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

ERNST & YOUNG LLP, Petitioner, -against- LEHMAN BROTHERS HOLDINGS INC., Respondent.	Index No. _________ **AFFIRMATION OF KEVIN M. MCDONOUGH IN SUPPORT OF VERIFIED PETITION TO CONFIRM ARBITRATION AWARD**

KEVIN M. MCDONOUGH, an attorney duly admitted to practice before the Courts of the State of New York and not a party to the above-captioned action, hereby affirms the following to be true, under penalty of perjury, pursuant to N.Y. C.P.L.R. § 2106:

1. I am a partner of the law firm of Latham & Watkins LLP, 885 Third Avenue, New York, New York 10022, counsel for Petitioner Ernst & Young LLP ("EY") in the above-captioned action. I make this affirmation in support of EY's Petition to Confirm Arbitration Award dated July 30, 2014, issued in the matter of *Lehman Brothers Holdings Inc. v. Ernst & Young LLP*, CPR File No. G-13-43 (the "CPR Proceeding").

2. On January 28, 2013, Lehman filed a Notice of Arbitration, asserting claims against EY for Accountant Malpractice and Breach of Contract arising out of EY's audits and reviews of Lehman's financial statements from 2001 to September 15, 2008. The CPR Proceeding was venued in New York, New York.

3. On April 19, 2013, EY submitted a Notice of Defense refuting the allegations in the Notice of Arbitration and asserting various affirmative defenses.

4. On July 12, 2013, the CPR Institute for Dispute Resolution confirmed the Honorable Fern M. Smith (Chair), the Honorable William G. Bassler and the Honorable Stephen Crane as the Panel for the CPR Proceeding, pursuant to the applicable CPR Rules for panel selection and an agreement reached by the parties.

5. On April 7, 2014, the Panel issued a unanimous Final Award in favor of EY on all claims. Attached hereto as Exhibit 1 is a true and correct copy of the Final Award.[1]

6. Attached hereto as Exhibit 2 is a true and correct cop of the Engagement Letter between EY and Lehman dated May 15, 2007.

Dated: July 30, 2014

Kevin M. McDonough

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[1] EY has redacted certain portions of the Award for purposes of complying with protective orders entered in related proceedings. EY will promptly file an unredacted copy of the Award in the event the Court requires one.

Exhibit 1

CPR INSTITUTE FOR DISPUTE RESOLUTION

LEHMAN BROTHERS HOLDINGS INC. Claimant, v. ERNST & YOUNG LLP Respondent.	CPR File No. G-13-43

FINAL AWARD

I. Parties

Claimant is Lehman Brother Holding Inc.
Respondent is Ernst & Young LLP

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IV. The Arbitration Clause

Each of the Engagement Letters provides:

> Except for claims seeking exclusively non-monetary or equitable relief, any Controversy or claim arising out of or relating to services covered by this letter or hereafter provided by us for the Company or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Company or of EY, or involving any person or entity for whose benefit the services in question are or were provided), shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitrations, in accordance with the dispute resolution procedures set forth in Schedule I to this letter. Judgment on any arbitration award may be entered in any court having jurisdiction.

Schedule I, a copy of which is attached to this Award, provides *inter alia,* "the arbitration will be conducted in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("Rules") in effect on the date of the engagement letter, or such other rules and procedures as the parties may designate by mutual agreement:..."

V. Procedural History

On January 28, 2013, pursuant to Rule 3 of the CPR Rules for Non-Administered Arbitration as well as the mandatory arbitration provisions in the parties' engagement letters, Claimants, Lehman Brothers Holdings, Inc. ("Claimants" or "Lehman") filed a Notice of Arbitration, asserting claims for Accountant Malpractice and Breach of Contract against Respondent, Ernst & Young LLP ("Respondent" or "EY"). Pursuant to its Notice, Lehman is seeking the following damages: (1) disgorgement of the nearly $160 million in audit and audit-related fees it paid EY for audits and reviews of financial statements; (2) the cost Lehman incurred in entering into Repo 105 transactions in lieu of less costly repurchase transactions; and (3) the harm that Lehman suffered as a result of business decisions that Lehman's Board would have made differently had it been informed about the effects of Repo 105 on Lehman's balance sheet. The undersigned were appointed to hear the case.

At the preliminary scheduling conference, the parties agreed to bifurcate these arbitration proceedings, with the Panel first ruling on EY's imputation-based defenses of *in pari delicto* and lack of reliance, and then, depending on the Panel's decision, proceeding to the arbitration's liability stage. To facilitate this process, on December 20, 2013, the parties submitted to the Panel opening briefs on EY's defenses as well as Stipulated and Disputed Facts for Bifurcated Hearings on EY's Imputation-Based Defenses ("Stipulated Facts").[1] The parties submitted their Replies on January 17, 2014. The Panel held a hearing on EY's defenses on February 11-12, 2014. Following the hearing, the Panel received on February 12, 2014, a new case from the SDNY (*In re MF Global Holdings Ltd. Inv. Litig.*, No. 11 Civ. 7866 (VM) (S.D.N.Y. Feb. 11, 2014). Respondents replied on February 14, 2014.

Both sides agreed that if the Panel believed that there were sufficient undisputed or indisputable facts to make an Award to EY without the need for a full evidentiary hearing, the arbitration would conclude at this initial phase. If, however, the Panel determined that the disputed facts, if any, were material to a decision on the issues, then the parties would proceed to a full evidentiary hearing on EY's imputation defenses as well as on all of the other elements of Lehman's claim.

VI. Facts

The Parties and their Agreements

Prior to filing for bankruptcy protection on September 15, 2008, Lehman was the fourth largest investment bank in the world, with extensive operations in the United States and abroad. (Stipulated Facts, ¶1.) EY began serving as Lehman's outside, independent auditor in May, 1994. For each of the fiscal years ending November 20, 2001 through November 30, 2007, EY entered into an engagement letter with Lehman and Lehman's Audit Committee outlining certain duties of EY and Lehman, as well as the agreed-upon scope of EY's work. (*Id.*, ¶7.)

Pursuant to the Engagement Letters, Lehman was responsible for, *inter alia*, making required Securities and Exchange Commission ("SEC") filings, including Lehman's annual 10-K filings and

[1] These stipulated facts apply only to this initial phase of the arbitration.

quarterly 10-Q filings. The 10-K filings included audited financial statements, as well as a variety of other information, including Management's Discussion & Analysis of Financial Condition and Results of Operations ("MD&A"). Lehman's 10-Q filings contained unaudited financial information and MD&A. (*Id.*, ¶9.)

EY was responsible for, *inter alia*, issuing an audit opinion letter in connection with Lehman's 10-K filings with the SEC in accordance with U.S. generally accepted auditing standards ("US GAAS") and expressing an opinion on whether Lehman's annual financial statements were presented fairly, in all material respects, in conformity with US GAAP. (*Id.*, ¶¶4, 10.) EY also reviewed and issued review reports, but did not express opinions on, Lehman's forms 10-Q. (*Id.*, ¶11.) Pursuant to US GAAS, EY was required to read, but not audit, the MD&A in Lehman's 10-K and 10-Q filings and consider whether the information in Lehman's MD&A was materially inconsistent with the information in the financial statements or contained a material misstatement of fact. (*Id.*, ¶12.)

Based on its audits, EY issued unqualified opinions on Lehman's year-end financial statements indicating that Lehman's financial statements presented fairly, in all material respects, the consolidated financial position of Lehman and the consolidated results of its operations and its cash flows in conformity with US GAAP. (*Id.*, ¶13.) It also indicated in its opinions that Lehman maintained, in all material respects, effective internal control over financial reporting. (*Id.*, ¶17.) Based on its reviews, EY also issued reports on Lehman's unaudited quarterly financial statements indicating that EY was not aware of any material modification that should be made to the unaudited financial statements for them to be in conformity with US GAAP. (*Id.*, ¶15.)

