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▪ Internal Correspondence

▪ New York – FSO

To: The Files

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Contingent Acquisition Facility Audit Approach

Background

Lehman Brothers Holdings Inc. provides contingent acquisition facilities (“CAF”) to investment and non-investment grade counterparties for corporate and/or private equity buyout acquisition financing. Actual funding of these contingent commitments is dependent upon both a proposed transaction being closed as well as the borrower fully utilizing Lehman’s financing commitments (as opposed to using other financing sources within the capital markets). As of November 30, 2007, the contractual committed amount of Lehman’s global contingent acquisition commitments was \$19.9 billion, up from \$14.7 billion at November 30, 2006. In accordance with the *AICPA Audit and Accounting Guide, Brokers and Dealers in Securities*, Lehman accounts for all its lending commitments at fair value, with changes in fair value recorded in earnings.

During 2007, illiquidity in the capital markets contributed to the market demanding a higher coupon on these contingent commitments as compared to the coupon originally agreed to at commitment date. Lehman compared these commitments to updated return expectations, resulting in a gross unrealized loss of \$1.3 billion at August 31, 2007. This gross calculation is conservative, as it does not factor in the probability that the deal will close at the stated term, as many of these commitments will expire unused. Management then estimated the amount of underwriting fees to be recognized when/if the deal is closed, along with LCDX hedge revenues, and net these amounts against the \$1.3 billion, resulting in a net loss of \$763 million at August 31, 2007. The netting of expected underwriting fees within Principal Transactions against the CAF writedowns is consistent across the industry. Activity in the syndication market picked up during the fourth quarter of 2007, resulting in 12 deal closings. Additionally, market factors led to recovery of certain positions where previous unrealized losses had been taken. As a result, Lehman recorded a gross gain of \$334 million and net gain of \$322 million (net of hedges) during Q4, largely comprised of unrealized MTM gains on existing deals. Gross and net writedowns on Lehman’s CAF portfolio for the fiscal year approximated \$966 million and \$441 million, respectively.

The CAF price testing file contains both closed and unclosed contingent commitments. Closed deals refer to financing agreements that have been agreed upon by all parties involved for the deal structure, commitment amount, fees, and timing. Closed deals are able to be traded in the

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secondary market. Although the funding agreement is closed, the funding amount is still contingent upon the actual transaction being closed after shareholder approval and/or regulatory approval. All closed deals are also issued an FCN identifier number. Lehman's commitment disclosure footnote only discloses true, or unclosed, CAF obligations.

In order to reflect the change in Lehman's potential commitments at fair value, Lehman's Product Control independently verifies the pricing of its CAF portfolio at the end of every month. The price verification process undertakes a variety of methods to independently substantiate the price at which each commitment has been marked. Ernst & Young ("EY") obtained Lehman's third and fourth quarter CAF price verification analyses, and met with Product Control to discuss and gain an understanding of Lehman's price verification methodology in order to independently verify Product Control's representations and Lehman's CAF valuation.

Lehman records its CAF loans and commitments at fair value. Losses are driven by differences between Lehman's Front Office price and par value for each CAF.

Unrealized loss for closed CAFs (loans) is calculated as follows:

Less:	Gross Writedown
	(Underwriting Fees)
	(M&A Advisory Fees)
	(Bridge Equity)
	(Net Carry)
	<hr/>
	= Unrealized Loss

Unrealized loss for unclosed CAFs (commitments) is calculated as follows:

Less:	Gross Writedown
	(Projected Underwriting Fees)
	<hr/>
	= Unrealized Loss

Whereas "Gross Writedown" equals the following:

$$(\text{Notional} \times \text{CAF Price}) - (\text{Notional} \times 1.00)$$

Lehman's gross writedowns on CAF positions are often softened, as any loss is netted against fees earned from underwriting the financing and from acting as issuer's M&A advisor. Lehman's total unrealized loss (excluding hedges) on its NY CAF positions as of November 30, 2007 totaled \$391.9 million, compared to \$789.9 million as of August 31, 2007 (See **EXHIBIT A**), leading to an unrealized gain of \$398 million.

Data Completeness & Sample Selection

As of the third quarter, August 31, 2007, Lehman's CAF loan price verification process was still in its infancy; at that point, Product Control did not have a well-documented policy and procedure in place for testing CAF loans.

