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Report Details How Lehman Hid Its Woes as It Collapsed

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It is the Wall Street equivalent of a coroner's report — a 2,200-page document that lays out, in new and startling detail, how Lehman Brothers used accounting sleight of hand to conceal the bad investments that led to its undoing.

The report, compiled by an examiner for the bank, now bankrupt, hit Wall Street with a thud late Thursday. The 158-year-old company, it concluded, died from multiple causes. Among them were bad mortgage holdings and, less directly, demands by rivals like JPMorgan Chase and Citigroup, that the foundering bank post collateral against loans it desperately needed.

But the examiner, Anton R. Valukas, also for the first time, laid out what the report characterized as "materially misleading" accounting gimmicks that Lehman used to mask the perilous state of its finances. The bank's bankruptcy, the largest in American history, shook the financial world. Fears that other banks might topple in a cascade of failures eventually led Washington to arrange a sweeping rescue for the nation's financial system.

According to the report, Lehman used what amounted to financial engineering to temporarily shuffle $50 billion of troubled assets off its books in the months before its collapse in September 2008 to conceal its dependence on leverage, or borrowed money. Senior Lehman executives, as well as the bank's accountants at Ernst & Young, were aware of the moves, according to Mr. Valukas, the chairman of the law firm Jenner & Block and a former federal prosecutor, who filed the report in connection with Lehman's bankruptcy case.

Richard S. Fuld Jr., Lehman's former chief executive, certified the misleading accounts, the report said.

"Unbeknownst to the investing public, rating agencies, government regulators, and Lehman's board of directors, Lehman reverse engineered the firm's net leverage ratio for public consumption," Mr. Valukas wrote.

Mr. Fuld was "at least grossly negligent," the report states, adding that Henry M. Paulson Jr., who was then the Treasury secretary, warned Mr. Fuld that Lehman might fail unless it stabilized its finances or found a buyer.

Lehman executives engaged in what the report characterized as "actionable balance sheet manipulation," and "nonculpable errors of business judgment."

The report draws no conclusions as to whether Lehman executives violated securities laws. But it does suggest that enough evidence exists for potential civil claims. Lehman executives are already defendants in civil suits, but have not been charged with any criminal wrongdoing.

A large portion of the nine-volume report centers on the accounting maneuvers, known inside Lehman as "Repo 105."

First used in 2001, long before the crisis struck, Repo 105 involved transactions that secretly moved billions of dollars off Lehman's books at a time when the bank was under heavy scrutiny.

According to Mr. Valukas, Mr. Fuld ordered Lehman executives to reduce the bank's debt levels, and senior officials sought repeatedly to apply Repo 105 to dress up the firm's results. Other executives named in the examiner's report in connection with the use of the accounting tool include three former Lehman chief financial officers: Christopher O'Meara, Erin Callan and Ian Lowitt.

Patricia Hynes, a lawyer for Mr. Fuld, said in an e-mailed statement that Mr. Fuld "did not know what those transactions were — he didn't structure or negotiate them, nor was he aware of their accounting treatment."

Charles Perkins, a spokesman for Ernst & Young, said in an e-mailed statement: "Our last audit of the company was for the fiscal year ending Nov. 30, 2007. Our opinion indicated that Lehman's financial statements for that year were fairly presented in accordance with Generally Accepted Accounting Principles (GAAP), and we remain of that view."

Bryan Marsal, Lehman's current chief executive, who is unwinding the firm, said in a statement that he was evaluating the report to assess how it might help in efforts to advance creditor interests.

Repos, short for repurchase agreements, are a standard practice on Wall Street, representing short-term loans that provide sometimes crucial financing. In them, firms essentially lend assets to other firms in exchange for money for short periods of time, sometimes overnight.

But Lehman used aggressive accounting in its Repo 105 transactions: it appears to have structured transactions such that they sold securities at the end of the quarter, but planned to buy them back again days later. These assets were mostly illiquid real estate holdings, meaning that they were hard to sell in normal transactions.

The effect of the accounting was to artificially and temporarily lower the firm's debt levels to hit certain targets, making the firm look healthier than it really was.

In a series of e-mail messages cited by the examiner, one Lehman executive writes of Repo 105: "It's basically window-dressing." Another responds: "I see ... so it's legally do-able but doesn't look good when we actually do it? Does the rest of the street do it? Also is that why we have so much BS [balance sheet] to Rates Europe?" The first executive replies: "Yes, No and yes. :)"

Mr. Valukas was appointed by the United States Trustee in the case in January 2009 to investigate the causes of the Lehman bankruptcy, as well as to find out if any fraud or misconduct took place.

Mr. Valukas writes in the report that "colorable claims" could be made against some former Lehman executives and Ernst & Young, meaning that enough evidence existed that could lead to the awarding of damages in a trial. He added that Lehman's directors were not aware of the accounting engineering.

By his reckoning, Lehman managed to "shed" about $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. At that time, Lehman sought to reassure the public that its finances were fine — despite pressure from short-sellers like the hedge fund manager David Einhorn.

Executives, including Herbert McDade, who was known internally as the firm's "balance sheet czar," seemed aware that repeatedly using Repo 105 was disguising the true health of the investment bank. "I am very aware ... it is another drug we r on," he wrote in an April 2008 e-mail cited by the examiner's report. At other times, he is described as calling for a limit to the number of Repo 105 transactions.

By May and June of 2008, a Lehman senior vice president, Matthew Lee, wrote to senior management and the firm's auditors at Ernst & Young flagging "accounting improprieties." Neither Lehman executives nor Ernst & Young alerted the firm's board about Mr. Lee's allegations, according to the report.

Mr. Fuld is described in the examiner’s report as denying having knowledge of the Repo 105 transactions, and there is no evidence that he directed subordinates to make use of that aggressive accounting. (He did recall issuing several directives to reduce the firm’s debt levels.) But Mr. McDade is reported as telling Mr. Fuld about using Repo 105 to achieve that goal.