Pursuant to the Engagement Letters and in compliance with the Sarbanes-Oxley Act of 2002, EY also agreed to communicate with Lehman's Audit Committee about, *inter alia*, changes in Lehman's significant accounting policies and methods for accounting for significant unusual transactions or for controversial or emerging areas and EY's judgments about the quality of Lehman's accounting principles. (*Id.*, ¶19.) Beginning with the Engagement Letter for EY's audit of Lehman's fiscal year-end 2003 financial statements, EY agreed to communicate to the Audit Committee "all alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management, including ramifications of the use of such alternative disclosures and treatments along with the treatment preferred by us." (*Id.*, ¶18.) And beginning with the Engagement Letter for EY's audit of Lehman's fiscal year-end 2004 financial statements, EY agreed to ensure that all significant deficiencies and material weaknesses in internal control over financial reporting that EY identified during the course of its integrated audit were communicated to management and to the Audit Committee. (*Id.*, ¶20.) The Engagement Letters also stated,

> As [Lehman] is aware, . . . there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Also, an audit of the financial statements is not designed to detect error or fraud that is immaterial to the consolidated financial statements. Similarly, an audit of internal control is not designed to detect deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. (*Id.*, ¶21.)

Repo 105 Transactions

In September 2000, the United States Financial Accounting Standards Board promulgated Statement of Financial Accounting Standards No. 140 ("FAS 140"), which dealt with accounting for transfers of financial assets, including repurchase agreements. A repurchase agreement is a transaction in which one party transfers collateral (typically securities) to another party in exchange for a short-term borrowing of cash, while simultaneously agreeing to repurchase the collateral (plus interest) at a specific time in the future. (*Id.*, ¶22.) Lehman's Repo 105 transactions were repos in which Lehman transferred highly liquid and high quality securities worth at least 105 percent of the cash received. (*Id.*, ¶24.)

Lehman and EY's Knowledge of and Involvement with Repo 105s

In 2001, Lehman drafted a written policy regarding the structuring of repurchase transactions as sales if Lehman provided 105 percent overcollateralization under FAS 140. (*Id.*, ¶54.) Pursuant to this policy, Lehman concluded that it could remove the securities it sold as Repo 105s from its balance sheet during the term of the repo and replace them with other assets in the form of cash, plus a forward repurchase commitment, which Lehman recorded as a derivative. (*Id.*, ¶25.) A copy of this policy was provided to EY, (*Id.*, ¶¶55, 116). Lehman also obtained a legal opinion from the U.K.-based Linklaters law firm with regard to these transactions.

Lehman refreshed its Repo 105 accounting policy from time to time between 2001 and 2008. Members of senior Lehman management approved the policy, [redacted] the Chief Financial Officer [redacted] the Financial Controller [redacted] and [redacted] Accounting Policy. (*Id.*, ¶64.) Over the years, the Repo 105s and their accounting were known to and accepted by [redacted] Lehman's CFOs, [redacted] Chief Operating Officer [redacted], [redacted] Financial Controllers, the Product Controller, [redacted] Accounting Policy and others. (*Id.*, ¶¶ 58, 64.)

In January of 2002, Lehman Head of Accounting Policy, Kristine Smith, prepared an Audit Committee agenda and presentation that discussed Repo 105. (*Id.*, ¶107.) The agenda and presentation were for an Audit Committee meeting to discuss Lehman's off-balance-sheet transactions in the wake of Enron's bankruptcy. The agenda and presentation were provided to EY in advance of the meeting. (*Id.*) There is no evidence that anyone from either party recalls the precise discussion at the January 2002 Audit Committee meeting. (*Id.*, ¶108.)

In 2004, several members of Lehman's senior management team began receiving emails tracking Lehman's use of Repo 105s and their impact on Lehman's net leverage and net balance sheet, and Lehman enacted various internal operating policies regarding the volume and usage of its Repo 105 transactions. (*Id.*, ¶¶73, 74, 79.) The parties dispute whether these policies were ever discussed with EY (*Id.*, ¶ 84), but for purposes of this stage in this arbitration, there is no dispute that Lehman did not adhere to these policies. (*Id.*, ¶85.)

Members of Lehman's senior management expressed concerns internally about the bank's use of Repo 105 transactions. (*Id.*, ¶¶86, 89, 91, 92.) Although Marie Stewart, head of Accounting Policy, testified [redacted] (Id.,

¶91.) Although [redacted] met frequently with EY, there is no evidence that [redacted] ever shared these concerns with them.

In 2002, Lehman did inform EY of a proposal to account for contemplated transactions called Repo 107s as sales under FAS 140. EY reviewed Lehman's proposal and concluded that sale accounting on Repo 107s would not be permitted. (*Id.*, ¶118.) In 2006, Lehman expanded the Repo 105 accounting policy to include Repo 108s. (*Id.*, ¶122.) EY reviewed the 2006 version of the Repo 105 accounting policy, which covered both the Repo 105 and Repo 108 transactions and did not object to Lehman's accounting policy conclusion. (*Id.*, ¶123.)

EY also discussed the Repo 105 program internally. (*Id.*, ¶126.) In 2006, EY auditor Bharat Jain sent an email to Jennifer Jackson questioning whether the quantity of Repo 105s being purchased presented a reputational risk to Lehman. (*Id.*, ¶127.) EY did not discuss Mr. Jain's email with management or with the Audit Committee. (*Id.*, ¶129.); however, it is stipulated that reputational risk is not a GAAP or GAAS measure and that EY was not required to and did not audit reputational risk. (*Id.*, ¶128.)

EY received at least some hard data with regard to Repo 105's usage. For example, in connection with its quarterly review procedures for the first three quarters of 2006, the first three quarters of 2007 and the first two quarters of 2008, EY received from Lehman a 100+ page document down as the Consolidated Global Balance Sheet Analysis (the "CGBSA"). (*Id.*, ¶133.) The CGBSA contained management analysis of Lehman's balance sheet, and one of the pages in the CGBSA included information about the volume of Lehman's Repo 105 usage and a graph showing the usage of Repo 105, including Lehman's increased usage at quarter-end. (*Id.*) The parties dispute, however, whether anyone from EY reviewed the CGBSA's Repo 105 information. (*Id.*) There is no evidence, however, that EY had a duty to make such a review.

Matthew Lee

On May 16, 2008, which was almost at the end of EY's contractual relationship with Lehman, Matthew Lee, an employee in Lehman's Finance Division, sent a letter to Lehman management expressing a number of concerns (the "Lee Letter"). (*Id.*, ¶136.) The Lee Letter did not refer to Repo 105 transactions. (*Id.*) Lehman provided a copy of the Lee Letter to EY a few days later. (*Id.*, ¶137.)

Lehman initiated an investigation of Lee's allegations. EY monitored that investigation, met with Lehman's internal auditors on multiple occasions and separately met with Matthew Lee. (*Id.*, ¶139.)

Sometime between May 16, 2008 and June 10, 2008, Matthew Lee drafted a second letter to Lehman management (the "Second Lee Letter"). The Second Lee Letter stated that Lehman was the only major investment bank engaging in Repo 105-like transactions and that Lehman increased the volume of its Repo 105s at quarter ends. (*Id.*, ¶142.) There is no documentary evidence that the Second Lee Letter was sent to EY or to Lehman. (*Id.*)

On June 10, 2008, Matthew Lee's attorney, Erwin Shustak, sent an email (the "Shustak email") to Jack Johnson, an in-house counsel at Lehman. That same day, [redacted] The Shustak email contained the following discussion of Lehman's Repo 105 transactions:

> Matthew believes Lehman is actively deceiving public investors, rating agencies and others by entering into sales transactions with third parties on a temporary basis with the result that the public is mislead [*sic*] as to the true value of Lehman's inventory which is in the billions of dollars. He sees the firm entering into more and more of these transactions at a time when the public is being told the firm's liquidity is improving.
>
> ...
>
> Matthew drafted a letter which he intended to deliver to senior management bringing what he considers to be these financial irregularities to their attention, as he feels compelled to do under Lehman's own Code of Ethics. I have prevailed on him to not deliver the letter so that I can continue our discussions and reach an amicable parting. (*Id.*, ¶143.)

Lee was in the process of being laid off as part of a reduction in force at the time in question. (*Id.*, ¶136.)