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To test Lehman's CAF price testing procedures, EY obtained the CAF loan price verification file as of fourth quarter, November 30, 2007. EY gained an understanding of the pricing procedures and substantively tested the pricing population at November 30th, 2007. EY haphazardly obtained commitment letters, which detailed the financing providers (including Lehman), the counterparty (issuer and acquirer), and the acquirer. The commitment letters also provide a framework for each financing provider's lending commitment, interest rate, applicable fees, and other contractual information. Additionally, EY re-calculated and agreed the notional amount for each facility of the Alliance Data deal to the Alliance Data commitment letter.

To ensure data completeness and integrity, EY compared the issuer names, cusips, and front office market values for the respective loans in the price verification file to a download from LAURA/CATS, a front office system database that houses origination, investment, and trading of loans.

Through discussion with Lehman Product Control personnel, Lehman's NY CAF price testing population consists of non-investment grade (high-yield) loans and commitments. High-yield typically is classified as those facilities rated below Baa3 by Moody's Investor Services and BBB- by Standard & Poor's. Due to current credit market conditions and widening bond yields, high-yield CAF are the riskiest in terms of pricing and the most problematic in terms of selling/unloading to third parties. The probability of loss impact from high-yield facilities is much greater than those from investment grade (high-grade).

As of November 30, 2007, Lehman carries \$9.7 billion of *unclosed* high-yield CAF commitments on its balance sheet, of which \$9.3 billion, or 96%, are subject to price testing out of the Lehman New York and London offices (See **EXHIBIT B**). Lehman carries \$10.2 billion of unclosed high-grade CAF commitments on its balance sheet, of which \$7.7 billion, or 75%, are subject to price testing out of the Lehman New York and London offices (See **EXHIBIT C**).

For EY's November 30, 2007 price verification retest, we selected 11 issuers with a total of 40 CAF facilities worth \$6.94 billion in market value. These figures amount to close to 40% of all (closed and unclosed) CAF facilities price tested in the Lehman New York office, in terms of total notional. The issuers we selected encompass all of the samples we initially reviewed during interim, including financing for some of the largest leveraged buyout deals from 2007—Blackstone Group's acquisition of Alliance Data Processing, Kohlberg Kravis Roberts & Co.' acquisition of TXU Energy and First Data Corp, among others. We believe our judgmentally selected samples adequately meet the sampling requirements of EY/GAM.

Product Control Price Verification

Lehman's Fixed Income Product Control verifies the Front Office marks on a monthly basis. The CAF population is downloaded from the Front Office LAURA system (P-Synd) which tracks closed and unclosed loans through loan IDs. Unclosed loans carry a dummy ID (-999), and once a loan is closed a unique identifier is given to the loan. Download contains the key variables for each facility, including the maturity date, cusip, Lehman's position, Front Office price, All-in-Spread (LIBOR + coupon), traded price and date, etc. As no formal policy for price testing is in place, the price verification procedure is relatively more manual and subjective than that of many

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other products. Lehman uses a variety of methods to gain comfort around the front office prices in its CAF price testing. In general, EY observed that Product Control recalculates CAF pricing by using the following methods (in sequence from most preferred to least preferred):

- I. Independent prices from Markit Partners Group Ltd., a third-party pricing source for credit derivative products
- II. Last traded market price from trading activity in the LAURA system, within a defined time threshold
- III. Deriving prices from a variety of bond indices, including the LCDX and CDX market data
- IV. Deriving prices based on other comparable commitments, based on either Markit source, traded price, or alternative method

I. Markit Partners Pricing

For certain closed CAF positions, Lehman Product Control receives a weekly e-mail from Markit Partners with independent consensus loan price information. Markit's average price is generated from submissions by investment banks, hedge funds, holdings companies, and insurance companies and it is generally recognized as an acceptable measure of fair value. Lehman maps the Loan Identification Number (LIN) to its population denoted by cusip numbers. If pricing information is observable from Markit, Product Control will use the Markit price to value the particular CAF, and calculate the potential adjustment using the following:

$$\text{(Markit Price – Front Office Price)/100} \times \text{Lehman's Current Position}$$

Findings:

EY obtained a PDF Markit file for November 30 to verify the integrity and completeness of Markit data. EY agreed the "Average Bid" price to Lehman's LIN and cusip numbers. EY deemed the CAF prices derived from Markit to be reasonably stated.

