. If the Repo 105 assets had been included, Lehman's net leverage ratio would have been materially higher.

- **1Q'08**: The Form 10-Q for the first quarter of 2008 reported that Lehman's net leverage ratio was 15.4, which was materially misleading because it failed to take into account $49.102 billion in Repo 105 assets that were temporarily removed from Lehman's balance sheet. If the Repo 105 transactions had been included, Lehman's net leverage ratio would have been materially higher.

- **2Q'08**: On June 9, 2008, Lehman issued a Form 8-K pre-announcing its financial results for the second quarter ended May 31, 2008. This disclosure said that Lehman had reduced its net leverage ratio to below 12.5. This statement was materially misleading because the Form 8-K failed to take into account $50.383 billion in Repo 105 assets that were temporarily removed from Lehman's balance sheet. Lehman issued another Form 8-K on June 16, 2008 announcing results for the second quarter of 2008, reporting a net leverage ratio of 12.0, and stating that the firm had reduced its gross assets and net assets by $147 billion and $70 billion, respectively, during the second quarter. These statements were materially misleading because the Form 8-K failed to disclose $50.383 billion in Repo 105 assets that had been removed temporarily from Lehman's balance sheet at quarter end. Had the assets been included, Lehman's net leverage ratio would have been materially higher.

40. E&Y was fully aware of each of these materially misleading statements by Lehman with respect to net leverage but took no steps to require Lehman to correct them.

VII. Lehman's Escalating Use of Repo 105 Raises Concerns At E&Y

41. Throughout the 2000s, Lehman continued to engage in Repo 105 transactions, particularly at the end of fiscal quarters. The transactions followed the same format and Lehman's financial statements failed to disclose them.

42. As time went on, Lehman used Repo 105 transactions more aggressively, and American affiliates or branches of Lehman began to transfer fixed income securities held by

them to United Kingdom affiliates of Lehman, in order for the securities to be used in Repo 105 transactions under the cover of the Linklaters' letter. Financial data showing the use of these American securities was available to E&Y, yet E&Y never considered the propriety of Lehman's transfer of American securities to the United Kingdom, despite internal E&Y guidelines explicitly requiring the auditors to consider whether a separate legal opinion was required for transactions governed by FAS 140:

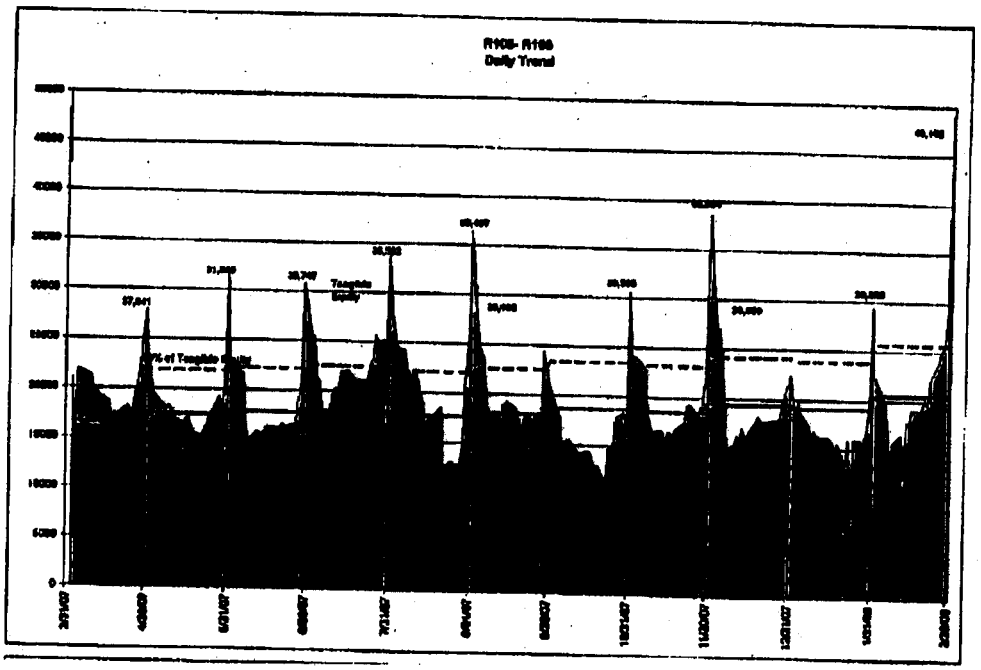
> **Foreign Jurisdictions**—Achieving the legal isolation criterion when the transaction occurs in a foreign market is even more complex. It is important to remember that the requirement is the same (i.e., the assets must be legally isolated from the transferor, even in the event of bankruptcy or other receivership or the applicable jurisdiction's equivalent). However, the language requirements in the legal opinion supporting legal isolation may differ due to the different legal environments in various countries. *In addition, engagement teams should consider the need to receive a legal opinion in each country in which assets may have originated when auditing global transfers of financial assets.* (emphasis added)

