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CASE MANAGEMENT CONFERENCE SET

5 Attorneys for Plaintiffs
JOSEPH AVENIUS, an individual, et al.

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6 DEPARTMENT 212

7 SUPERIOR COURT OF CALIFORNIA

8 SAN FRANCISCO COUNTY

9 UNLIMITED CIVIL JURISDICTION

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12 JOSEPH AVENIUS, an individual; JUANITA
AVENIUS, an individual; JOHN
13 BRADSHAW, an individual; LIZABETH
BRADSHAW, an individual; MARK BRADY,
14 an individual; DAVID CONCORDIA, an
individual; RICHARD CONTI, an individual;
15 DYNAPURE TECHNOLOGIES, INC., a
Nevada corporation; DAVID EVERS WICK, an
16 individual; JOYCE EVERS WICK, an
individual; LAWRENCE GRECO, an
17 individual; FEB GRUBMAN, an individual;
EDWARD HATCH, an individual; DONALD
18 JOHNSON, an individual; ANTHONY
KEHLENBECK, an individual; MARK
19 KOLESINSKY, an individual; DAVID
LOUNDY, an individual; MICHAEL
20 MATHER, an individual; PHILLIP
MATTHEWS, an individual; DONALD
21 MILLER, an individual; MARY ANNE
MILLER, an individual; DANIEL PALERMO,
22 an individual; QUINTET, LLC, a Nevada
limited liability company; JEFFERY W.
23 RHOADS, an individual; ROBIN
RODABAUGH, an individual; PETER
24 ROSEN, an individual; ALAN ROSS, an
individual; DAVID RUBIN, an individual;
25 ALLEN SHINN, an individual; RIZALINA
SMART, an individual; ROBERT
26 SMYKOWSKI, an individual; THOMAS
VALLARINO, an individual; LEONARD
27 VIDAL, an individual; VALERIE VIDAL, an
individual; IRA WALTER, an individual;
28 LINDA WALTER, an individual; NORMAN

Case No. **CGC -06 -453422**

COMPLAINT FOR:

- (1) VIOLATIONS OF
CALIFORNIA
CORPORATIONS CODE
SECTIONS 25400, *ET SEQ.*
- (2) UNFAIR BUSINESS
PRACTICES (CAL. BUS. &
PROF. CODE §§ 17200, *ET SEQ.*
AND §§ 17500, *ET SEQ.*

JURY TRIAL DEMANDED

1 WALTER, an individual; DORIS WALTER,
2 an individual; ROBERT WILEN, an
3 individual; JEFFREY WILLIAMS, an
4 individual,

5 Plaintiffs,

6 v.

7 BANC OF AMERICA SECURITIES LLC;
8 THE BANK OF NEW YORK; BEAR,
9 STEARNS SECURITIES CORP.;
10 CITIGROUP, INC.; CREDIT SUISSE (USA)
11 INC.; DEUTSCHE BANK SECURITIES,
12 INC.; THE GOLDMAN SACHS GROUP,
13 INC.; LEHMAN BROTHERS INC.;
14 MERRILL LYNCH, PIERCE, FENNER &
15 SMITH, INC.; MORGAN STANLEY & CO.,
16 INCORPORATED; UBS FINANCIAL
17 SERVICES, INC.; and DOES 1 through 100,

18 Defendants.

19 Plaintiffs Joseph Avenius, Juanita Avenius, John Bradshaw, Lizabeth Bradshaw,
20 Mark Brady, David Concordia, Richard Conti, DynaPure Technologies, Inc., David Everswick,
21 Joyce Everswick, Lawrence Greco, Feb Grumman, Edward Hatch, Donald Johnson, Anthony
22 Kehlenbeck, Mark Kolesinsky, David Loudy, Michael Mather, Philip Mathews, Donald Miller,
23 Mary Anne Miller, Daniel Palermo, Quintet, LLC, Jeffery W. Rhoads, Robin Rodabaugh, Peter
24 Rosen, Alan Ross, David Rubin, Allen Shinn, Rizalina Smart, Robert Smykowski, Thomas
25 Vallarino, Leonard Vidal, Valerie Vidal, Ira Walter, Linda Walter, Norman Walter, Doris Walter,
26 Robert Wilen, and Jeffrey Williams ("Plaintiffs"), for their Complaint, allege as follows:

27 **NATURE OF THE CASE**

28 1. Defendants participated in a massive, illegal stock market manipulation
scheme, the effect of which has been to wrongfully manipulate the price of shares in Novastar
Financial, Inc. ("NFI"). Defendants control 83% of the prime brokerage market. At all relevant
times herein, Defendants took orders for purchases, sales and short sales of the stock of NFI.
Defendants had no intention of covering such orders with borrowed stock or with stock issued by
NFI, as they are required to do. Rather, Defendants intentionally failed to deliver NFI stock for
settlements of these positions, thereby effecting transactions in NFI that involve no change or

1 improper change in the beneficial ownership of the security. Defendants' actions caused and
2 continue to cause a false and misleading appearance of the market for NFI, deceiving investors
3 about the pricing and availability of the supply of shares for sale while intentionally causing
4 dramatic distortions with regard to the nature and amount of active trading in NFI stock, which
5 have caused NFI's share price to drop. Plaintiffs, individual shareholders of NFI, were harmed by
6 the drop in and depression of NFI's stock price. As set forth below, Defendants' illegal conduct
7 gives rise to claims for (i) violations of California Corporations Code §§ 25400, *et seq.* and (ii)
8 unfair business practices in violation of Business & Professions Code §§ 17200, *et seq.* and 17500,
9 *et seq.*

10 PARTIES

11 2. Joseph and Juanita Avenius, (collectively "Avenius") are individuals and
12 residents of Hillsborough, New Jersey and are current or former owners of NFI common stock.

13 3. John and Lizabeth Bradshaw (collectively "Bradshaw") are individuals and
14 residents of Indianapolis, Indiana and are current or former owners of NFI common stock.

15 4. Mark Brady ("Brady") is an individual and resident of Dallas, Texas and is
16 a current or former owner of NFI common stock.

17 5. David Concordia ("Concordia") is an individual and resident of Worcester,
18 Massachusetts and is a current or former owner of NFI common stock.

19 6. Richard Conti ("Conti") is an individual and resident of Martinez, Georgia
20 and is a current or former owner of NFI common stock.

21 7. DynaPure Technologies, Inc. ("DynaPure") is a Nevada corporation with its
22 principal place of business in Carson City, Nevada and is a current or former owner of NFI
23 common stock.

24 8. David and Joyce Everswick (collectively "Everswick") are individuals and
25 residents of Succasunna, New Jersey and are current or former owners of NFI common stock.

26 9. Laurence Greco ("Greco") is an individual and resident of Moraga,
27 California and is a current or former owner of NFI common stock.
28

1 10. Feb Grubman (“Grubman”) is an individual and resident of Chicago,
2 Illinois and is a current or former owner of NFI common stock.

3 11. Edward Hatch (“Hatch”) is an individual and resident of Granite Bay,
4 California and is a current or former owner of NFI common stock.

5 12. Donald Johnson (“D. Johnson”) is an individual and resident of Casa
6 Grande, Arizona and is a current or former owner of NFI common stock.

7 13. Anthony Kehlenbeck (“Kehlenbeck”) is an individual and resident of
8 Northfork, California and is a current or former owner of NFI common stock.

9 14. Mark Kolesinski (“Kolesinski”) is an individual and resident of Phoenix,
10 Arizona and is a current or former owner of NFI common stock.

11 15. David Loundy (“Loundy”) is an individual and resident of Gencoe, Illinois
12 and is a current or former owner of NFI common stock.

13 16. Michael F. Mather (“Mather”) is an individual and resident of Mt.
14 Pleasant, South Carolina and is a current or former owner of NFI common stock.

15 17. Phillip Mathews (“Mathews”) is an individual and resident of San
16 Francisco, California and is a current or former owner of NFI common stock.