Pursuant to the Engagement Letter in force at the time, Lehman was required to inform EY of all allegations involving financial improprieties received by management or the Audit Committee and provide EY full access to these allegations and any internal investigations of them, on a timely basis. (*Id.*, ¶146.) The parties dispute whether Lehman provided EY with the Shustak email or if EY was ever made aware of the email's existence. (*Id.*, ¶145.) On June 12, 2008, EY partners Bill Schlich and Hillary Hansen met with Matthew Lee. Matthew Lee recalls discussing the Repo 105 transactions with the EY partners for "30 to 60 seconds." (*Id.*, ¶151.) According to his sworn testimony, Lee did not raise any questions regarding the accounting for the Repo 105 transactions, inform EY of any spiking in the volume at the end of reporting periods, or inform EY of his belief that other major investment banks were no longer engaging in Repo 105 transactions. (*Id.*) Further, according to EY partners Schlich and Hansen, Lee stated several times during that meeting that he was not aware of any material modifications that EY needed to make to comply with GAAP. (*Id.*, ¶152.)

On July 22, 2008, Beth Rukofker, Lehman's internal auditor, made a formal presentation to the Audit Committee regarding Lehman's investigation of Lee's allegations. She reported that the investigation by Lehman Internal Audit was substantially complete and that no material issues had been identified. (¶158.) Bill Schlich of EY attended this meeting. (*Id.*) Thus, whether by Lehman itself, or by EY, the Audit Committee was aware that certain allegations about the Repo 105 transactions had been made. There is no stipulated fact that EY had any more information about the Lee allegations than had the Audit committee.

VII. Parties' Positions

EY maintains that Lehman's malpractice and breach of contract claims are barred by fundamental principles of agency and *in pari delicto* because while the purpose and usage of the Repo 105 transactions were well known and approved at the highest levels of Lehman management, their concerns, if any, were never communicated to EY. In addition, EY claims, if additional disclosures should have been made about the purpose and usage of the Repo 105s, the place for those disclosures would have been in Lehman's MD&A, not in the financial statement, and unlike the financial statement, the MD&A is not audited by EY.

Thus, EY concludes, the imputation-based defense of *in pari delicto* is a complete defense to Lehman's claims because any wrongdoing associated with the Repo 105s is overwhelmingly attributable to Lehman, whose management conceived of, developed and utilized the transactions. Further, EY argues that Lehman cannot claim reliance on EY, when, through its own senior management, Lehman already knew what it now claims EY should have told Lehman through its Audit Committee.

Lehman contends that EY's imputation theory would be an unprecedented and unwarranted extension of the doctrine of *in pari delicto*, because it would effectively insulate auditors from all malpractice and breach of contract claims. In addition, Lehman maintains that the cases upon which EY relies are inapposite because they held that an auditor cannot be held liable to its client for failing to discover the client's own fraud, whereas here, the parties agree that no fraud has been committed.

VIII. Discussion and Analysis

Choice of Law

Under Rule 10.1 of the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution, absent the agreement of the parties, the Panel has the discretion to apply the law it deems to be appropriate. Lehman states that in applying this discretion the Panel could reasonably find that either New York or Delaware law applies, but that in any event under either law the doctrine of imputation is not a defense to the malpractice and breach of contract committed by EY.

EY maintains that the Panel should apply New York law. It is undisputed that while both Lehman and EY are incorporated in Delaware, Lehman is headquartered in New York, the Engagement Letters were signed in New York, the primary EY audit team was from EY's New York office, and EY's audit team performed the vast bulk of its audit work in New York as well. We thus find that New York law applies in this arbitration.

The Law of Imputation and the Imputation-Based Defenses

The defense of *in pari delicto* serves as a bar to a variety of claims for wrongdoing, including claims for malpractice and breach of contract, both of which Lehman has alleged here. *See Kirschner v. KMPG LLP*, 938 N.E.2d 941, (N.Y. 2010) at 949, 959 [analyzing the adverse interest exception to the *in pari delicto* doctrine and answering in the affirmative a certified question from the Delaware Supreme Court in a companion action whether "the doctrine of *in pari delicto* (would) bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence based on the auditor's failure to detect fraud committed by the corporation; and, the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in its audits of the corporation's financial statements."] In fact, courts have relied upon the doctrine in instances where, as here, the allegations involve an accountant's failure to disclose. (*See In re Parmalat Sec. Litig.* (S.D.N.Y. 2009) 659 F.Supp.2d 504, 515, 530-32 [finding defense of *in pari delicto* a bar to malpractice claim against accountants who, *inter alia*, failed to disclose schemes of corporate insiders to loot subsidiary].)

Imputation is a doctrine of agency law that provides that "the acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their principals." (*Kirschner v. KPMG LLP, supra* at 950.) The doctrine of imputation plays an important role in the *in pari delicto* defense and serves two important public policy purposes. (*Id.*) First, denying judicial relief to an admitted wrongdoer deters illegality, and second, *in pari delicto* avoids entangling courts in disputes between wrongdoers. (*Kirschner, supra* at 950.)

The *Kirschner* Court had to deal specifically with the issue of the imputation to the corporation of fraudulent acts by management in senior positions and the availability of the *in pari delicto* defense to auditor negligence. Acknowledging traditional agency principles, the Court noted that when corporate officers carry out the everyday activities central to the company's operation their conduct falls within the scope of their corporate authority. Not only acts are imputed to the corporation, but knowledge as well. As the Court noted, the presumption that agents communicate information to their principals does not depend on a case-by case assessment of whether this is likely to happen. Instead, it is a legal presumption that governs in every case, except where the corporation is actually the agent's intended victim. (*Kirschner, supra* at 951.)

Lehman would restrict *Kirschner*'s *in pari delicto* defense to where management's acts are fraudulent or illegal. We do not read *Kirschner* so narrowly. In the Court's own words: The *in pari delicto* rule "applies where both parties acted wilfully. Indeed, the principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said the defense applies even in difficult cases and should not be 'weakened by exceptions.'" (Citation omitted.)

The justice of the *in pari delicto* rule is most obvious where a willful wrongdoer is suing someone who is alleged to be merely negligent. However, as the Court makes abundantly clear, the principle also applies where both parties acted willfully. There is no dispute that Lehman acted willfully in this case.

Analysis of the Facts

Imputation and the *in pari delicto* defense

Lehman attempts to distinguish *Kirschner* and *Parmalat* on the ground that both cases involved allegations of fraud, whereas here, both parties agree that no fraud was involved with the Repo 105 transactions. Lehman has failed to explain, however, why this distinction makes any difference. It merely states that, in contrast to the frauds that were committed in the *Kirschner* and *Parmalat* cases, "Lehman's disclosure claims . . . relate to EY's failure to properly review and report to the Audit Committee on Lehman's accounting policies and financial statements." (Opening Brief, p.18.) This does not explain why the principles underlying the doctrine of imputation and the *in pari delicto* defense should be applied any differently in these two situations.[2]

Lehman is suing EY for, *inter alia*, failing to inform its Audit Committee about the existence and ramifications of the Repo 105 transactions and for failing to comply with its requirements under FAS 140, GAAS and GAAP. It is undisputed, however, that Lehman's management knew about and

[2] Lehman correctly notes that EY has not pointed to any cases where imputation negated an auditor's express obligation to report to the Audit Committee about technical deficiencies in accounting policies and non-fraudulent shortcomings in financial statements. The fact that there are no such cases does not necessarily mean that imputation does not herein apply, however. Instead, it could mean that these very specific facts have not yet arisen in the context of a reported decision.

developed the Repo 105 accounting policy for the specific purposes about which Lehman now complains. (Stip. Facts, ¶¶67, 68, 70 ["the Repo 105 process was transparent and was something that was well-known within the institution."], 73, 74, 76, 98 [several members of Lehman's senior management with knowledge of Lehman's Repo 105s and their usage signed certifications or sub-certifications regarding the accuracy and reliability of the information contained in the 10-Ks and 10-Qs that Lehman filed with the SEC]; *see also* Notice of Arb., ¶27 ["From the early days of the program, Lehman's management made clear to [EY] that Repo 105 would be used to manage Lehman's balance sheet so as to temporarily reduce Lehman's net leverage ratio."].) Indeed, it is undisputed that Lehman intentionally used Repo 105s to achieve leverage and balance sheet targets and ultimately to impact the net leverage ratio that Lehman reported in its MD&A. (*Id.*, ¶¶ 69, 70, 72, 74, 75.)