43. In 2006, one of E&Y's auditors, Bharat Jain, reviewed the Lehman Policy and became concerned about the heavy use of the Repo 105 transactions. In an e-mail to his senior manager, Jennifer Jackson, on September 7, 2006, Jain noted that he would "like to know what is our thought process behind *how much of these Lehman should do from reputational risk*, etc. perspective. Are we comparing to other competitors, are we referring to any industry publications, any regulatory guidance, etc.?"

44. Jain's concerns flowed from E&Y's "balanced audit approach," which required E&Y to obtain "some level of understanding of the business and the industry" of its audit client, rather than performing audits "in a vacuum." As one E&Y presentation, titled "Understand the Business Template (UBT)," explained, "[o]ur understanding of the entity and the environment(s) in which it operates enables us to identify business risks."

45. When Jackson received Jain's e-mail, she viewed it as raising serious issues. As Jackson testified, "[t]he raising of the concern around reputational risk ... didn't happen every day.... I can't think of an[other] example off the top of my head where Lehman entered into transactions, and we had a concern around reputational risk." Jackson therefore decided to take up the issue of "reputational risk" from the Repo 105s with Schlich, the engagement partner to whom she directly reported. However, she testified that she did not recall whether she actually discussed the matter with Schlich, and Schlich claims no recollection of their doing so. In any event, it is clear that auditors at E&Y were concerned in 2006 that the Repo 105 transactions, if known to the public, would damage Lehman's reputation.

46. In August 2007, E&Y was provided with a "Balance Sheet Netting and Other Adjustments" (known as the "Netting Grid") by Lehman, which explicitly showed that, as of the end of the first quarter fiscal 2007, Lehman had engaged in $29 billion in Repo 105 transactions. A November 2007 Netting Grid also showed the same volume of Repo 105 transactions. E&Y also had access to internal Lehman reports breaking down the Repo 105 transactions by geographic area, which showed that some $12 billion of these transactions involved securities originating in the United States. Further, Lehman's "Balance Sheet Analysis Package" dated February 2008, also given to E&Y, included a detailed analysis of the Repo 105 volume, including the following chart that showed a spike in Repo 105/108 deals to nearly $50 billion for the first quarter of 2008:



Despite access to all the information described above, in January 2008, E&Y issued an opinion letter stating that Lehman's audited financial statement for the fiscal year ending November 30, 2007 "present[ed] fairly, in all material respects, the consolidated financial position of the Company .... in conformity with U.S. generally accepted accounting principles."

47. Lehman's Martin Kelly testified that in late 2007 or early 2008, he informed Schlich of the increased volume of the Repo 105 transactions, because of his concerns with the rapid expansion of the Repo 105 program, and the use of securities transferred from the United States. Despite running away from all of the evidence showing his knowledge of the increase of Repo 105 transactions, Schlich did concede that if Lehman exceeded the general limit of $20-$30 billion, and indeed reached as high as $50 billion, it would have been of great concern to him, and "prompt[ed] additional questions to [Lehman's] management."

48. E&Y knew that the dramatic rise in Lehman's reliance on Repo 105 transactions was motivated by Lehman's desire to lower its leverage ratio. In various earnings calls with

securities analysts, monitored by several E&Y auditors, Lehman consistently emphasized its reduction in leverage. For instance, in a March 18, 2008 earnings call for the first quarter of 2008, E&Y auditors heard Lehman's CFO, Erin Callan, state:

- "... the industry's trend over the past quarter has been towards de-leveraging, weaker valuations, and thus shrinking balances on the whole."

- "We did, very deliberately, take leverage down for the quarter. We ended with a net leverage ratio of 15.4 times down from 16.1 at year end. And we will continue to allocate capital on the balance sheet in the market in a way that we consider prudent, and that reflects the liquidity profile of the balance sheet."