II. Last Traded Market Price

If independent prices from Markit Partners are unavailable, Product Control then attempts to use the last market traded price as a price indication for the CAF facility. Due to recent market illiquidity, Lehman generally disregards all trade prices more than 15 days from the cutoff date, November 30, 2007. Recent trade data is derived from LAURA system download, as it is the Front Office trading and execution system. Recent trading data is used to for closed loans.

Findings:

To independently verify trading price, for all samples derived from trades, EY obtained the corresponding month-end (October and November) LAURA system downloads and verified the trade date, price, and noted the counterparty for the respective trades. EY found no discrepancies.

III. Bond Indices

If the above methods are not available (the loans are unclosed CAF), Lehman Product Control derived the CAF price by using a proprietary model ("PriceCO") within the Bank Loan price verification file to generate a price for the CAF. The formula calculates the loan price using a

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loan's maturity, coupon, a given day's prevailing LIBOR rate, and the CDX/LCDX value to calculate a price for the related CAF. Some of the prices are derived from index values as of November 30, 2007, while prices for others are generated by Product Control by looking at the month to month change of various bond indices, including the LCDX (a tradeable index that includes 100 single name default swaps referencing an entity whose loans trade in the secondary leveraged loan market or LCDS market) and CDX (a tradeable index that includes single name corporate credit default swaps) market data for specific industries.

Findings:

As EY's Lehman terminal does not possess the proprietary Microsoft Excel model, EY observed Tony Hou, Product Control, use the formula and obtained a screenshot to substantiate Product Control's recalculation. EY independently verified Product Control's model inputs, by obtaining the November 30, 2007 LCDX and CDX spreads from Markit Partners, the November 30, 2007 LIBOR rate from the British Bankers Association, and agreed the index changes for the industries Lehman used as benchmarks. EY verified all model inputs, and by inference we deem that the respective CAF valuations are reasonably stated.

IV. Derived from Comparable CAFs

For a portion of CAFs that Product Control did not employ the aforementioned methods for price verification, Product Control based the CAF price on a comparable facility from a similar issuer, taking into account differences in maturity, coupon and other factors. EY held discussions with Product Control personnel, noting that if no preferred method of price verification exists, Product Control will use a benchmark issuing company with similar business model and capital structure to assist in valuation of the CAF. The input parameters are then fed into Lehman's PriceCO model to come up with a reasonable value for the CAF.

In addition, prices for certain facilities of the same issuer are derived from relationships between types of loans. For example, a revolver for First Data Corp. is priced 2 basis points below the term loan. The relationships are based upon conversations Product Control had with Front Office trading desk, and are typically characteristic of the relationship between the types of loans per prior Front Office experience. As subordination date, maturity, coupon, and a variety of other factors affect the trading price of CAFs, Product Control felt that the best way to summarize the relationships was from Front Office's experience upon issuance of such loans. The relationships Product Control noted are as follows:

- Delayed Draw Term Loans trade 0.5 points above Term Loans
- Term Loans trade 2 points above Revolving Facilities
- Senior Subordinate Notes trade 4 points above Senior PIK Bridge
- Senior Bridges trade 1 point above Subordinate Bridges

In addition, Product Control also conducts reviews of sale/syndication activity that may have occurred subsequent to the quarter end as well as discussions with senior Front Office executives who have insight into the Leveraged Buy Out ("LBO") market and who play an active role in working with the other investment banks to price these syndications.

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Findings:

Discussions were held with Product Control to obtain an understanding and gain comfort over the rationale of their association between different companies as well as the relationships between different types of CAF facilities. EY obtained the October 31, 2007 and November 31, 2007 CDX and LCDX spreads from Markit Partners for the respective CAFs that employed the alternative pricing method. EY observed Product Control run the PriceCO model on the comparable facilities to obtain information on price sensitivity due to coupon differences, spread changes, maturity dates, etc. that is used to price the benchmarked CAF.

Conclusion

EY noted that there was no formal process documented to price test CAF positions prior to fiscal year 2007, and that for a portion of the year there were no controls in place for price verification. The price testing procedures were unique to many positions, and are relatively subjective in nature.

As such, EY has adopted a substantive approach to price test Lehman's CAF loan portfolio as of year end, to ensure adequate coverage of the price testing population to detect material misstatements. We held multiple discussions throughout the audit period to obtain sufficient understanding over Product Control's rationale and methodology of CAF price verification.

As per the procedures documented above, we believe that our nature, extent, and timing is sufficient to detect material misstatements related to Lehman's CAF portfolio, and we deem its CAF position to be fairly stated as of November 30, 2007.

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