17 18. Donald Miller (“D. Miller”) is an individual and resident of Duncanville,
18 Texas and is a current or former owner of NFI common stock.

19 19. Mary Anne Miller (“M. Miller”) is an individual and resident of Dallas,
20 Texas and is a current or former owner of NFI common stock.

21 20. Daniel Palermo and Gail Walter (collectively “Palermo”) are individuals
22 and residents of Tarrytown, New York and are current or former owners of NFI common stock.

23 21. Quintet, LLC (“Quintet”) is a Nevada limited liability company with its
24 principal place of business in Reno, Nevada and is a current or former owner of NFI common
25 stock.

26 22. Jeffery W. Rhoads (“Rhoads”) is an individual and resident of St. Charles,
27 Missouri and is a current or former owner of NFI common stock.

28 23. Robin Rodabaugh (“Rodabaugh”) is an individual and resident of Atwater,

1 Ohio and is a current or former owner of NFI common stock.

2 24. Peter Rosen ("Rosen") is an individual and resident of Jersey City, New
3 Jersey and is a current or former owner of NFI common stock.

4 25. Alan Ross ("Ross") is an individual and resident of Camden E, Ontario,
5 Canada and is a current or former owner of NFI common stock.

6 26. Dave Rubin ("Rubin") is an individual and resident of Sequim, Washington
7 and is a current or former owner of NFI common stock.

8 27. Allen Shinn ("Shinn") is an individual and resident of London, England and
9 is a current or former owner of NFI common stock.

10 28. Rizalina "Glenda" Smart ("Smart") is an individual and resident of
11 Fayetteville, Georgia and is a current or former owner of NFI common stock with her late husband
12 Tom Smart.

13 29. Robert Smykowski ("Smykowski") is an individual and resident of Poway,
14 California and is a current or former owner of NFI common stock.

15 30. Thomas Vallarino ("Vallarino") is an individual and resident of Manhattan
16 Beach, California and is a current or former owner of NFI common stock.

17 31. Leonard and Valerie Vidal (collectively "Vidal") are individuals and
18 residents of Millersville, Maryland, and are current or former owners of NFI common stock.

19 32. Linda Walter ("L. Walter") is an individual and resident of Tarrytown, New
20 York and is a current or former owner of NFI common stock.

21 33. Ira Walter ("I. Walter") is an individual and resident of Columbus, Ohio
22 and is a current or former owner of NFI common stock.

23 34. Norman and Doris Walter (collectively "N. Walter"), are individuals and
24 residents of Southbury, Connecticut and are current or former owners of NFI common stock.

25 35. Robert Wilen ("Wilen"), is an individual and resident of Palo Alto,
26 California and is a current or former owner of NFI common stock.

27 36. Jeffrey Williams ("Williams"), is an individual and resident of Houston,
28 Texas and is a current or former owner of NFI common stock.

1 37. Defendant Banc of American Securities LLC, (“Banc of America”) is a
2 Delaware corporation. Upon information and belief, Banc of America has its principal office in
3 San Francisco, California. Upon information and belief, Banc of America is the tenth largest
4 prime brokerage firm in terms of aggregate client assets (2.0% of prime brokerage market).
5 Furthermore, Banc of America is a market specialist in NFI stock.

6 38. Defendant The Bank of New York is a New York corporation. Bank of
7 New York is in the business of, among other things, providing prime brokerage services and
8 securities lending. The Bank of New York is qualified to and does do business in the state of
9 California.

10 39. Defendant Bear, Stearns Securities Corp. (“Bear Stearns”) is a Delaware
11 Corporation with its principal place of business in New York, New York. Upon information and
12 belief Bear Stearns is the second largest prime brokerage firm in terms of aggregate client assets
13 (20.9% of the prime brokerage market). Bear Stearns is qualified to and does do business in the
14 state of California.