- "We did have a deliberate decision this quarter to take leverage down, which I think is more appropriate for the increased illiquidity of the balance sheet, and if the environment continues this way we'll continue to be focused on that discipline...."

49. Similarly, in a second quarter 2008 earnings call on June 16, 2008, Lehman's CFO, Ian Lowitt, reiterated a focus on reducing leverage:

- "Turning now to leverage, we reduced our gross assets by $147 billion, from $786 billion to $639 billion in the second quarter, and we reduced net assets by 470 billion, from $397 to $327 billion. As a result, we reduced our gross leverage from 31.7 times to 24.3 times at May 31, and we reduced net leverage from 15.4 times to 12 times prior to the impact of last week's capital rates, including the new capital, our gross leverage declines by approximately four turns and our net leverage by about two turns. Our deleveraging included a reduction of assets across the Firm, including residential and commercial mortgages, real estate held for sale and acquisition finance."

- "If we maintain our leverage ratio in the low double digits, so call it, 12 to 15, we could have net assets of probably $400 billion to $410 billion."

- "It was a decision that the Firm took. We were not pushed to do this by anybody. I think we feel the appropriate leverage for us to operate is in the low single digits at the moments. We're in the process of moving out of positions that we think are too concentrated and diversifying our balance sheet. So I think that we feel that's all appropriate and the right way for us to go. I think that leverage is only one metric that gets utilized. ... the leverage we want to have in low double digits.

  .... So I think leverage is always going to be important. People are going to look at it. We're going to operate conservatively..."

50. E&Y, whose auditors heard these statements as they were being delivered, knew that Lehman was purporting to reduce its leverage, an important metric, by using Repo 105 transactions that served no purpose other than to artificially reduce the leverage ratio. Aware that the public was being misled, E&Y never questioned the practice or sought to have it disclosed to the investing public.

VIII. E&Y Failed To Disclose Whistleblower Allegations Regarding Repo 105

51. In May 2008, E&Y was given a copy of a letter to senior financial executives at Lehman from Matthew Lee, a Senior Vice President in Lehman's Finance Division responsible for Lehman's Global Balance Sheet and Legal Entity Accounting, which raised serious questions concerning Lehman's financial statements. E&Y was directed by Lehman's Audit Committee to meet with Lee and to report back the results of its investigation of Lee's allegations.

52. On June 12, 2008, Schlich, and another E&Y partner, Hillary Hansen, interviewed Lee. As demonstrated by contemporaneous notes made by Hansen, and Lee's own testimony, Lee told Schlich and Hansen of E&Y that (as E&Y already knew), Lehman was removing $50 billion in fixed income securities from its balance sheet each quarter by purporting to "sell them" to European counterparties for a short time. Hansen's notes thus state that Lee told them: "Repo 105/Repo 108 reduced assets to 50B – moving off b/s in Europe & back in 5 days later off balance sheet..."

53. Immediately following the meeting with Lee, Hansen raised concerns about the Repo 105 transactions with Schlich, who casually dismissed the concerns by telling Hansen that the Repo 105 transactions were being properly recorded as sales. Schlich and Hansen then met with Lehman's Global Product Controller, Gerard Reilly, to review Lee's allegations. In a brief meeting, they failed even to mention Repo 105. Further, at a meeting of Lehman's Audit

Committee on June 13, 2008, Schlich failed to mention the Repo 105 concerns that Lee had conveyed – even though E&Y had been specifically instructed to inform Lehman's Audit Committee of all concerns raised by Lee.

IX. Lehman's Demise

54. In 2008, Lehman desperately attempted to create the false appearance that it was reducing its leverage and removing assets from its balance sheet, in order to quell anxiety about the Company's liquidity. These efforts proved ineffective, and in September 2008 Lehman filed a petition under Chapter XI of the Bankruptcy Code informing the public that it had "significant liquidity problems."

55. Thus, the risk that Lehman faced a liquidity problem because it could not sell its increasingly illiquid inventory without incurring substantial losses, ultimately materialized. As noted, Lehman sought to mitigate the adverse impact of selling illiquid positions through the use of Repo 105 transactions, and E&Y blessed this deceptive strategy.

56. In the meanwhile, many investors had either purchased Lehman stock, or continued to hold the stock, unaware of Lehman's true financial picture.