It is also undisputed that Lehman knew about the risks associated with the Repo 105s too. For example, [redacted] (*Id.*, ¶78.) And Lehman enacted various internal operating procedures to encourage the continuous use of the Repo 105 transactions rather than spikes in volume of those transactions at the end of reporting periods. (*Id.*, ¶¶79-82.) Further, members of Lehman's senior management team expressed concerns internally about the bank's use of the Repo 105s. (*Id.*, ¶86.) In one e-mail, Product Controller Gerry Reilly described Repo 105s as a "bad drug." (*Id.*)

Under the doctrine of imputation, the acts and knowledge of Lehman's management, all of whom were acting within the scope of their authority when they either approved, or discussed, or analyzed the Repo 105s, are presumptively imputed to their principal – Lehman. (*See Kirschner, supra*, 938 N.E.2d at 950.) It is of no consequence, contrary to Lehman's contentions, that none of these agents actually committed an act of fraud. Under *Kirschner*, the agent need only "act[] less than admirably [or] exhibit[] poor business judgment" for the doctrine of imputation to apply. (*Id.*) Here, Lehman's management's knowledge of and involvement in the Repo 105 transactions and their stated purpose can be imputed to Lehman.

Lehman is correct that *in pari delicto* most generally alleges that the Principal wrongdoer has committed an "immoral or unconscionable" wrongdoing. (*See Nomura Sec. Int'l, Inc., supra*, 280 F.Supp.2d at 200 ["This defense bars recovery for a plaintiff who is an active, voluntary participant in the unlawful activity that is the subject of the suit."]; *Stahl, supra*, 237 A.D.2d 231.) It does not, however, require that the wrong be characterized as a fraud or some other independently actionable conduct. (*See Nomura, supra*, 280 F.Supp.2d at 200.)

That having been said, Lehman has alleged that, based on EY's ineffective audit, advice and counsel, it drafted and filed with the SEC materially false disclosures that concealed Lehman's use of the Repo 105s to manipulate its reported net leverage. The filing of false disclosures with the SEC would constitute immoral or unconscionable wrongdoing. The analysis turns then to whether this conduct can be imputed to Lehman, and if so, whether Lehman is equally or more culpable.

EY contends that Lehman management's involvement in the Repo 105s was far greater than EY's, citing the stipulated facts discussed, *supra*, and *Kirschner*, where the court explained that "the corporation's agents would almost invariably play the dominant role in the fraud and therefore would be more culpable than the outside professional's agents who allegedly aided and abetted the insiders or did not detect the fraud at all or soon enough." (*Kirschner, supra*, 938 N.E. 2d at 958.) In addition, EY persuasively points to the undisputed fact that Lehman, through its agents, intentionally used Repo 105s to achieve leverage and balance sheet targets and ultimately to impact the net leverage ratio that Lehman reported in its MD&A. (*Id.*, ¶ 69, 72, 74, 75.) According to EY, it is therefore undisputed "that Lehman's agents willfully participated in the alleged wrongdoing in this case, and Lehman indisputably has far greater responsibility than EY does for that wrongdoing." (EY Reply Br., pp.12-13.)

EY further maintains that Lehman was more culpable because it shielded from EY highly relevant information, including Lehman's manipulative purpose for the Repo 105s, the Shustak email and the many internal concerns about its reverse-engineering of net leverage. (*Id.*, p.13 [citing Stip. Facts, ¶¶ 40 ["Lehman Bankruptcy Examiner concluded that Lehman used Repo 105s to manipulate its net leverage ratio at the end of financial reporting periods"]; 69 ["[t]here is evidence that Lehman used Repo 105s and other sales of liquid assets in an effort to achieve leverage and balance sheet targets, and ultimately to impact the net leverage ratio Lehman reported in its MD&A."]; 71 ["[m]embers of Lehman's senior management discussed with each other Lehman's use of Repo 105 for the express purpose of meeting balance sheet and leverage ratio targets"]; 73-87; 91-92; 96; 142-147.)[3] In addition, EY contends that it was less culpable because, although it reviewed Lehman's Repo 105 accounting policy and correctly concluded that it complied with GAAP (*see* Stip. Facts, ¶¶ 25, 116), it was not required to, and in fact never did, approve the manner in which Lehman used those GAAP-compliant transactions. (*See* Stip. Facts ¶¶10, 55 [Marie Stewart testified that [redacted]; 56; 116.) Moreover, EY maintains, it was less culpable because it was not responsible for auditing Lehman's MD&A, which is where Lehman's net leverage ratio was reported. (*Id.*, ¶12 [noting that EY was only "required to read the MD&A in Lehman's 10-K and 10-Q filings and consider whether the information in Lehman's MD&A was materially inconsistent with information in the financial statements or contained a material misstatement of fact."]

Lehman responds that EY was hired to report to the Audit Committee on (1) methods for accounting for significant unusual transactions or for controversial or emerging areas; (2) all alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management; and (3) changes in Lehman's significant accounting policies and methods for accounting for significant unusual transactions or for controversial or emerging areas. (*See* Stip. Facts, ¶¶18-19.) In addition, Lehman maintains, EY was hired to, and failed to provide accurate advice to Lehman about its disclosures pertaining to the Repo 105s in light of the facts known by EY. According to Lehman, if knowledge of these issues were simply imputed to the Audit Committee without any communication with EY, EY's express obligations to report back to the Audit Committee and to provide accurate advice and auditing services would serve no purpose and auditor malpractice would cease to exist as a viable cause of action.

Lehman relies on *Peterson v. Winston & Strawn LLP* (7th Cir. 2013) 729 F.3d 750 to support its position. In *Peterson*, the court stated, "[w]hen the goal of hiring a professional adviser is to cope with the consequences of known facts, the parties' equal access to the facts is beside the point." (*Id.* at 752.)

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[3] It should be noted, however, that with regard to Lehman's management's internal concerns, the parties dispute whether those concerns were ever conveyed to EY. (*See, e.g.*, Stip. Facts, ¶91, 97.) Moreover, Lehman contends that these concerns were expressed after EY had approved the Repo 105 policy and that EY had access to all of the information that formed the basis for these concerns. (Lehman Reply, p.9.) The stipulated facts do not support this argument.

Aside from the fact that *Peterson* is applying Illinois not New York law, the rationale and the facts underpinning the *Peterson* case are substantially different from the stipulated facts in this arbitration. In *Peterson*, the plaintiff was asking Winston & Strawn for advice for its course of conduct. EY was not asked to give its opinion as to whether Lehman's manipulative use of the Repo 105 program was proper or suspect.

Here, the parties' extensive list of stipulated facts demonstrates the extent to which Lehman's agents were aware of the allegedly illicit purposes behind the Repo 105 program. The stipulated facts strongly support a finding that Lehman was more culpable than EY. This is especially true because neither side argues that the factual record would be materially altered by a further hearing. Both sides agree that the case stands ready for summary disposition on these defenses.

In addition to *Peterson* the other key case relied on by Lehman is *Nat'l Sur. Corp. v. Lybrand*, 256 A.D. 226, 236 (N.Y. App. Div. 1939), but, like *Peterson*, the case is inapplicable as it merely applied negligence principles and did not discuss the *in pari delicto* defense.

