Lehman Bros.: Pinprick That Burst the Bubble

The culprits blamed for the failure of Lehman Brothers in September of 2008 included the company's top executives, their accountants, their highly-leveraged loans that had started going bad, their success at hiding those bad loans by cooking the books, and their lenders demanding more and better collateral, according to Anton Valukas in his 2,200 page report released Thursday.

There is certainly plenty of blame to go around, and it looks like there will be criminal charges filed too. The biggest lie, however, wasn't mentioned: that this implosion of Lehman Brothers caught everyone by surprise. "Lehman Brothers … just months before its collapse, was a venerable member of Wall Street with high credit and investment ratings. The default of Lehman Brothers was a low probability event, which was totally unexpected," according to a write-up about the matter in Wikipedia.

When the implosion did take place, "something had to be done to keep the whole financial system from collapsing," or something like that. And, always on the lookout for opportunities to expand government, collectivists created bailouts that have resulted in what many are calling the Great Recession which has negatively impacted nearly every living soul in the country.

Peter Schiff, Marc Faber, George Reisman, and other Austrian School economists predicted the collapse, and were either vilified or ignored altogether by the media. See, for example, The *New American's* online article "Peter Schiff Was (and Is) Correct About the Economy," which contains several YouTube videos of pre-meltdown interviews with Peter Schiff including examples where the talking heads actually laugh out loud at Schiff's predictions of what is now fact.

But Warren Buffett smelled a rat when he was approached by Chief Executive Richard Fuld for a little financial assistance as early as March of 2008. In fact, initial conversations went so well that Fuld prepared an internal employee memo announcing Buffett's "investment" in the firm. Buffett, however, required that top executives invest in the company "under the same terms" as Berkshire-Hathaway, and they declined. Buffet "took it as a negative" and backed away. During those discussions, Fuld had complained about short sellers driving down Lehman's stock, and Buffett "did not like" the CEO's comments because "it was indicative of a failure to admit to one's own problems."

When Henry Paulsen, then-Treasury Secretary, was pressed by Fuld to call Buffett to reopen discussions, he made the call to Buffett "reluctantly." But Buffett agreed to take another look at investing in Lehman. He then learned about a "$100 million problem in Japan" that Fuld hadn't told

Buffett about, and Buffett said that Fuld was "less than forthcoming" about the matter. After that conversation, Buffett backed off for good.

One of Buffet's favorite expressions is: "Only when the tide goes out do you find out who's swimming naked." Although Fuld knew well ahead of time that Lehman "was swimming naked," others didn't catch on until much later. In fact, Paulsen himself knew that Lehman was in trouble and had warned Fuld early in 2008 that "Lehman might fail unless it stabilized its finances or found a buyer."

One of the strategies used to hide the facts was an accounting swindle that even buffaloed Lehman's accounting firm Ernst & Young: Repo 105. According to the *Economist* magazine,

> Lehman would give collateral to its counterparty and receive cash in return. Because the deal was being recorded as a sale, the collateral disappeared from Lehman's balance-sheet and the bank used the cash it generated to pay down debt. To outsiders, it looked as though Lehman had reduced its leverage. In fact, the obligation to buy back the collateral remained. Once the quarter-end had come and gone, Lehman borrowed money to repay the cash and buy back the collateral, and its leverage spiked back up again.

According to Valukas, "Lehman painted a misleading picture of its financial condition," and the transaction neatly removed about $50 billion of poorly-performing assets from the company's balance sheet at the end of the first and second quarters of 2008. Valukas could "see no legitimate business reason to undertake the transaction, which was more expensive that a normal repo financing and had to be done through its London-based arm *because Lehman was unable to get an American lawyer to agree that Repo 105 involved a true sale of assets*." (Emphasis added.)

Emails reviewed in the Valukas report revealed that the executives knew exactly what was going on:

- "It's basically window-dressing."
- "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?"
- "Yes, No and yes. :)"

Valukas said that Fuld certified the misleading accounts, and added, "Unbeknownst to the investing public, rating agencies, government regulators, and Lehman's board of directors, Lehman 'reverse engineered' the firm's net leverage ratio [to an acceptable level] for public consumption." The auditor said that Fuld was "at least grossly negligent," and that these actions may be considered as "actionable balance sheet manipulation," which is lawyer-ese for "do not pass GO, do not collect $200, go immediately to jail."

Two of Lehman's big banks also knew in advance that there was trouble, and demanded more collateral to back up their existing loans. Just days before the bankruptcy filing on September 15th, JPMorgan Chase and Citigroup made demands of Lehman in the amount of $16 billion which caused Lehman then to default on a $1.2 billion payment to Freddie Mac on the 15th, triggering the bankruptcy.

The reverberations of the collapse of Lehman Brothers continue to be felt. In addition to the huge fees that creditors are paying to settle the bankruptcy (approaching $1 billion), there will be lawsuits filed in the next six months (the statute of limitations for claims filed by a bankruptcy trustee is two years) which will keep lawyers happy and well-fed for years to come. Certain to be sued are Fuld, his chief financial officer Chris O'Meara, and two other top officials, Erin Callan and Ian Lowitt. Ernst & Young will likely be a target, as will the banks that got paid off early.

??The impact on the country as a whole was noted because the day after the Lehman Brothers bankruptcy, Barack Obama moved ahead of John McCain in the presidential polls, never to fall behind again.

And, of course, the biggest losers, once again, were and are the U.S. taxpayers who have "anteed up" to the tune of hundreds of billions of dollars, while losing more ground to the collectivists who are always on the lookout for an opportunity to continue to collect. It's even better if they know about that opportunity in advance.

Photo: Lehman Brothers NYC headquarters