15 40. Defendant Citigroup, Inc. (“Citigroup”) is a Delaware Corporation. Upon
16 information and belief Citigroup is the sixth largest prime brokerage firm in terms of aggregate
17 client assets (2.7% of the prime brokerage market). Citigroup is qualified to and does do business
18 in the state of California.

19 41. Defendant Credit Suisse (USA) Inc. (“Credit Suisse”) is a Delaware
20 corporation. Upon information and belief, Credit Suisse is the ninth largest prime brokerage firm
21 in terms of aggregate client assets (2.2% of the prime brokerage market). Credit Suisse is
22 qualified to and does do business in the state of California.

23 42. Defendant Deutsche Bank Securities, Inc. (“Deutsche Bank”) is a Delaware
24 corporation. Upon information and belief, Deutsche Bank is the eighth largest prime brokerage
25 firm in terms of aggregate client assets (2.5% of the prime brokerage market). Deutsche Bank is
26 qualified to and does do business in the state of California.

27 43. Defendant The Goldman Sachs Group, Inc. (“Goldman”) is a Delaware
28 corporation with its principal place of business in New York, New York. Upon information and

1 belief, Goldman is the third largest prime brokerage firm in terms of aggregate client assets
2 (16.5% of the prime brokerage market.) Goldman is qualified to and does do business in the state
3 of California.

4 44. Defendant Lehman Brothers Inc. ("Lehman") is a Delaware corporation.
5 Upon information and belief, Lehman is the seventh largest prime brokerage firm in terms of
6 aggregate client assets (2.6% of the prime brokerage market). Lehman is qualified to and does do
7 business in the state of California.

8 45. Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") is
9 a Delaware corporation. Upon information and belief, Merrill Lynch is the fifth largest prime
10 brokerage firm in terms of aggregate client assets (4.6% of the prime brokerage market). Merrill
11 Lynch is qualified to and does do business in the state of California.

12 46. Defendant Morgan Stanley & Co., Incorporated ("Morgan Stanley") is a
13 Delaware corporation. Upon information and belief Morgan Stanley is the largest prime
14 brokerage firm in terms of aggregate client assets (23.1% of the prime brokerage market). Morgan
15 Stanley is qualified to and does do business in the state of California.

16 47. Defendant UBS Financial Services, Inc. ("UBS") is a Delaware corporation.
17 Upon information and belief, UBS is the fourth largest prime brokerage firm in terms of aggregate
18 client assets (5.9% of the prime brokerage market). UBS is qualified to and does do business in
19 the state of California.

20 48. The names and capacities of the Defendants named as Does 1 through 100,
21 inclusive, are presently unknown to the Plaintiffs. Plaintiffs are informed and believe that Does 1
22 through 100, inclusive, are the affiliates, partners, co-venturers, co-conspirators and/or aiders and
23 abettors of the other Defendants, and each other, and Defendants agreed, conspired and
24 participated with the other Defendants in doing the things alleged herein, and ratified and accepted
25 the benefits of the acts of the other Defendants, such that they are in some manner responsible for
26 the acts and omissions complained of herein. Accordingly, these Defendants, each of whom is
27 legally responsible for the acts alleged herein, are sued by these fictitious names. When the
28

1 identities and capacities of Does 1 through 100, inclusive, are ascertained, Plaintiffs will seek
2 leave of Court to amend the Complaint accordingly.

3 **NFI'S BUSINESS**

4 49. NovaStar Financial, Inc. (NYSE:NFI) is a specialty finance company that
5 originates, purchases, sells, invests in and services residential nonconforming loans. Founded in
6 1996, NovaStar efficiently brings together the capital markets, a nationwide network of mortgage
7 brokers, and American families financing their homes. NovaStar is headquartered in Kansas City,
8 Missouri, and has lending operations nationwide including California.

9 50. Structured as a Real Estate Investment Trust (REIT), NFI manages a long-
10 term mortgage asset portfolio consisting of nonconforming mortgage loans acquired primarily
11 from its wholly owned subsidiary, NovaStar Mortgage, Inc. ("NMI"), and mortgage securities
12 retained in securitization transactions. NFI regularly securitizes the mortgage loans it originates
13 by pooling mortgage loans to serve as collateral for asset-back bonds. From these securitizations,
14 NFI generally retains certain mortgage securities, which primarily represent the right to receive the
15 net cash flows of the underlying mortgage loan collateral in excess of bond expenses and cost of
16 funding.