Lack of reliance defense

As a general matter, the parties dispute whether reliance is even an element of Lehman's malpractice claim. EY contends that it is, citing *FDIC v. Ernst & Young* (5th Cir. 1992) 967 F.2d 166, 170, *Resolution Trust Corp. v. Coopers & Lybrand* (S.D.N.Y. 1996) 915 F.Supp. 584, 588 and *Mosier v. Stonefield Josephson, Inc.* (C.D.Cal. July 30, 2013) 2013 WL 4859635. According to EY, while *FDIC* and *Resolution Trust* both involved the application of Texas law, New York courts have cited to *FDIC* with approval and have also held that proximate cause is an element of an accounting malpractice claim. (*See ATC Healthcare, Inc. v. Goldstein, Golub & Kessler LLP* (N.Y. Sup. Ct. Oct. 19, 2009) 958 N.Y.S.2d 59 [citing *FDIC* with approval and stating that plaintiffs must prove proximate cause to prevail on claim of accounting malpractice].)

According to Lehman, under New York malpractice law, a client need not prove reliance if the defendant's alleged malpractice relates to express contractual obligations to its client. Lehman relies on *Ackerman v. Price Waterhouse* (N.Y.App. Div. 1998) 252 A.D.2d 179, 201 to support its position. *Ackerman* is inapposite from the instant matter, however, since it very narrowly addressed the issue of reliance when discussing predominance for purposes of class certification. (*Id.* at 196-98 ["We believe that a presumption of reliance is available *under the circumstances presented*." [Emphasis added.]) *Ackerman* did not involve questions of imputation.

Assuming *arguendo* that reliance is a requisite element of Lehman's claims, the analysis turns to whether EY has shown that Lehman lacked reliance based on the principles of imputation. EY has cited four cases to support its position – *In re NM Holdings Co., LLC* (6th Cir. 2010) 622 F.3d 613, *FDIC*, *supra*, 967 F.2d at 170-72, *Mosier v. Stonefield Josephson, Inc.* (C.D.Cal. July 30, 2013) 2013 WL 4859635 and *In re AgriBio Tech Inc.* (D.Nev. April 1, 2005) 2005 WL 4122738. The latter two of these cases support EY's position, while the former are distinguishable from the instant matter.

In *Mosier*, the court granted summary judgment and dismissed plaintiff's accountant malpractice claims because, *inter alia*, the corporation's principals were aware of the fraud underlying the claims. (*Mosier*, *supra*, 2013 WL 4859635, at *9.) In that case, the corporation's Receiver had asserted that the accountant was liable for failing to disclose in its audit reports the fraud that the corporation's principals were perpetrating. (*Id.*) That court concluded that any claim that the corporation relied on the audits would be without merit since the principals all already knew about the fraud. (*Id.*) Similarly, in *AgriBio*, the court dismissed plaintiff's claims against the corporation's accountant for professional negligence because the client could not have "justifiably relied" on the accountant to inform it about its own wrongful conduct. (*AgriBio, supra*, 2005 WL 4122738, at *12.) Although there is no fraud alleged in this case, the Panel finds that EY is entitled to the defenses of imputation and *in pari delicto*; therefore, reliance is moot.

Breach of Contract claim

Because EY is entitled to its defense of Imputation, the Breach of Contract claim also fails. Even if this claim were available, however, it would still fail, due to lack of proximate cause.

Lehman contends that, even if its alleged lack of reliance bars its claim that EY's work was a substantial factor in causing Lehman's alleged losses, it can still maintain a claim for the audit-related fees that it paid to EY because EY's audit was not GAAS-compliant. Lehman relies on *Stanley L. Bloch, Inc. v. Klein* (Sup.Ct. 1965) 258 N.Y.S.2d 501, 507-08, to support its position, but *Bloch* is inapplicable.

In *Bloch*, an accountant prepared an audit showing that the plaintiff was operating at a profit when in fact the plaintiff was operating at a loss. (*Id.* at 506-07.) Although "the record [did] not contain sufficient credible evidence to warrant the conclusion that [the accountant's] errors . . . were the proximate cause of" consequential damages sought by the plaintiff, the court found that the client was "entitled to recover the auditing fees that paid for the erroneous audit." (*Id.* at 507-08.)

Lehman's reliance on *Block* is misplaced because the court only awarded auditing fees for the time period during which the plaintiff had, in fact, established proximate cause. (*Id.* at 508.) The court did not award any fees for plaintiff's other claimed consequential damages since, as the court explained, those damages did not "flow naturally, directly and solely from defendants' negligence or their breach of contract." (*Id.*) *Bloch*, therefore, does not support Lehman's position. More important, a showing of proximate cause is noticeably absent from the record herein. Lehman does not, and apparently cannot, show that any of its actions regarding the Repo 105 program would have been materially different had EY provided different information or advice.

IX. Costs and Fees

Rule 17 of the CPR Rules for Non-Administered Arbitration defines in detail the allowable costs of the Arbitration and the Tribunal's discretion in fixing those costs, including "the costs for legal representation and assistance and experts incurred by a party to such extent as the Tribunal may deem appropriate." (Rule 17.2.d.)

Rule 17.3 states that "Subject to any agreement between the parties to the contrary, the Tribunal may apportion the costs of arbitration between or among the parties in such manner as it deems reasonable, taking into account the circumstances of the case, the conduct of the parties during the proceeding, and the result of the arbitration."

The Tribunal has considered all of the relevant factors, including the fact that Lehman is now in bankruptcy, and that EY collected considerable fees from Lehman during the relevant years. We have also taken into account the fact that the law in this area is still developing; therefore, Lehman had a colorable claim, although it failed on the merits.

Considering the relevant factors, we determine that each side should bear its own fees for legal representation and experts and 50% of the other arbitration costs, including the costs of the Tribunal's research attorney.

X. Conclusion

Based on the findings and conclusions set forth above, the Panel finds that the imputation-based defense of *in pari delicto* is a complete defense to Lehman's claims, because any wrongdoing associated with the Repo 105s is overwhelmingly attributable to Lehman.

FINAL AWARD

For the reasons stated above, a Final Award is entered on behalf of the Respondent Ernst & Young on all causes of action, and this matter is dismissed with prejudice, each side to bear its own costs. The Panel views this Award as final for purposes of any judicial proceedings in connection therewith. (*See* CPR Rule 15.1.) Any issue not specifically addressed in this Award is denied and any pending matters are cancelled as moot.

SO ORDERED.

Dated: April 7, 2014

William G. Bassler

The Honorable William G. Bassler
Arbitrator

Stephen G. Crane

The Honorable Stephen Crane
Arbitrator

Fern M. Smith

The Honorable Fern M. Smith
Chairperson

Schedule I

Dispute Resolution Procedures

Except as otherwise expressly set forth therein, the following procedures shall be used to resolve any controversy or claim ("dispute") as provided in this engagement letter. If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law. Nothing in these procedures is intended to preclude either party from applying to any court of competent jurisdiction exclusively for non-monetary or equitable relief.

Mediation

A dispute shall be submitted to mediation by written notice to the other party or parties. The mediator shall be selected by agreement of the parties. If the parties cannot agree on a mediator, a mediator shall be designated by the CPR Institute for Dispute Resolution at the request of a party. Any mediator so designated must be acceptable to all parties.

The mediation shall be conducted as specified by the mediator and agreed upon by the parties. The parties agree to discuss their differences in good faith and to attempt, with facilitation by the mediator, to reach an amicable resolution of the dispute. The mediation shall be treated as a settlement discussion and therefore shall be confidential. The mediator may not testify for either party in any later proceeding relating to the dispute. No recording or transcript shall be made of the mediation proceedings.

Each party shall bear its own costs in the mediation. The fees and expenses of the mediator shall be shared equally by the parties.

Arbitration

If a dispute has not been resolved within 90 days after the written notice beginning the mediation process (or a longer period, if the parties agree to extend the mediation), the mediation shall terminate and the dispute shall be settled by arbitration. The arbitration will be conducted in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("Rules") as in effect on the date of the engagement letter, or such other rules and procedures as the parties may designate by mutual agreement; provided, however, that any such rules and procedures shall (1) not serve to limit the liability of the parties, (2) apply equally to all parties, and (3) provide a fair process (e.g., neutral decision-makers and appropriate hearing procedures). In the event of a conflict, the provisions of this document will control.

The arbitration will be conducted before a panel of three arbitrators, two of whom are to be designated by the parties from the CPR Panels of Distinguished Neutrals using the screened selection process provided in the Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or concerning the applicability, interpretation, or enforceability of these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abide and be bound by these procedures.