X. E&Y Misrepresented Lehman's Compliance With Applicable Accounting Standards

57. Generally Accepted Auditing Standards ("GAAS") have been established to ensure that external auditors fulfill their obligations when auditing and reviewing financial statements and other information. GAAS consists of authoritative standards, originally established by the American Institute of Certified Public Accountants ("AICPA"), which were adopted, amended and expanded upon by the Public Company Accounting Oversight Board

("PCAOB"), and with which auditors must comply when conducting audits and reviews. An auditor is required to perform its annual audits and quarterly reviews of financial information in accordance with GAAS, which include, *inter alia*: (1) ten basic standards establishing the objections of a financial statement audit and providing guidance for the quality of audit procedures to be performed; (2) interpretations of these standards by the AICPA, set forth in Statements on Auditing Standards ("AU"); and (3) additional standards promulgated by PCAOB.

58. As Lehman's auditor, E&Y signed off on each of Lehman's annual disclosures, certifying their compliance with GAAP. Each Form 10-K included a "Report of Independent Registered Public Accounting Firm" signed by E&Y, representing:

> In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company .... in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects the information set forth therein.

59. One of the primary responsibilities of an external auditor is to express an opinion on whether a company's financial statements are presented fairly, in all material respects, in accordance with GAAP. (*See* AU § 110.)

60. Similarly, each quarterly disclosure (Form 10-Q) contained a "Report of Independent Registered Public Accounting Firm" signed by E&Y, stating that, based on a review of Lehman's consolidated financial statements in accordance with the standards of the PCAOB, "we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles."

61. Lehman's accounting for the Repo 105 transactions failed fundamental tenets of financial reporting under GAAP. GAAP requires that the overall impression created by financial

statements be consistent with the business realities of the company's financial position and operations, so that the financial statements are useful and comprehensible to users in making rational business and investment decisions. (*See, e.g.*, Financial Accounting Standards Board – Statement of Financial Accounting Concepts ("FASCON") No. 1, ¶¶ 9, 16, 33-34; No. 5, ¶ 5.) FASCON 1 states that "[f]inancial reporting should include explanations and interpretations to help users understand financial information." (*Id.* at ¶54.) Under GAAP, "***nothing material is left out of the information*** that may be necessary to [ensure] that [the report] validly represents the underlying events and conditions." (FASCON No. 2, ¶¶ 79-80.)

62. Lehman's accounting treatment for the Repo 105 transactions, and the absence of any disclosures about Repo 105, created a false impression of Lehman's financial condition. Readers of Lehman's reports could not have learned about the Repo 105 program and therefore received an erroneous impression of Lehman's leverage. Further, Lehman falsely stated in its audited financial statements that *all* its repurchase agreements were treated as financing arrangements, not as sales.

63. Lehman also made materially false and misleading statements in the MD&A section of its periodic reports, relating to decreases in its leverage ratio. These representations were misleading because disclosure of Lehman's Repo 105 transactions was necessary for an understanding of the Company's true financial condition. The Repo 105 transactions artificially reduced Lehman's leverage ratio, but the public was unaware that the Company was required to spend tens of billions of dollars to buy back the very securities it had purportedly "sold" in the Repo 105 transactions.

64. GAAP rules require that financial statements place substance over form. FASCON No. 2, *Qualitative Characteristics of Accounting Information*, for example, states in

relevant part: ". . . The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form . . ." (FASCON 2, ¶ 59.) Additionally, AU § 411 states, in relevant part: "Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance." (AU § 411.06.)

65. Lehman's Repo 105 transactions lacked substance as "sales." Elevating form over substance, Lehman engaged in tens of billions of dollars or Repo 105 transactions at the end of the fiscal quarters simply to improve the appearance of its balance sheet and mislead the public as to its leverage ratio.