17 51. NFI operates its mortgage lending operation through NMI. As NFI stated in
18 its Form 10-K for 2003, "[t]he primary function of our mortgage lending operations is to generate
19 nonconforming loans, the majority of which will serve as collateral for our mortgage securities."
20 NMI has developed an independent nationwide network of loan brokers and mortgage lenders who
21 submit mortgage loans to it.

22 52. For 2005, NFI reported that its portfolio of loans under management was
23 \$14 billion, up 15% from 2004. Total nonconforming loan production was \$9.3 billion, up 10%
24 from 2004. Book value grew 21% between 2004 and 2005. For full-year 2005, NovaStar reported
25 \$132.5 million in net income available to common shareholders, up 21% from 2004. Earnings per
26 share available to common stockholders was \$4.42, a 4% increase on a larger number of shares
27 outstanding compared with \$4.24 in 2004. Portfolio net interest income for 2005 was \$219.9
28 million, an increase of 49%.

1 available for lending by institutions. Shares in cash accounts or retirement accounts cannot be
2 borrowed as part of short sales, thus limiting the supply of shares that are available for short sales.

3 59. Prime brokers charge a fee to the short sellers for the service of delivering
4 the borrowed shares to the buyer.

5 60. Prime brokers are required to deliver the stock within three days of the short
6 sale. If the prime broker fails to deliver the security to the buyer within the normal three day
7 settlement period, the shares become “fails to deliver” and the sale is a “naked short sale.”

8 61. In a fail to deliver, the sale to buyer still occurs, but it is of phantom shares,
9 because real shares were never borrowed and delivered.

10 62. Upon information and belief, the vast majority of fails to deliver where the
11 fails are persistent, are intentional, and not due to inadvertent errors. Prime brokers are motivated
12 to intentionally fail to deliver stocks because this removes a core cost from their securities lending
13 business – the cost of providing the security, thus allowing them to earn more money through the
14 charging of fees, commissions and/or interest through phantom securities transactions. Upon
15 information and belief, the prime brokers earn approximately \$10 billion annually from their
16 securities lending operations.

17 63. A persistent large number of fails to deliver create immense downward
18 pressure on the price of a company’s stock. Failing to deliver shares can create an unlimited
19 supply of the stock for sale. Without supply side constraints, the markets for publicly traded
20 stocks cannot price the stocks at their fair value. Without having to buy or borrow a security for
21 settlement, naked short positions can grow very large, which puts further downward pressure on
22 the stock’s price.

23 64. “Fails to deliver” lists are prepared and published daily detailing each
24 company as to which there has been a substantial number of failures to deliver stock within the
25 ‘national clearance and settlement system’ at the Depository Trust and Clearing Corporation
26 (“DTCC”) and its subsidiaries. Upon information and belief, these lists represent only a portion of
27 the actual fails to deliver, as additional fails to deliver take place outside of the DTCC clearing
28 system. These lists began to be published in January, 2005.

1 65. NFI has been on these lists consistently since they were first published
2 meaning that large quantities of stock began failing to be properly delivered for settlements with
3 shares issued by NFI since at least January 2005.

4 66. Upon information and belief, in the fourth quarter of 2004, failures to
5 deliver ran as high as 12.5% of the shares issued by NFI, or one of every eight shares authorized to
6 trade, and these fails are just what is reported through the DTCC system as fails. For 2005, the
7 data show the failures to deliver running as high as 6.5% of NFI's shares. This pattern of
8 substantial and persistent failures to deliver NFI stock continues in 2006.

9 67. Upon information and belief the Defendants, who control 83% of the prime
10 brokerage market, have at all times alleged herein and continue to, intentionally fail to deliver NFI
11 stock to buyers in short sales transactions.

