New York suit charges Lehman auditor Ernst & Young with collusion in fraud

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New York Attorney General Andrew Cuomo filed a civil suit Tuesday in the state's Supreme Court charging the giant accounting firm Ernst & Young with complicity in massive fraud committed by Lehman Brothers in the months leading up to the investment bank's September 2008 collapse.

In a statement, Cuomo said that Lehman used an accounting gimmick that "was a house of cards business model designed to hide billions in liabilities in the years before Lehman collapsed." He continued, "Just as troubling, a global accounting firm, tasked with auditing Lehman's financial statements, helped hide this crucial information from the investing public."

The lawsuit charges that Ernst & Young was aware of the transactions and sanctioned them. It also asserts that the accounting firm failed to object when Lehman misled analysts about its debt levels during its earnings calls.

Lehman used the accounting sleight of hand to temporarily "park tens of billions of dollars" with European banks just before it had to issue quarterly financial reports. It did this in order to reduce debt on its balance sheet and give investors a "false" impression of its financial health, the lawsuit alleges.

The bankruptcy filing of Lehman, a long-time Wall Street fixture, triggered the crash of US and global credit markets, which in turn ushered in the deepest recession since the 1930s. More than two years later, no federal regulator or agency has filed charges against Lehman, its executives or its auditing firm Ernst & Young. The suit filed Tuesday by Cuomo, who will become governor of New York next month, is the first significant legal action arising from Lehman's collapse.

Cuomo's action, however, is civil, not criminal. And it fails to name former Lehman CEO Richard Fuld or any other top Lehman executive. It asks that Ernst & Young be required to pay the state of New York $150 million, the amount the accounting firm earned while serving as Lehman's auditor between 2001 and Lehman's failure in 2008. The suit also seeks damages and other monies from Ernst & Young.

The task of conducting the case will be turned over to Cuomo's successor as attorney general, Eric T. Schneiderman. Ernst & Young is one of the "Big Four" US accounting firms. It audits, among other major companies, Coca-Cola and Google.

Ernst & Young issued a statement Tuesday denying the charges and saying it would vigorously contest them. However, it is widely expected that a settlement will be reached between it and the state of New York in which the company will pay a fine and avoid a court case that would undoubtedly expose embarrassing facts about its actions and those of Lehman.

The New York suit comes more than nine months after the court-appointed examiner of Lehman's bankruptcy, Anton Valukas, issued a 2,200-page report documenting Lehman's systematic efforts to manipulate its balance sheet in order to deceive investors and the public about its staggering and unsustainable levels of debt. The March 11 document concluded that Lehman issued financial statements that were "materially misleading" and that its top executives engaged in "actionable balance sheet manipulation."

According to the examiner's report, Lehman specialized in vastly overvaluing its mortgage-backed securities and manipulating its books to produce end-of-quarter financial reports that concealed its true level of indebtedness. The bank's major accounting gimmick was known internally as "Repo 105."

Repos, short for repurchasing agreements, are a standard practice on Wall Street. To obtain short-term cash to fund operations, a bank will borrow from another bank, giving that bank some of its assets with the stipulation that it will buy back the assets within a set number of days.

For accounting purposes, such transactions are recorded as financings, not sales, and the assets that are shifted, often overnight, remain on the balance sheet of the bank doing the borrowing. Lehman, however, valued its repo assets at 105 percent or more of the cash it received, and on that basis recorded its "Repo 105s" as sales—moving bad debts off of its balance sheet just long enough to doctor its quarterly financial reports.

According to the examiner, Lehman by such means shed $39 billion from its balance sheet at the end of the fourth quarter of 2007, $49 billion in the first quarter of 2008, and $50 billion in the second quarter.

The accounting scam was so smelly that Lehman was unable to find a US law firm that would sign off on its legality. In the end, it retained a British firm that sanctioned the maneuver as legitimate under British law. Lehman had to conduct its "Repo 105" operations through its London-based branch and shift funds from the US to Europe to carry out the deals.

Valukas asserted that CEO Richard Fuld and three chief financial officers knew of and approved the shady transactions, and that Ernst & Young covered up for the executives. The examiner concluded that the four executives breached their "fiduciary duty" to Lehman's shareholders and board of directors, and added that there was "sufficient evidence" to support a legal claim that Fuld was "at least grossly negligent."

The examiner's report further detailed the role of the Federal Reserve Bank of New York in allowing Lehman to exchange worthless securities for public funds from March of 2008, when Bear Stearns collapsed and was taken over by JPMorgan Chase in a deal subsidized by the Fed, to September of that year, when Lehman filed for bankruptcy protection. The president of the New York Fed at the time was Timothy Geithner. Obama rewarded Geithner for his services as chief bagman for Wall Street by making him his treasury secretary.

Neither Fuld, whose compensation for 2007 totaled $22 million, nor any other Lehman executive has been prosecuted for their crimes. Nor has any other top executive on Wall Street.

Both the Securities and Exchange Commission (SEC) and the Justice Department have announced investigations into the Lehman collapse, but neither has utilized the wealth of incriminating evidence contained in Valukas' report to indict either Lehman or Ernst & Young or prosecute any of the executives involved.

Since the examiner's report, Bank of America and Citigroup have acknowledged falsely classifying billions of dollars in repo transactions as sales rather than financings, akin to Lehman's Repo 105s. The *Wall Street Journal* reported Tuesday: "Many banks have engaged in window dressing on a broader scale—systematically reducing their debt before reporting financial results. The practice isn't illegal, though intentionally masking debt to deceive investors violates guidelines set by regulators…

"In a speech this month, SEC Chairman Mary Schapiro said 'misleading window dressing in quarterly reports' was one factor that has fostered investor skepticism. But the SEC said it hasn't found any widespread inappropriate practices in companies' repo accounting. It hasn't taken any public action against any companies over the issue beyond requiring more disclosure."

In other words, Lehman's fraudulent methods were, and remain, pervasive on Wall Street and the actual role of federal regulators is to cover them up and tacitly condone them.

The *Journal* quoted William K. Black, a bank regulator during the 1990s savings-and-loan crisis who now teaches at the University of Missouri-Kansas City, as saying, "They haven't taken any significant action in pretty much forever. It's the usual problem of what you do with a ubiquitous practice."

All of the major banks employed—and continue to employ—intricate accounting schemes to shift their losses off of their balance sheets. They precipitated the financial crisis by making billions repackaging what they knew to be dubious sub-prime home loans and selling them as "collateralized debt obligations."

Lehman's practices have been partially exposed only because it was the weakest of the big Wall Street firms and was forced into bankruptcy, in part because its bigger rivals, smelling blood, took aggressive actions to push their struggling rival over the edge. The bigger firms—Citigroup, Bank of America, JPMorgan Chase, Goldman Sachs, American International Group (AIG)—were deemed "too big to fail" and made the beneficiaries of hundreds of billions of dollars in taxpayer bailout funds.

As a *Financial Times* columnist noted Wednesday: "But then comes the question: what about other banks and auditors that used similar tricks? Citigroup and Deutsche Bank (audited by KPMG) and Bank of America (audited by PwC) all used Repo 105-style transactions, albeit in lower quantities than Lehman. The fact these banks did not explode will probably see them, and their auditors, avoid legal problems. These auditors should be relieved that Citi and BofA were both too big to fail and so received bailouts from Uncle Sam."