66. Thus, the following public disclosure statements by Lehman, made with E&Y's knowledge and approval, contained false and misleading misrepresentations:

a. **Forms 10-K**: Lehman's Form 10-Ks for the years 2001 through 2008 failed to reveal the Repo 105 transactions, and thus were false and misleading. Furthermore, these omissions rendered false and misleading Lehman's disclosures regarding the Company's leverage ratios.

b. **Forms 10-Q**: Each Form 10-Q Lehman filed from 2001 through its final quarterly filing for the second quarter of 2008 failed to disclose the Repo 105 transactions and was therefore false and misleading. As with the Forms 10-K, these omissions rendered false and misleading Lehman's disclosures regarding the Company's leverage ratios.

c. **Press releases**: Lehman pre-announced its financial results in various press releases, which, as with all of Lehman's other public disclosures, failed to disclose the existence of Repo 105 transactions and were thus false and misleading. These press

releases included, in the years 2007-2008, those issued on March 14, 2007 (1Q'07), June 12, 2007 (2Q'07), September 18, 2007 (3Q'07), December 13, 2007 (fiscal year 2007), March 18, 2008 (1Q'08), and June 9 and 16, 2008 (2Q'08).

d. **Earnings calls**: Members of Lehman's senior management consistently touted reductions in the Company's leverage ratio while failing to disclose the Repo 105 program that made such reductions possible. As detailed above, the statements made in the first and second quarter 2008 earnings calls, on March 18, 2008 and June 16, 2008, respectively, were therefore false and misleading. Lehman made similar statements on the Company's success in reducing leverage in earnings calls on June 9, 2008, and December 13, 2007. All of these statements, of which E&Y was aware, were false and misleading.

XI. E&Y Failed To Meet GAAS Standards

67. E&Y's knowledge and approval of the Repo 105 program, the absence of a business purpose for such transactions, and the increased volume of Repo 105 transactions at quarter-end raised various obligations under GAAS that E&Y failed to meet. Specifically, E&Y violated the following GAAS standards in connection with its audits:

68. *First*, E&Y was required to discuss with Lehman's Audit Committee the quality of Lehman's accounting principles as applied to financial reporting. (*See* AU § 380.11.) This would include moving $30-$50 billion temporarily off the balance sheets at quarter-end, including the use of American-based securities based on an overseas "True Sale" opinion that could not be obtained in the United States. AU § 380.11 states that auditors must discuss accounting policies, unusual transactions, the clarity and completeness of the financial statements, and unusual transactions with the audit committee. Contrary to that standard, E&Y

never communicated anything about the Repo 105 transactions to Lehman's Audit Committee. E&Y's concerns regarding "reputational risk," as raised by Jain, the use of American-based securities, and the increasing volume of Repo 105 transactions, all raised issues that E&Y failed to bring to the Audit Committee. Further, E&Y failed to challenge public statements by Lehman's management concerning the reductions in leverage that E&Y knew had been accomplished largely by the use of Repo 105 transactions.

69. *Second*, upon learning that Lehman intended to embark on Repo 105 transactions for no reason other than to "manage balance sheet metrics," and the increased use of these transactions in 2007 and 2008, E&Y was required by GAAS to conduct a bona fide investigation of Repo 105 and inform management and the Audit Committee of the relevant issues. (AU § 316.79 ("Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential . . . . Fraud involving senior management and fraud . . . that causes a material misstatement of the financial statements should be reported directly to [the audit committee]").)

70. *Third*, AU §§ 336 and 9336 address an auditor's use of a legal opinion as evidential matter supporting, for instance, a management assertion that a financial asset transfer meets the "isolation" criterion in FASB 140. AU § 9336 states that a legal letter that includes conclusions using certain qualifying language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of FAS. Not only was the Linklaters letter replete with qualifying statements, but E&Y knew that no United States law firm had approved the Repo 105 transactions and that Lehman had to conduct the Repo 105 transactions through a United Kingdom-based affiliate, LBIE. E&Y failed to consider whether it could rely

on the Linklaters opinion letter at all, much less in connection with securities that originated in the United States.

71. E&Y permitted Lehman to engage in an accounting fraud, while reaping over $150 million in fees. E&Y, as a purported independent auditor, was obligated instead to ensure that Lehman's financial statements disclosed the Repo 105 transactions. The financial statements said not a word about Repo 105, falsely represented that Lehman was treating all repo transactions as financings, and E&Y accordingly must be held accountable for the consequences of this fraud.

CLAIMS

FIRST CAUSE OF ACTION
(Martin Act Securities Fraud – General Business Law §§ 352 and 353)

72. The Attorney General repeats and re-alleges paragraphs 1 through 71 above as if fully stated here.

73. The acts and practices alleged above violated Article 23-A of the General Business Law, as defined in General Business Law § 352, in that Defendant E&Y issued false statements regarding its audits and reviews of Lehman's financial statements.