12 68. These failures by Defendants to deliver NFI issued stock for proper
13 settlement have created dramatic distortions with regard to the nature and amount of trading in
14 NFI's publicly held stock.

15 69. NFI's share price is depressed because of the oversupply caused by failing
16 to settle transactions with shares issued by NFI. Shares issued by NFI in the normal course of
17 raising capital as a public company are not being properly valued because of the dilutive effect of
18 the phantom shares, which were not issued by NFI. Selling but failing to deliver actual shares
19 issued by NFI has the effect of generating a virtually unlimited supply of NFI shares for sale,
20 which negatively alters normal supply side market constraints found in a properly functioning
21 market.

22 70. Upon information and belief, Defendants' market manipulation took place
23 in the state of California.

24 71. Plaintiffs are informed and believe that Defendants and Does 1 through 100,
25 individually and collectively, each and all of them, agreed and conspired to engage in the
26 unlawful, unfair, or fraudulent business acts or practices, and/or aided and abetted, as alleged
27 herein, the acts of each other, and encouraged, ratified, and/or accepted the benefits of the acts of
28 each other.

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3 **DAMAGE TO NFI SHAREHOLDERS RESULTING FROM DEFENDANTS'**

4 **WRONGFUL CONDUCT**

5 72. Defendants' wrongful actions have resulted in substantial harm to Plaintiffs.
6 Among the harms Defendants' actions have caused Plaintiffs are: loss of the price per share of
7 NFI common stock, which has declined by more than 50%; and impairment of NFI's share price
8 continued ability to grow at historic rates.

9 73. Each Plaintiff sold shares of NFI during the timeframes alleged herein that
10 Defendants acted wrongfully at prices that were artificially depressed due to Defendants' wrongful
11 conduct. Plaintiffs were damaged in an amount subject to proof at trial, which amount exceeds the
12 jurisdictional minimums of this court.

13 **FIRST CAUSE OF ACTION**

14 **(California Corporations Code §§ 25400, et seq. – Plaintiffs Against All Defendants)**

15 74. Paragraphs 1 through 73, inclusive, of this Complaint are incorporated by
16 reference as if set forth in full herein.

17 75. By virtue of the allegations set forth above, Defendants violated California
18 Corporations Code Sections 25400(a) and (b) et seq.. Defendants' violations were committed
19 either directly or indirectly within California.

20 76. Defendants knew that the transactions they were effecting would be
21 reported solely as a sale, without a corresponding purchase or change in the beneficial ownership
22 of NFI common stock. Defendants acted with the intent to and thereby did create a false or
23 misleading appearance with respect to the market for NFI's common stock, in violation of Section
24 25400(a).

25 77. Defendants effected repeated transactions in NFI common stock, creating
26 actual or apparent active trading in NFI and depressing the price of NFI with the knowledge that
27 such action would depress the price and to induce the sale of that stock by others in violation of
28 Section 25400(b).

1 1. For general damages in an amount according to proof at trial, in an amount
2 in excess of the jurisdictional minimum of this Court.

3 2. For special damages in an amount according to proof at trial, in an amount
4 in excess of the jurisdictional minimum of this Court.

5 3. For prejudgment interest.

6 4. Other applicable remedies as provided in the Corporations Code.

7 5. For costs.

8 6. For such and further relief as the Court may deem appropriate.

9 **On the Second Cause of Action:**

10 1. For restitution in an amount according to proof at trial, in an amount in
11 excess of the jurisdictional minimum of this Court.

12 2. For special damages in an amount according to proof at trial, in an amount
13 in excess of the jurisdictional minimum of this Court.

14 3. For prejudgment interest.

15 4. Other applicable remedies as provided in the Corporations Code.

16 5. For costs.

17 6. For such and further relief as the Court may deem appropriate.

18
19 Dated: June 22, 2006

STEIN & LUBIN LLP

20
21
22 By: 

THEODORE A. GRIFFINGER, JR.
Attorneys for Plaintiffs
JOSEPH AVENIUS, an individual, et al.