The arbitration panel shall have no power to award non-monetary or equitable relief of any sort or to make an award or impose a remedy that (1) is inconsistent with the agreement to which these procedures are attached or any other agreement relevant to the dispute, or (2) could not be made or imposed by a court deciding the matter in the same jurisdiction.

Discovery shall be permitted in connection with the arbitration only in accordance with the Rules. All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the Rules, to the extent required by law, or as the other parties, in good faith, shall agree. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests, except to the extent such disclosure is necessary for the disclosing party to comply with applicable law or regulatory requirements.

The result of the arbitration will be binding on the parties, and judgment on the arbitration award may be entered in any court having jurisdiction.

PROOF OF SERVICE BY EMAIL & U.S. MAIL

Re: Lehman Brothers Holding Inc. vs. Ernst & Young
Reference No. 1425013854

I, SARAH NEVINS, not a party to the within action, hereby declare that on April 16, 2014 I served the attached FINAL AWARD on the parties in the within action by Email and by depositing true copies thereof enclosed in sealed envelopes with postage thereon fully prepaid, in the United States Mail, at San Francisco, CALIFORNIA, addressed as follows:

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Aaron L. Renenger Esq.
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Parties Represented:
Ernst & Young

I declare under penalty of perjury the foregoing to be true and correct. Executed at San Francisco, CALIFORNIA on April 16, 2014.

SARAH NEVINS
snevins@jamsadr.com

Exhibit 2

ERNST & YOUNG

Ernst & Young LLP
5 Times Square
New York, New York 10036-6530

Phone: (212) 773-3000
www.ey.com

May 15, 2007

Lehman Brothers Holdings Inc.
Attention: Mr. Christopher O'Meara

Dear Mr. O'Meara:

1. This will confirm the engagement of Ernst & Young LLP ("we", "us", or "E&Y") by the Audit Committee of Lehman Brothers Holdings Inc. (the "Company") to perform an audit of the Company's financial statements and its internal control over financial reporting (referred to hereinafter as the "integrated audit") as well as additional audits listed in Appendix I. As part of the integrated audit, we will audit and report on the consolidated financial statements of the Company for the year ended November 30, 2007 (the "audit of the financial statements"). In connection with our audit of the consolidated financial statements of the Company, we will review the Company's unaudited interim financial information before the Company files its quarterly reports on Form 10-Q and we will issue a report to the Audit Committee that provides negative assurance as to conformity with U.S. generally accepted accounting principles. We also will audit and report on management's assessment of the effectiveness of the Company's internal control over financial reporting and on the effectiveness of internal control over financial reporting as of November 30, 2007 (the "audit of internal control"). All of the services described in this paragraph may hereafter be referred to as either "Audit Service" or "Audit Services."

Integrated Audit Responsibilities and Limitations

2. The objective of our audit of the consolidated financial statements is to express an opinion on whether the consolidated financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. The objectives of our audit of internal control are to express an opinion on (1) whether management's assessment of the effectiveness of internal control over financial reporting is fairly stated, in all material respects, based on suitable control criteria, and (2) the effectiveness of internal control over financial reporting. Should conditions not now anticipated preclude us from completing either our audit of the financial statements or our audit of internal control and issuing our reports thereon, we will advise the Audit Committee and management promptly and take such action as we deem appropriate.

3. We will conduct our integrated audit in accordance with the standards of the Public Company Accounting Oversight Board (the "PCAOB"). Those standards require that we obtain reasonable, rather than absolute, assurance that the consolidated financial statements are free of material misstatement, whether caused by error or fraud, and that the Company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. As the Company is aware, there are inherent limitations in the audit process, including, for example, selective testing and the

LM 3/11/08 as of 2/8/08
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2007 Engagement Letter (signed original) possibility that collusion or forgery may preclude the detection of material error, fraud, and illegal acts. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Also, an audit of the financial statements is not designed to detect error or fraud that is immaterial to the consolidated financial statements. Similarly, an audit of internal control is not designed to detect deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness.

4. We will consider the Company's internal control over financial reporting in determining the nature, timing, and extent of our audit procedures for the purpose of expressing our opinion on: (1) the consolidated financial statements; (2) management's assessment of the effectiveness of internal control over financial reporting; and (3) the effectiveness of internal control over financial reporting. Our report on item (2) above relates to whether management's assessment process, including documentation, provides a reasonable basis for its assessment. Our report on item (3) above relates to the effectiveness of the entity's internal control taken as a whole, and not to the effectiveness of each individual internal control component.

5. In accordance with the standards of the PCAOB, we will communicate certain matters related to the conduct and results of the audit to the Company's Audit Committee. Such matters include, when applicable, disagreements with management, whether or not resolved; serious difficulties encountered in performing the audit; our level of responsibility under PCAOB auditing standards for the financial statements, for internal control, and for other information in documents containing the audited financial statements; unadjusted audit differences that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements as a whole; changes in the Company's significant accounting policies and methods for accounting for significant unusual transactions or for controversial or emerging areas; our judgments about the quality of the Company's accounting principles; our basis for conclusions as to sensitive accounting estimates; and management's consultations, if any, with other accountants.

6. In accordance with the rules of the Securities and Exchange Commission (the "SEC") implementing the requirements of Section 204 of the Sarbanes-Oxley Act of 2002, we will communicate to the Audit Committee all critical accounting policies and practices used by the Company, and all alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management, including ramifications of the use of such alternative disclosures and treatments along with the treatment preferred by us. We also will advise the Audit Committee of other material written communications between management and us.

7. We will obtain pre-approval from the Company's Audit Committee for any services we are to provide to the Company pursuant to the Audit Committee's pre-approval process, policies, and procedures. We also will communicate annually with the Audit Committee on independence matters as required by the independence standards of the PCAOB. We will communicate annually with the Audit Committee and provide a report on certain matters as specified in the Final Corporate Governance Rules of the New York Stock Exchange. We

will inform the Chair of the Audit Committee and management if the Audit Services are selected for inspection by the PCAOB and also will communicate any information of which we become aware as a result of such inspection that has a material effect on the financial statements previously reported on by us or that could result in a significant modification to an audit report previously issued by us. Upon your request, we will provide the Audit Committee and the Company with a copy of any publicly available inspection reports on E&Y issued by the PCAOB, but we will not provide any confidential inspection reports issued by the PCAOB to E&Y, the confidentiality of which is provided for in the Sarbanes-Oxley Act of 2002 and the PCAOB's inspection rules.

8. We will conduct our audit in accordance with auditing standards generally accepted in the United States and when applicable the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and the *Consolidated Audit Guide for Audits of HUD Programs* (the "HUD Guide"). The scope of our audit and the contents of the various financial reports will meet the requirements of the HUD Guide. Those standards require that we obtain reasonable, rather than absolute, assurance that the consolidated financial statements are free of material misstatement, whether caused by error or fraud. As you are aware, there are inherent limitations in the audit process, including, for example, selective testing and the possibility that collusion or forgery may preclude the detection of material error, fraud, and illegal acts.

9. If we determine that there is evidence that fraud or possible illegal acts may have occurred, we will bring such matters to the attention of an appropriate level of management. If we become aware of fraud involving senior management or fraud (whether by senior management or other employees) that causes a material misstatement of the consolidated financial statements, we will report this matter directly to the Audit Committee. We will ensure that the Audit Committee is adequately informed of illegal acts that come to our attention unless they are clearly inconsequential. In addition, we will inform the Audit Committee and appropriate members of management of significant audit adjustments noted during our audit procedures.

10. We will also ensure that all significant deficiencies and material weaknesses in internal control over financial reporting that we identify during the course of our integrated audit are communicated in writing to management and the Audit Committee. The identification of a material weakness that remains uncorrected as of the date of management's assessment will cause us to express an adverse opinion on the effectiveness of the Company's internal control over financial reporting. We also will communicate to management in writing all internal control deficiencies (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the integrated audit and not previously communicated by us or by others. We also will communicate to the Board of Directors the existence of any significant deficiency or material weakness as a result of ineffective oversight by the Audit Committee of the Company's external financial reporting and internal control over financial reporting.