SECOND CAUSE OF ACTION
(Martin Act Securities Fraud – General Business Law § 352-c (1)(a))

74. The Attorney General repeats and re-alleges paragraphs 1 through 73 above as if fully stated here.

75. The acts and practices of Defendant E&Y alleged above violated Article 23-A of the General Business Law, in that they involved the use or employment of a fraud, deception, concealment, suppression, or false pretense, where said uses or employments were engaged in to

induce or promote the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of securities.

THIRD CAUSE OF ACTION
(Martin Act Securities Fraud – General Business Law § 352-c (1)(c))

76. The Attorney General repeats and re-alleges paragraphs 1 through 75 above as if fully stated here.

77. The acts and practices alleged above violated Article 23-A of the General Business Law, in that Defendant E&Y made, or caused to be made, representations or statements which were false, where (i) Defendant knew the truth, or (ii) with reasonable efforts could have known the truth, or (iii) made no reasonable effort to ascertain the truth, or (iv) did not have knowledge concerning the representations or statements made, where said representations or statements were engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation, or purchase within or from this State of any securities.

FOURTH CAUSE OF ACTION
(Persistent Fraud and Illegality – Executive Law § 63(12))

78. The Attorney General repeats and re-alleges paragraphs 1 through 77 above as if fully stated here.

79. The acts and practices alleged herein constitute conduct proscribed by § 63(12) of the Executive Law, in that Defendant E&Y (a) engaged in repeated fraudulent acts or otherwise demonstrated persistent fraud and (b) repeatedly violated the Martin Act in the carrying on, conducting or transaction of business within the meaning and intent of Executive Law § 63(12).

WHEREFORE, Plaintiff demands judgment against Defendant as follows:

A. Directing that Defendant, pursuant to Article 23-A of the General Business Law, and § 63(12) of the Executive Law, pay restitution, disgorgement and damages caused, directly or indirectly, by the fraudulent and deceptive acts and repeated fraudulent acts and persistent illegality complained of herein plus applicable pre-judgment interest;

B. Directing that Defendant return and pay to the State all fees received by E&Y from Lehman from 2001 to the present;

C. Enjoining Defendant from engaging in any future violations of New York law;

D. Directing that Defendant pay Plaintiff's costs, including attorneys' fees;

E. Directing such other equitable relief as may be necessary to redress Defendant's violations of New York law; and

F. Granting such other and further relief as may be just and proper.

Dated: December 21, 2010
New York, New York

ANDREW M. CUOMO
Attorney General of the State of New York

MARIA T. VULLO
Executive Deputy Attorney General for Economic Justice

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK by ANDREW M. CUOMO, Attorney General of the State of New York

Plaintiff,

- against -

ERNST &YOUNG LLP,

Defendant.

Index No. 451586/2010

AFFIRMATION OF SERVICE

STATE OF NEW YORK)
) S.S:
COUNTY OF NEW YORK)

I, ARMEN MORIAN, an attorney admitted to practice law in the courts of the State of New York, affirm under penalty of perjury pursuant to CPLR § 2016 as follows:

I am an Assistant Attorney General in the Office of the Attorney General of the State of New York and counsel for the Plaintiff in the above-captioned action. I am over 18 years of age and not a party to the litigation.

On December 21, 2010, I served the Defendant, Ernst & Young LLP, a true copy of the Summons and Complaint in the above-referenced action along with a Notice of Commencement of Action Subject to Mandatory Electronic Filing, through its counsel, Barry H. Berke, Esq. of the law firm Kramer Levin Naftalis & Frankel LLP, 1177 Avenue of the Americas, New York, New York 10036, via electronic mail at the address bberke@kramerlevin.com, with Mr. Berke's consent to receive service in such manner on behalf of his client.

Dated: December 22, 2010
New York, New York

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK By ANDREW M. CUOMO, Attorney General of the State of New York, Plaintiff, v. ERNST & YOUNG LLP Defendant.	Index No. 451586/2010 **STIPULATION**

IT IS HEREBY STIPULATED AND AGREED, by and between the attorneys for the respective parties hereto, that Defendant Ernst & Young LLP's time to answer, move, or otherwise respond to the Complaint filed in this matter on December 21, 2010, is hereby extended until February 11, 2011.

Dated: January 5, 2011
New York, New York

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