Reviews of Unaudited Interim Financial Information

11. Our review of the Company's unaudited interim financial information will be performed in accordance with relevant PCAOB auditing standards.

12. A review of interim financial information consists principally of performing analytical procedures and making inquiries of management responsible for financial and accounting matters. It involves a review of the condensed financial information included in the filing on Form 10-Q and does not include any earlier earnings releases or other such communications. A review is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we will not express an opinion on the interim financial information.

13. A review includes obtaining sufficient knowledge of the entity's business and its internal control as it relates to the preparation of both annual and interim financial information to identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence; and select the inquiries and analytical procedures that will provide us with a basis for communicating whether we are aware of any material modifications that should be made to the interim financial information for it to conform with U.S. generally accepted accounting principles.

14. A review is not designed to provide assurance on internal control or to identify significant deficiencies. However, we will communicate to the Audit Committee any significant deficiencies noted during our review procedures.

15. If, during our review procedures, we determine that there is evidence that fraud or possible illegal acts may have occurred, we will bring such matters to the attention of the appropriate level of management. If we become aware of fraud involving senior management or fraud (whether caused by senior management or other employees) that causes a material misstatement of the interim financial information, we will report this matter directly to the Audit Committee. We will ensure that the Audit Committee is adequately informed of illegal acts that come to our attention unless they are clearly inconsequential. We also will inform the Audit Committee and appropriate members of management of significant unadjusted differences noted during our review procedures.

Management's Responsibilities and Representations

16. The consolidated financial statements, unaudited interim financial information, and management's assessment of the effectiveness of internal control over financial reporting are the responsibility of the Company's management. Management is responsible for establishing and maintaining effective internal control over financial reporting, for properly recording transactions in the accounting records, for safeguarding assets, and for the overall fair presentation of the consolidated financial statements and unaudited interim financial information. Management of the Company is also responsible for the identification of, and for the Company's compliance with, laws and regulations applicable to its activities.

17. Management is responsible for adjusting the consolidated financial statements and unaudited interim financial information to correct material misstatements and for affirming to us in its representation letter that the effects of any unadjusted differences accumulated by us during the applicable Audit Service and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the consolidated financial statements and unaudited interim financial information taken as a whole.

18. Management is responsible for apprising us of all allegations involving financial improprieties received by management or the Audit Committee (regardless of the source or form and including, without limitation, allegations by "whistle-blowers"), and providing us full access to these allegations and any internal investigations of them, on a timely basis. Allegations of financial improprieties include allegations of manipulation of financial results by management or employees, misappropriation of assets by management or employees, intentional circumvention of internal controls, inappropriate influence on related party transactions by related parties, intentionally misleading us, or other allegations of illegal acts or fraud that could result in a misstatement of the financial statements or otherwise affect the financial reporting of the Company. If the Company limits the information otherwise available to us under this paragraph (based on the Company's claims of attorney/client privilege, work product doctrine, or otherwise), the Company will immediately inform us of the fact that certain information is being withheld from us. Any such withholding of information could be considered a restriction on the scope of our Audit Services and may prevent us from opining on the Company's financial statements or internal control over financial reporting; alter the form of report we may issue on such financial statements or internal control over financial reporting; prevent us from consenting to the inclusion of previously issued auditor's reports in future Company filings or otherwise affect our ability to continue as the Company's independent registered public accounting firm. The Company and we will disclose any such withholding of information to the Audit Committee.

19. Management is responsible for evaluating the effectiveness of the Company's internal control over financial reporting using suitable control criteria and for supporting its assessment with sufficient evidence, including documentation. Management also is responsible for presenting a written 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. In connection with its assessment of internal control over financial reporting, management will affirm to us in its representation letter that it has: (1) disclosed to us all significant deficiencies in the design or operation of internal control over financial reporting, and (2) identified those that it believes to be material weaknesses.

20. As required by PCAOB auditing standards, we will make specific inquiries of management about the representations contained in the consolidated financial statements and unaudited interim financial information and management's assessment of the effectiveness of internal control over financial reporting. Those standards also require that, at the conclusion of the applicable Audit Service, we obtain representation letters from certain members of management about these matters. The responses to those inquiries, the written

representations, and the results of our procedures comprise the evidential matter we will rely upon in completing the applicable Audit Service. Management is responsible for providing us with all financial records and related information and making available to us all internal control documentation and records necessary to complete our Audit Services on a timely basis. Management's failure to do so may cause us to delay our reports, as applicable, modify our procedures, or even terminate our engagement.

21. Management agrees to cause all of the Company's consolidated foreign subsidiaries and affiliates to provide any authorization, to the fullest extent permissible under applicable law, necessary to permit compliance by an Auditor with requests from the SEC or the PCAOB for production of Audit Documents. In addition, the Company hereby waives, to the fullest extent permissible under applicable law, the rights provided under any laws, regulations, professional standards, or other provisions that might restrict the ability of any Auditor to comply with requests by the SEC or the PCAOB for production of Audit Documents and consents, to the fullest extent permissible under applicable law, to action taken in furtherance of the foregoing by any Auditor. For purposes of this Section 21, "Auditor" means E&Y or a foreign public accounting firm or associated person participating in the Audit Services. For purposes of this Section 21, "Audit Documents" means documents or information in an Auditor's possession, custody or control that was obtained in the conduct of the Audit Services by the Auditor.

22. Management of the Company is responsible for the Company's process for surveying officers and directors, and for requesting that persons known by the Company to be the beneficial owners of more than 5% of the Company's common stock ("substantial stockholders"), officers, and directors disclose matters to the Company for communication to E&Y regarding the nature of any direct or material indirect business relationships (as such terms are defined in Regulation S-X) that the substantial stockholder, officer, or director, or any member of their immediate family (i.e., a person's spouse, spousal equivalent, and dependents), has with E&Y or any of its affiliates, or an ownership interest of five percent or more in, or situations where they serve as an officer or director of any Company (public or private) that has a direct or material indirect business relationship with E&Y or any of its affiliates. We will advise the Audit Committee and management if we become aware of any direct or material indirect business relationship that may relate to our performance of Audit Services for the Company.

Fees and Billings

23. Our fee estimate for fiscal 2007 services will be discussed at a later date. All additional services that management may engage Ernst & Young to perform must comply with the pre-approval policy for Independent Auditor Services. Our fees also will depend on the Company's documentation of internal control, the procedures the Company performs to support management's assertion of the effectiveness of internal control over financial reporting, and on the results of our examination procedures.

24. Our estimated fees and schedule of performance are based upon, among other things, our

preliminary review of the Company's records and the representations Company personnel have made to us, the Company's documentation of internal control over financial reporting, the procedures the Company performs to support management's assessment of the effectiveness of internal control over financial reporting, and the results of our audit procedures to date. They also are dependent upon the Company's personnel providing a reasonable level of assistance during our integrated audit. Should our assumptions with respect to these matters be incorrect or should the documentation of internal control, results of our procedures, condition of the records, degree of cooperation, extent of procedures performed by the Company to support management's assessment, or other matters beyond our reasonable control require additional commitments by us beyond those upon which our estimated fees are based, we may adjust our fees and planned completion dates. In addition, fees for any special audit-related projects, such as the issuance of financial statements for certain subsidiaries, proposed business combinations or research and/or consultation on special business or financial issues, will be billed separately from the fees referred to above and may be the subject of written arrangements supplemental to those in this letter.

25. In the event we are requested or authorized by the Company or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Company, the Company will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

Other Matters

26. We also will perform Audit Services that have been pre-approved by the Audit Committee and opine on separate audit reports for the Company and its consolidated subsidiaries as described at Appendix I.

27. From time to time, and depending upon the circumstances, personnel from any affiliate of E&Y, any other member of the global Ernst & Young network or any of their respective affiliates other than E&Y, and from independent third-party service providers (including independent contractors), may participate in providing the Audit Services.

28. The Secretary of Housing and Urban Development, the HUD Inspector General, and the General Accounting Office or their representatives will be permitted access to the relevant audit working papers or other documents in the event that they elect to perform a review of our audit procedures. In connection with their review of the working papers, we will make photocopies of the working papers, if so requested

29. The Company shall not, during the term of the Agreement and for 12 months following its termination for any reason, solicit for employment, or hire, any E&Y personnel involved in the performance of the Audit Services; provided that the Company shall not breach its obligation hereunder by generally advertising available positions or hiring E&Y personnel who either respond to such advertisements or come to the Company on their own initiative

without direct or indirect encouragement from the Company.

30. In addition, the Company shall not, without the prior written consent of E&Y, solicit for employment or for a position on its Board of Directors, or hire, any current or former partner, principal, or professional employee of E&Y, any affiliate thereof, or any other member of the global Ernst & Young network or any of their respective affiliates, a) if such partner, principal, or professional employee has been involved in the performance of any audit, review, or attest service for or relating to the Company at any time since the date of filing of the Company's most recent periodic annual report with the SEC (or, if the Company has not previously filed such a report, since the beginning of the most recent fiscal year to be covered by the Company's first such report) or in the 12 months preceding that date and b) unless such partner, principal, or professional employee does not influence E&Y's operations or financial policies and has no capital balances or any other financial arrangement with E&Y.

31. By your signature below, you confirm that the Company, through its Board of Directors, has authorized the Audit Committee to enter into this agreement with us on the Company's behalf and that you have been authorized by the Audit Committee to execute this agreement.

32. Subject to the provisions of Section 21, in the event that a party (the "Requested Party") is required by law or governmental regulation (by oral questions, interrogatories, requests for information or documents subpoena, civil investigative demand or similar process) to disclose any confidential information the Requested Party shall provide the other party with prompt notice of such request(s), to the extent permitted by applicable law or regulation, so that such party may seek an appropriate protective order and/or waive the Requested Party's compliance with the provisions in this engagement letter and will cooperate with such party in protecting the confidential or proprietary nature of the information which must be so disclosed. It is further agreed that if, in the absence of a protective order or the receipt of a waiver hereunder, the Requested Party is nonetheless, in the opinion of its counsel (who may be its employee), compelled to disclose any confidential information, it may disclose such information without liability hereunder, provided that it shall exercise commercially reasonable efforts to obtain assurance from the recipient that confidential treatment will be accorded such information.

33. Except for claims seeking exclusively non-monetary or equitable relief, any controversy or claim arising out of or relating to services covered by this letter or hereafter provided by us for the Company or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Company or of E&Y, or involving any person or entity for whose benefit the services in question are or were provided), shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration, in accordance with the dispute resolution procedures set forth in Schedule I to this letter. Judgment on any arbitration award may be entered in any court having jurisdiction.

34. If any portion of this letter is held to be void, invalid, or otherwise unenforceable, in whole

or part, the remaining portions of this letter shall remain in effect.

We will perform the Audit Services described herein for each of the Company's subsequent fiscal years based on the terms and conditions set forth in this agreement until either the Audit Committee or E&Y terminates the agreement. Changes in the scope of our Audit Services and estimated fees for such services in subsequent fiscal years will be communicated in supplemental letters.

If these arrangements are acceptable, please sign one copy of this agreement and return it to us.

We very much appreciate the opportunity to serve as the Company's independent registered public accounting firm and would be pleased to furnish any additional information you may request concerning our responsibilities and functions. We trust that our association will be a long and mutually beneficial one.

Yours very truly,

Ernst + Young LLP

Lehman Brothers Holdings Inc.

By: ______________________

Christopher O'Meara
Chief Financial Officer

____
Date

Schedule I

Dispute Resolution Procedures

Except as otherwise expressly set forth therein, the following procedures shall be used to resolve any controversy or claim ("dispute") as provided in this engagement letter. If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law. Nothing in these procedures is intended to preclude either party from applying to any court of competent jurisdiction exclusively for non-monetary or equitable relief.

Mediation

A dispute shall be submitted to mediation by written notice to the other party or parties. The mediator shall be selected by agreement of the parties. If the parties cannot agree on a mediator, a mediator shall be designated by the CPR Institute for Dispute Resolution at the request of a party. Any mediator so designated must be acceptable to all parties.

The mediation shall be conducted as specified by the mediator and agreed upon by the parties. The parties agree to discuss their differences in good faith and to attempt, with facilitation by the mediator, to reach an amicable resolution of the dispute. The mediation shall be treated as a settlement discussion and therefore shall be confidential. The mediator may not testify for either party in any later proceeding relating to the dispute. No recording or transcript shall be made of the mediation proceedings.

Each party shall bear its own costs in the mediation. The fees and expenses of the mediator shall be shared equally by the parties.

Arbitration

If a dispute has not been resolved within 90 days after the written notice beginning the mediation process (or a longer period, if the parties agree to extend the mediation), the mediation shall terminate and the dispute shall be settled by arbitration. The arbitration will be conducted in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("Rules") as in effect on the date of the engagement letter, or such other rules and procedures as the parties may designate by mutual agreement; provided, however, that any such rules and procedures shall (1) not serve to limit the liability of the parties, (2) apply equally to all parties, and (3) provide a fair process (e.g., neutral decision-makers and appropriate hearing procedures). In the event of a conflict, the provisions of this document will control.

The arbitration will be conducted before a panel of three arbitrators, two of whom are to be designated by the parties from the CPR Panels of Distinguished Neutrals using the screened selection process provided in the Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or concerning the applicability, interpretation, or enforceability of these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abide and be bound by these procedures.

The arbitration panel shall have no power to award non-monetary or equitable relief of any sort or to make an award or impose a remedy that (1) is inconsistent with the agreement to which these procedures are attached or any other agreement relevant to the dispute, or (2) could not be made or imposed by a court deciding the matter in the same jurisdiction.

Discovery shall be permitted in connection with the arbitration only in accordance with the Rules. All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the Rules, to the extent required by law, or as the other parties, in good faith, shall agree. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests, except to the extent such disclosure is necessary for the disclosing party to comply with applicable law or regulatory requirements.

The result of the arbitration will be binding on the parties, and judgment on the arbitration award may be entered in any court having jurisdiction.

Appendix I

Consolidated Subsidiaries

Lehman Brothers Holdings Inc.	November 30, 2007
Lehman Brothers Inc.	November 30, 2007
Lehman Brothers Derivative Products Inc.	November 30, 2007
Lehman Brothers Financial Products Inc.	November 30, 2007
Lehman Brothers Commercial Corporation	November 30, 2007
Lehman Brothers OTC	November 30, 2007
Brasstown Mansfield I	December 31, 2007
Brasstown Entrada I	December 31, 2007
Wharf Re	December 31, 2007
Lehman Re Ltd.	December 31, 2007
NL Funding, L.P.	December 31, 2007
Neuberger Berman Management Inc.	November 30, 2007
Neuberger Berman, LLC	November 30, 2007
Lehman Brothers Trust Co. of Delaware	December 31, 2007
Lehman Brothers AIM Holdings LLC	December 31, 2007
Lehman Brothers Futures Asset Management Corp.	November 30, 2007
Lehman Brothers Management LLC	December 31, 2007
Lehman Brothers Bank	December 31, 2007
SFJV 2003-1, LLC	December 31, 2007
Long Point Funding Pty Limited	November 30, 2007
Pindar Funding Pty Limited	November 30, 2007
Lehman Brothers Trust Company, N.A.	December 31, 2007
Lehman Brothers Inc. – Puerto Rico Branch	December 31, 2007
Lehman Brothers Commercial Bank	December 31, 2007
Ivanhoe Lane Pty Limited	November 30, 2007
Serafino Investments Pty Limited	November 30, 2007

Other Audits

The Lehman Brothers Foundation	December 31, 2007
Lehman Brothers 401(K) Plan	December 31, 2007
Lehman Brothers Pension Plan	December 31, 2007
Lehman Brothers U.K. Pension Plans	December 31, 2007
Lehman Brothers Holdings E-Capital LLC I	December 31, 2007
Lehman Brothers Holdings E-Capital Trust I	December 31, 2007